Level 2: Study Session 05-07: Financial Statement Analysis
202 questions.

Introduction by the Author :
Hi there, CFA fellows, here you are . You see , it doesn't need to be an expensive prep course to get first class preparation for the CFA exams.
The following questions are original CFA AIMR questions and not just composed by prep course providers. They all come with a clear answer.
In order to understand why the questions are commented by "answer is correct / incorrect" it is important to know that all questions have automatically been responded with the first (and only the first) answer.
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And now , here we go ...

Which of the following are major items affecting the classification of cash flows?

* equity versus proportionate consolidation method of accounting for investment in affiliates
* purchase versus pooling-of-interests accounting for acquisitions
* exclusion of off-balance sheet items
* all of the responses affect the classification of cash flows
* capitalizing versus expensing

That answer is incorrect.
Correct answer:
all of the responses affect the classification of cash flows

All of the responses affect the classification of cash flows.

Use the following information to calculate ABC Co.'s cost of sales using the current rate method.

Inventory 12/31/99   5,000 pounds
Inventory 12/31/00   6,000
Purchases for 2000   9,500

The average rate for the period was 1.53 and the period-end rate was 1.56. The 12/31/99 inventory had a historical rate of 1.50 and the 12/31/00 inventory rate was 1.52. The goods were purchased at a rate of 1.53.

* 12,735
* not enough information is available
* 13,005
* 12,915
* 13,020

That answer is incorrect.
Correct answer:
13,005

Using the inventory equation: COGS = BI + purchases - EI gives [(5000)+(9500)-(6000)]*1.53 = 13,005.

Telluride has a wholly owned foreign subsidiary, Fuente, Ltd., whose functional currency is the local currency (LC). The relevant exchange rates (LC/US$) for Fuente are:

Purchase of Fixed assets at their historic rate 1.10
January 1, 1999 = 1.03
Average for 1999 = 0.95
December 31, 1999 = 0.87
Selected data from 1999 financial statements of Fuente are:
Accounts receivable = 3.8LC
Fixed Assets, net = 35.6LC
Long Term Debt = 19.6LC
Revenue = 47.1LC
Interest expense = 3.4LC

The amount that accounts receivable, net fixed assets and long-term debt will be recorded at in the reporting currency (U. S. Dollars) are:

 * 4.0, 37.5, 20.6
 * 4.4, 40.9, 22.5
 * 3.3, 39.2, 17.1
 * 3.6, 33.8, 18.6
 * 4.4, 32.4, 22.5
 * 3.3, 31.0, 17.1

That answer is incorrect.
Correct answer:
4.4, 40.9, 22.5

The all current rate method should be used as the functional currency is the local currency. This means all assets and liabilities are translated at the year end rate. Therefore divide the appropriate asset or liability by 0.87 to get dollars.

In the U. S., which of the following are allowable methods for accounting for inter-corporate stock investments?

I. The cost method
II. The market method
III. The equity method
IV The consolidation method

 * All of these answers
 * None of these answers
 * II, III, and IV
 * I, II, and III
 * I, II, and IV

That answer is correct!

All of the methods listed are allowed. The appropriate method used to report intercorporate equity investments depends on the degree of control the investing company has over the investee firm.

An underlying assumption of using the equity method is:

 * it may be necessary to record unrealized gains or losses
 * the investment is not marketable
 * the parent has access to the earnings of the investee
 * the security may not be valued at cost
 * it streamlines financial reporting

That answer is incorrect.
Correct answer:
the parent has access to the earnings of the investee

If the undistributed earnings are going to remain permanently reinvested and the parent does not really have access to those earnings, then it is questionable whether the equity method is appropriate at all. In this case, the equity method would not be appropriate, and the analyst should not consider the investee's earnings as investment income, but should adjust reported income to reflect only dividends received.

The following is true with regards to accounting for foreign currency translation using the temporal method:

I. Also referred to as remeasurement
II. Used to convert the local currency data into the functional currency
III. Used to convert the functional currency data into the parent company currency
III. Also referred to as translation

 * I, II, and III
 * II and IV
 * III only

* I and II
* II only
* III and IV

That answer is incorrect.
Correct answer:
I and II

Remeasurement applies to the temporal method, whereas the all-current method is known as the translation process, and is used to describe the conversion of the functional currency data into the parent company (reporting) currency.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M
1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M
BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:
Jan. 1, 1994 10,000 shares at $10 per share
Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

The effect of these investments on Simpson's reported net income for 1994 and1995, respectively are:

* No effect, no effect
* Increase $10,000, increase $660,000
* Increase $10,000, increase $360,000
* Increase $20,000, increase $660,000
* No effect, increase $360,000

That answer is incorrect.
Correct answer:

Increase $10,000, increase $660,000

For 1994, the cost method is used. Under this method Simpson will record the dividends received and income. Total dividends are $1M and Simpson owns 1% of the stock and the dividends will therefore be $10,000. In 1995, the equity method is used and Simpson will record its pro rata share of BC's net income. In 1995 Simpson owns 30% of the outstanding stock and will therefore record $660,000 as income ($2.2M x 30%).

If a company continuously has actual returns that are ________ than expected returns, there will be ever increasing deferred losses, which will have to be amortized into the pension cost, thus ________ pension cost.

* lower, reducing
* none of these answers
* lower, increasing
* higher, increasing

That answer is incorrect.
Correct answer:
lower, increasing

Conversely, if actual returns are consistently greater than the expected return, this will eventually result in a lower pension cost.

Roses, Inc. is a British subsidiary of a U.S. based multinational corporation, Flowers Corporation. Roses, Inc. operates primarily in the British market. The end-of-period rate for the British pound is currently 1.56 dollars per pound. The average rate for the period is 1.53 dollars per pound. Roses, Inc. had local currency sales of 3000 pounds for the period. How would Roses' sales be reported on Flower's books?

* $4,680
* (pounds) 3,000
* $1,960

* not enough information is provided
* $4,590
* $1,923

That answer is incorrect.
Correct answer:
$4,590

Regardless of whether the temporal method or the current rate method is used; sales will be converted to U.S. dollars at the average rate for the period. Therefore sales will be recorded at $4,590 (3,000 x 1.53).

Firm A has agreed to pay Firm B $12.5 million for B's net assets. Firm B report's the following:

Assets @ historical cost $21.8 million
Assets @ fair market value $22.0 million
Liabilities @ fair market value $10.2 million

Any excess purchase price cannot be attributed to an identifiable intangible. Which of the following applies to the entries that Firm A will have to make?

* $0.9 million must be treated as goodwill.
* None of these is correct.
* Firm B's common equity is combined with A's common equity at historical cost.
* The excess of fair market value over historical cost must be written off.
* $0.7 million must be treated as goodwill.

That answer is incorrect.
Correct answer:
$0.7 million must be treated as goodwill.

(Asset @ fair market value - Liabilities at fair market value = net assets); ($22.0 - $10.2 = $11.8 million); Excess of purchase price over fair market value = goodwill. Any excess purchase price that cannot be attributed to an identifiable intangible must be treated as goodwill.

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. Although, all transactions are denominated in Japanese yen, and the books and records are maintained in yen, the functional currency is the dollar. MasterToy, the parent company reports its earnings in U.S. dollars.

The exchange rates in Yen/US$ are:
December 31, 1998 150
December 31, 1997 130
1998 Average 140
1997 Average 120
Rate on date 1998 dividends paid 145
Rate on date of stock issue 100
Rate on date of fixed asset acquisition 100

What are the appropriate exchange rates for accounts receivable, fixed assets and capital stock, respectively, when preparing consolidated financial statements for 1998?

* 140,140,140
* 150,100,100
* 150,150,100
* 140,100,100
* 150,150,150
* 150, 140,140

That answer is incorrect.
Correct answer:
150,100,100

Under the temporal method monetary items (cash, marketable securities, accounts receivable and liabilities) are translated at the current rate. Non-monetary assets are translated at the historical exchange rate when they were purchased. Non monetary items include inventory, fixed assets and capital stock (preferred stock, par value of common stock and paid-in capital). Income statement accounts (except cost of goods sold and depreciation) are translated at the average exchange rate for the year. Cost of goods sold and depreciation are translated at their historical rates. Dividends are translated at the rate that was in effect when they were issued.
Any translation gains and losses are reported on the income statement.

Mike Smith, CFA, an analyst with Blue River Investments, is considering buying a Montrose Cable Company Corporate bond. The balance sheet and income statement are given below.

Balance Sheet (in thousands)
Current Assets $ 4,735
Fixed Assets   43,225
 Total Assets $ 47,960
Current Liabilities $ 4,500
Long-term Debt   10,000
 Total Liabilities $ 14,500

Income Statement (in thousands)
Revenue $18,500
Operating and Administrative expenses   14,050
Operating Income $ 4,450
Depreciation and Amortization   1,675
Interest Expense   942
Income before income taxes $ 1,833
Taxes   641
Net Income $ 1,192

Mike calculates the following three ratios:
EBITDA/Interest expense = 4.72
Long-term debt/equity = -0.30
Current assets/current liabilities = 1.05

Mike identifies three off-balance sheet items for Montrose:
1. Montrose has guaranteed the long-term debt (principal only) of an unconsolidated affiliate. This obligation has a present value of $995, 000.
2. Montrose has sold $500,000 of accounts receivable with recourse at a yield of 8 percent.
3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment will be $1,000,000.

If Mike recalculates the EBITDA/Interest ratio to take into account the guarantee on the long-term debt, the adjusted EBITDA/Interest ratio would be:

* 5.23
* 4.72
* 3.99
* 4.27
* 4.78

That answer is incorrect.
Correct answer:
4.72

The guarantee of long-term debt will not affect operating income (EBITDA) or the interest expense. This ratio, therefore, remains unchanged.

What industry has been specifically targeted by the American Institute of Certified Public Accountants for its abuse of early revenue recognition, also known as front-end income loading?

* CFA prep companies
* internet firms
* construction firms utilizing the percentage of completion method
* software development firms
* mail-order catalog companies

That answer is incorrect.
Correct answer:
software development firms

The area that has come under the most scrutiny recently is the recognition of revenue from software sales. Early revenue recognition has been so prevalent in the software industry that recently Statement of Position (SOP) 97-2 "Software Revenue Recognition" was issued by the American Institute of Certified Public Accountants. This statement was issued in order to prevent some of the more common abuses of front-end income loading.

ABC Co. has made the following accounting changes in 2001:

1. Previously, ABC expensed the cost of all purchases of moving containers. Beginning in 2001, these purchases were capitalized these and amortized them on a straight-line basis over 10 years.

2. ABC has many operating leases, many of which expired at the end of 2000. These leases were renewed, but treated as capital leases from 2001 onwards.

What is the effect of the capitalization of container costs on 2001 net income and return on assets?

* higher net income; higher return on assets
* higher net income; unchanged return on assets
* unchanged net income; unchanged return on assets
* not enough information is provided
* higher net income; lower return on assets

That answer is correct!

Net income will be higher; This is the first year the containers have been capitalized; the amortization will be only one-tenth of the cost. If they had been expensed, then net income would have been lower. Return on assets will be higher. The percentage increase in net income will be greater than the higher assets (assuming assets>income).

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. All of Nippon MT's operations and sales take place in Japan, transactions are denominated in Japanese yen, and the books and records are maintained in yen. The functional currency is the Yen. MasterToy, the parent company reports its earnings in U.S. dollars.

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The method MasterToy should use to translate the Japanese yen results of Nippon MT to U.S. dollars is:

 * Purchase method
 * Transfer method
 * Temporal Method
 * Current rate method
 * Pooling method

That answer is incorrect.
Correct answer:
Current rate method

The yen is the functional currency and therefore the current rate method should be used.

Profit sharing and employer 401K contributions are examples of which type of pension plans?

 * pay-related
 * flat
 * defined contribution
 * any of these answers is possible, depending on the structure of the plan
 * defined benefit

That answer is incorrect.
Correct answer:
defined contribution

Under a defined contribution pension plan, the employer guarantees contributions made to the pension plan which may be fixed or variable. In either case, the amount of the contribution required by the firm is known at the time, and therefore, there is no risk/uncertainty on the part of the firm. There are no guarantees of the final benefit payments to be received by the employee, and the employee bears the risk associated with the performance of the pension. Profit sharing and employer 401K contributions are examples of defined contribution plans.

Which of the following statements is incorrect?

 * in the U.S. goodwill must be amortized over a period not to exceed 40 years
 * return on Equity will be lower for companies that amortize goodwill than those that write off goodwill directly to stockholders' equity
 * goodwill is reported as a long-term intangible asset
 * in some countries, goodwill can be written off directly to stockholders' equity
 * goodwill arises when the pooling method is used to account for a business combination

That answer is incorrect.
Correct answer:
goodwill arises when the pooling method is used to account for a business combination

Goodwill arises when the purchase method is used to account for a business combination.

Increases in the following pension plan assumptions have what impact on interest cost?

 * Discount rate: interest cost usually increases; Compensation rate: interest cost decreases; Expected return on assets: no effect.
 * Discount rate: interest cost usually increases; Compensation rate: interest cost increases; Expected return on assets: interest cost usually increases.
 * Discount rate: no effect; Compensation rate: no effect; Expected return on assets: no effect.
 * Discount rate: interest cost usually decreases; Compensation rate: interest cost decreases; Expected return on assets: no effect.
 * Discount rate: interest cost usually increases; Compensation rate: interest cost increases; Expected return on assets: no effect.

That answer is incorrect.

Correct answer:
Discount rate: interest cost usually increases; Compensation rate: interest cost increases; Expected return on assets: no effect.

The interest cost will generally increase with an increase in discount rate (PBO decreases and interest rate increases with the interest rate effect dominating). The service cost generally dominates the interest cost effect, which means the higher the discount rate the lower the pension cost, and vice-versa. It should be noted that both service cost and interest cost are calculated using beginning of year PBO. Therefore, if the discount rate is changed, the effect will not be felt on the pension cost for one year.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
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1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M
BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:
Jan. 1, 1994 10,000 shares at $10 per share
Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

The effect of these investment's on Simpson's cash flow for 1994 and 1995, respectively (ignoring cost of the investment) are:

* Increase by $10,000, increase by $660,000
* Increase by $20,000 increase by $660,000
* No effect, no effect
* Increase by $10,000, no effect
* Increase by $20,000, increase by $360,000
* Increase by $10,000, increase by $360,000

That answer is incorrect.

Correct answer:
Increase by $10,000, increase by $360,000

The cash received equals the dividend payment for both years.

When comparing the consolidation and equity methods, which of the following statements are true?

I. Recorded assets and liabilities are higher using the equity method.

II. The owners' equity recorded is identical regardless of which method is used.

III. Consolidation and the equity method produce identical net income and net worth.

IV. Under consolidation, all the revenues, expenses, and cash flows of the subsidiary (Company S) are included in the corresponding accounts of the parent company (Company P). The 20% not owned by the parent company, the "minority interest," is subtracted out. In contrast, the equity method incorporates the parent's share of the subsidiary's net income as a one-line item.

V. Under the consolidation method, only the investment account and the net income are affected by investee results. Virtually every account in the parent company's financial statements is affected by the equity method.

* All of these answers
* II, IV and V
* II, III, and IV
* None of these answers
* I, II, and V

That answer is incorrect.
Correct answer:
II, III, and IV

Recorded assets and liabilities are higher using consolidation. Under the equity method, only the investment account and the net income are affected by investee results. Virtually every account in the parent company's financial statements is affected by consolidation.

Which of the following does not apply to the all-current method of accounting for foreign exchange?

 * the income statement is translated first
 * income statement accounts are all translated at the average exchange for the year
 * this method is referred to as the translation process
 * all assets and liabilities are translated at the current rate
 * capital stock is translated at its historic exchange rate
 * this method is used to convert the financial data from the local currency into the functional currency

That answer is incorrect.
Correct answer:
this method is used to convert the financial data from the local currency into the functional currency

The functional currency is the local currency

Chalker Industries maintains a defined benefit pension plan covering all its U.S. employees. The projected benefit obligation was determined using a discount rate of 8 percent. The assumed rate of compensation growth is 6 percent, and the assumed earnings on plan assets used for determining pension cost is 11 percent. The pension plan is currently overfunded.
If there were a decrease in the discount rate the effect on Chalker's projected benefit obligation (PBO) and accumulated benefit obligation (ABO), respectively, in the following year would be:

 * No effect, decrease

* Increase, increase
* Decrease, no effect
* Increase, no effect
* Decrease, Decrease
* No effect; no effect

That answer is incorrect.
Correct answer:
Increase, increase

If the discount rate decreases then all the liability measures (PBO, ABO and VBO) will increase as they are all present values of future expected cash outflows.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells all its shares in Company B for $120 per share during Year 2. Under the market method, the total (2-period) dollar return is:

* $4,000
* $3,000
* $4,500
* $2,500
* $2,000
* none of these is correct

That answer is incorrect.
Correct answer:
$2,500

The total (two period) return remains at $2,500 as under the cost method. However, the return recognized each period differs considerably.

Under current accounting rules, acquisitions are accounted for using one of two methods:

* the equity method or the consolidation method.
* the purchase method or the equity method.
* the proportionate consolidation or the joint venture method.
* the purchase method or the pooling-of-interests method.
* the cost method or the equity method.

That answer is incorrect.
Correct answer:
the purchase method or the pooling-of-interests method.

The purchase method or the pooling-of-interests method are the two methods allowed under GAAP. These two methods are not alternatives to each other, but are theoretically meant to reflect the underlying economic reality of the transaction. As purchase accounting and pooling-of-interests accounting normally result in very different financial statements, financial ratios and trends in components of the financial statements, it is important for the analyst to understand the differences and how they arise.

For consolidated financial statements, ________ equals the amount of net income and net assets that do not belong to the parent company.

* None of these answers
* Goodwill
* Equity
* Minority interest
* Proportionate share

That answer is incorrect.
Correct answer:
Minority interest

Minority interest is recorded when a parent company consolidates the financial results of a subsidiary and does not own 100% of the subsidiary. The minority interest recorded on the income statement (balance sheet) represents the proportion of net income (net assets) of the subsidiary that does not "belong' to the parent company.

Cumulative translation adjustment is:

* the gain or loss accumulated over the entire life of the firm
* the adjusting entry necessary to recognize the impact of foreign exchange on net income
* the gain or loss from foreign currency translation accumulated over the fiscal period
* the change in the functional currency over the period
* the change in the net asset position of the firm for the period

That answer is correct!

The cumulative translation adjustment (CTA) is the gain or loss cumulated over the entire life of the company.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
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1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M
BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:
Jan. 1, 1994 10,000 shares at $10 per share
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Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

The effect of these investments on Simpson's reported sales for 1994 and 1995, respectively are:

* Increased $0.5M, no effect

* No effect, no effect
* No effect, increased $18M
* Increased $0.5M, increased $18M

That answer is incorrect.
Correct answer:
No effect, no effect

The cost method is the appropriate method for 1994, as Simpson does not have significant influence because there is no ready market for the stock. Under the cost method Simpson does not recognize sales of the investee. In 1995, the equity method is the appropriate method. Under this method they will not recognize sales either. Therefore, there is no effect on Simpson's reported sales in 1994 or 1995 of the purchase of BC stock.

Under the fair value method of accounting for stock options issued as compensation:

* The compensation cost recognized in the income statement equals the excess of the market price of stock over the exercise price at the measurement date.
* The compensation cost recognized equals the value of options calculated using an option-pricing model at the issuance date.
* The compensation cost recognized on the balance sheet equals the excess of the market price of stock over the exercise price at the measurement date.
* None of these answers.
* The compensation cost recognized equals the value of options calculated using an option-pricing model at the measurement date.

That answer is incorrect.
Correct answer:
The compensation cost recognized equals the value of options calculated using an option-pricing model at the measurement date.

If an option is issued at-the-money or out-of-the-money, which is the case with most executive stock options, no compensation expense is recorded under the intrinsic value method. However, under the fair value method, a compensation cost would be recorded, because (as you know from option pricing), a stock option that is not in-the-money may still have value.

If a company makes an investment in another company and there is no significant influence, if the security/investment has ________, the ________ method of accounting for the investment is used.

 * none of these answers
 * a market price, cost
 * a market price, cost or equity
 * no readily available market price, cost
 * no readily available market price, equity

That answer is incorrect.
Correct answer:
no readily available market price, cost

When there is a public market for the security (and no significant influence over the investee), these marketable securities are classified as one of three categories in order to determine which accounting method is used: held-to-maturity, trading, available for sale.

Examples of assets and liabilities of a company that may not be recorded on the balance sheet and that should be included at their fair market value:

 * environmental obligations
 * goodwill
 * all of the responses are correct
 * contingent liabilities such as lawsuits
 * operating leases
 * purchase commitments

That answer is incorrect.
Correct answer:
all of the responses are correct

Remember that GAAP uses double entry bookkeeping, so if an adjustment is made to recognize a previously unrecorded asset, another account must also be adjusted - either a liability must be recorded, or the equity account should be increased. Similarly, if an adjustment is made to recognize a previously unrecorded liability, then either an asset account should be recorded or the equity account should be decreased.

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. All of Nippon MT's operations and sales take place in Japan, transactions are denominated in Japanese yen, and the books and records are maintained in yen. The functional currency is the Yen. MasterToy, the parent company reports its earnings in U.S. dollars.

The exchange rates in Yen/US$ are:
December 31, 1998 150
December 31, 1997 130
1998 Average 140
1997 Average 120
Rate on date 1998 dividends paid 145
Rate on date of stock issue 100
Rate on date of fixed asset acquisition 100

What are the appropriate exchange rates for inventory, fixed assets and capital stock, respectively, when preparing consolidated financial statements for 1998?

* 140,100,100
* 150, 140,140
* 150,100,100
* 150,150,100
* 140,140,140
* 150,150,150

That answer is incorrect.
Correct answer:
150,150,100

Under the current rate method all assets and liabilities are translated at 1998 year-end rate. The capital stock is translated at the historical rate.

Chalker Industries maintains a defined benefit pension plan covering all its U.S. employees. The projected benefit obligation was determined using a discount rate of 8 percent. The assumed rate of compensation growth is 6 percent, and the assumed earnings on plan

assets used for determining pension cost is 11 percent. The pension plan is currently overfunded.
If there was an increase in the assumed rate of return on plan assets the effect on Chalker's pension cost and balance sheet in the year of change would be:

* Increase pension cost, no effect on balance sheet
* Decrease pension cost, decrease liability recorded on balance sheet
* Increase pension cost, decrease liability recorded on balance sheet
* Decrease pension cost, no effect on balance sheet
* No effect; no effect
* No effect, increase asset recorded on balance sheet

That answer is incorrect.
Correct answer:
Decrease pension cost, no effect on balance sheet

The expected return on pension plan assets is deducted at arriving at the pension cost for the year. Therefore, if the expected return is increased then the pension cost will decrease. Changing the expected return on pension assets does not affect the asset balance or the liability balance (PBO, ABO or VBO) and therefore the funded status of the plan will not change. Note the pension plan is overfunded so no minimum liability is recognized on the balance sheet.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells its share of Company B for $120 per share during Year 2. Under the cost method, at the end of Year 1, Company A recognizes the increase in market price of the shares of Company B as:

* none of these is correct
* $3,000 unrealized gain
* $2,000 realized gain
* 500 realized loss
* $2,500 unrealized gain

That answer is correct!

Company A recognizes the realized gain or loss equal to the difference between the proceeds of the sale and the original cost only when the security is sold.

What is the appropriate method used to report intercorporate equity investments when the investing company owns 30% of the investee company?

* cost or market
* lower of cost or market
* consolidation
* none of these answers
* equity

That answer is incorrect.
Correct answer:
equity

The equity method is appropriate when degree of ownership is 20-50%. The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee. The different accounting methods reflect the degree to which the investee is viewed as being under the control of the parent (investing) company.

Under what conditions will a minimum liability be recorded on the balance sheet?

* when the plan is over funded
* during the year that the plan is first established
* if the ABO exceeds the fair value of assets
* if the PBO exceeds the fair value of assets
* never

That answer is incorrect.
Correct answer:
if the ABO exceeds the fair value of assets

If the ABO exceeds the fair value of assets; an additional minimum pension liability will be recognized in the balance sheet. This amount will be reduced (increased) if the company has incurred an accrued (prepaid) pension cost.

Transaction exposure:

* the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates
* results when changes in foreign currency exchange rates alter future revenues and expenses
* arises from the possibility of incurring future currency exchange gains or losses resulting from existing business transactions
* is also referred to as accounting exposure
* represents the amount by which the market value of a company could change because of a change in exchange in exchange rates

That answer is incorrect.
Correct answer:
arises from the possibility of incurring future currency exchange gains or losses resulting from existing business transactions

Transaction exposure arises if a company has contractually binding agreements designated in a foreign currency. Under these conditions changes in the exchange rate will give rise to currency gains or losses. This is a cash flow exposure - not an accounting exposure.

If a company has $200M in plan assets, an expected rate of return of 10% and an actual return of $15M, the company will have a deferred investment loss of ________.

* $10M
* $5M
* $15M
* $0
* $20M

That answer is incorrect.
Correct answer:
$5M

The company will have a deferred investment loss of [$15M - ($200M * .10)] = $5M.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells all of its shares in Company B for $120 per share during Year 2. Under the market method, the carrying value of the Investment in Company B on Company A's books at the end of Year 1 is:

* $14,500
* $12,500
* $13,000
* none of these is correct
* $12,000
* $10,500

That answer is incorrect.
Correct answer:
$12,500

Under the market method, securities with a public market are carried at their current market value. (100 shares @ $125 per share = $12,500)

Which category of marketable securities recognizes unrealized gains and losses in the income statement?

* available-for-sale
* none of these answers
* held-to-maturity
* trading

That answer is incorrect.
Correct answer:
trading

Trading: These are securities (debt or equity) that the company intends to hold only for a short period of time. The market method is used for these securities, and they are classified as current assets. Unrealized gains and losses are recorded on the income statement.

Examples of a lack of significant influence may include:

I. The existence of a majority owner that controls investee's operations

II. No seats on the Board of Directors

III. Lack of ability to obtain financial and operating data or restrictions precluding the investor from voting its shares

* All of these answers
* II only
* I and III
* None of these answers
* I only

That answer is correct!

It is assumed that the investor has significant influence when ownership reaches the 20% level. However, it is recognized that there are times where, despite ownership of 20% or more, the use of the equity method is not appropriate, as significant influence does not exist. Examples include: the existence of a majority holder that controls investee's operations; lack of seats on the Board of Directors; lack of ability to obtain financial and operating data; restrictions precluding the investor from voting its shares.

Which of the following factors will not affect the measurement of the ABO and PBO?

 * interest cost
 * prior service costs
 * pension plan returns
 * benefits paid
 * service cost

That answer is incorrect.
Correct answer:
pension plan returns

There are five factors that can affect the measurement of both ABO and PBO. They are: Service cost; Interest cost, Actuarial gains and losses, Prior service cost, and Benefits paid.

Investments in marketable securities can be classified as which of the following:

I. Held-to-maturity
II. Trading-to-maturity
III. Liquid
IV Buys and holds

 * II only
 * I and III
 * III only
 * None of these answers
 * I only

That answer is incorrect.
Correct answer:
I only

Marketable securities are classified as one of three categories in order to determine which accounting method is used: held-to-maturity, trading, available for sale.

ABC Co., a U.S. based company has a subsidiary in the UK. The foreign subsidiary generates its revenue in its local currency, the British pound. Results are as follows:

Year 1 2
Revenues 20,000 22,000
The subsidiary is showing a revenue growth of 10%. If the average exchange rate was 1.50 in Year 1 and 1.56 in Year 2, how much of the growth reflected in the parent's financial statements is due to changes in the foreign exchange rate?

* $4,320
* $3,120
* not enough information available
* $190
* $1,320

That answer is incorrect.
Correct answer:
$1,320

Use a constant exchange rate for converting the foreign subsidiary's results into $:

Year 1 20,000 * 1.50 = $30.000
Year 2 22,000 * 1.50 = $33.000; $3,000 is real growth; Total growth is (22,000 * 1.56 = $34,320) - (20,000 * 1.50 = 30,000) = $4,320; the difference is due to exchange: $1,320.
Alternative calculation is 22,000 x 0.06 = $1,320

Increases in the following pension plan assumptions have what impact on the accumulated benefit obligation (ABO)?

* Discount rate: ABO decreases; Compensation rate: no effect; Expected return on assets: no effect.
* Discount rate: ABO increases; Compensation rate: no effect; Expected return on assets: no effect.
* Discount rate: ABO decreases; Compensation rate: ABO decreases; Expected return on assets: no effect.
* Discount rate: ABO decreases; Compensation rate: no effect; Expected return on assets: ABO decreases.

* Discount rate: ABO decreases; Compensation rate: ABO increase; Expected return on assets: no effect.

That answer is correct!

The higher the discount rate, the lower the present value of the pension obligations (VBO, ABO, and PBO). The rate of compensation growth affects the PBO, but not the ABO, since the ABO does not take into account future salary growth. The rate of compensation growth affects the PBO, but not the ABO, since the ABO does not take into account future salary growth.

Which of the following are common causes of an improvement in the quality of earnings?

* Increasing percentage of income arising from peripheral activities (not central operations), such as investment income.
* Decrease in inventory turnover, which may indicate production or marketing problems not yet recorded in income.
* None of these answers.
* Incurring extra costs to make sure a merger qualifies for pooling-of-interest, so goodwill will not have to be recorded. (Goodwill results in lower future income as it is amortized).
* Reduction of costs that increase this year's net income and may affect future earnings power, such as research and development, advertising or maintenance costs.

That answer is incorrect.

Correct answer:

None of these answers.

One of the objectives of a quality of earnings analysis is to determine when there has been a decline in the quality of earnings. All of the above items are some of the more common causes of a decline in earnings quality.

Telluride has a wholly owned foreign subsidiary, Fuente, Ltd., whose functional currency is the local currency (LC). The relevant exchange rates (LC/US$) for Fuente are:

Purchase of Fixed assets at their historic rate 1.10
January 1, 1999 = 1.03
Average for 1999 = 0.95
December 31, 1999 = 0.87
Selected data from 1999 financial statements of Fuente are:
Accounts receivable = 3.8LC
Fixed Assets, net = 35.6LC
Long Term Debt = 19.6LC
Revenue = 47.1LC
Interest expense = 3.4LC

The amount that revenue and interest expense will be recorded at in the reporting currency (U. S. Dollars) are:

* 54.1, 3.9
* 44.7, 32.2
* 41.0, 3.0
* 49.6, 3.6

That answer is incorrect.
Correct answer:
49.6, 3.6

The all current rate method should be used as the functional currency is the local currency. This means all income statement items are translated at the average rate for the year. Therefore divide the appropriate revenue or expense by 0.95 to get dollars.

If the investee is profitable, and dividends paid are less than net income, the equity method results in ________ net income than the cost method.

* none of these-the is no relationship between net income under the two methods
* higher
* lower
* the same

That answer is incorrect.
Correct answer:

higher

This is because the proportionate share of net income is larger than the dividend received. If the investee was distributing 100% of net income as a dividend, then these two methods would be the same.

________ are those that have operating and financing characteristics that are dissimilar to the other subsidiaries.

* Minority interests
* Nonhomogeneous subsidiaries
* Unconsolidated subsidiaries
* Equity subsidiaries
* Homogeneous

That answer is incorrect.
Correct answer:
Nonhomogeneous subsidiaries

A classic example would be a financing subsidiary of a manufacturing conglomerate. In these instances, the subsidiary and parent have dissimilar operating and financing characteristics, and therefore would be considered nonhomogeneous. Many analysts would argue that consolidating these nonhomogeneous subsidiaries leads to less useful information.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells all of its shares in Company B for $120 per share during Year 2. Under the cost method, the total 2-period dollar return on the investment would be:

* $2,500
* $1,500

* $3,000
* none of these is correct
* $2,000

That answer is correct!

When the security is sold, Company A recognizes the realized gain or loss equal to the difference between the proceeds of the sales and the original cost ($12,000 - $10,000) plus the dividends received ($500), for a 2-period return of $2,500.

Under what conditions will the Accumulated Benefit Obligation (ABO) and the Projected Benefit Obligation (PBO) be identical?

* when the discount rate used is the current interest rate.
* when all assumptions regarding such factors as employee turnover, retirement dates, and future salary increases are correct.
* a flat benefit (non pay-related) plan.
* a pay-related plan.
* they are always identical.

That answer is incorrect.
Correct answer:
a flat benefit (non pay-related) plan.

The ABO and the PBO are based on the same assumptions and are discounted using the same discount rate; they differ only with respect to the exclusion or inclusion of future compensation growth. For a flat benefit (non pay-related) plan, therefore, the ABO and PBO will be identical.

Which of the following statements related to pension plan costs are true?

I. The lower the discount rate, the higher the present value of the pension obligations (VBO, ABO, and PBO).

II. The higher the discount rate the lower the service cost will be.

III. The interest cost is unaffected by the discount rate assumption

IV. The lower the expected return on plan assets, the lower the pension expense

* III and IV
* II and III
* I and II
* I and III
* I and III

That answer is incorrect.
Correct answer:
I and II

The discount rate affects the liability measurement and service cost and interest cost. The higher the discount rate, the lower the liability and the lower the service cost. The expected return on assets affects the pension cost - the higher the expected return the lower the pension expense

Which of the following statements is incorrect regarding the impact of assumptions on pension plan obligations?

* The discount rate assumption obviously has a significant impact on the reported pension obligations and plan status, as it is used to compute the present value of benefit obligations.
* The most immediate impact of assumptions is on the obligations, which in turn affects the reported pension plan status.
* An increase in the assumed rate of compensation growth will increase the difference between ABO and PBO.
* A higher (lower) discount rate will result in a higher (lower) calculated benefit obligation (PBO, VBO and ABO).
* The expected rate of return on plan assets has no effect on the benefit obligations and plan assets. Hence it has no effect on the plan status.
* A lower rate of compensation growth will decrease the calculated PBO, and vice-versa.

That answer is incorrect.
Correct answer:
A higher (lower) discount rate will result in a higher (lower) calculated benefit obligation (PBO, VBO and ABO).

A higher (lower) discount rate will result in a lower (higher) calculated benefit obligation (PBO, VBO, and ABO).

If a company with a higher P/E multiple acquires a company whose shares sell at a lower price-earnings multiple and uses the pooling method, then the acquirer's earnings per share will ________.

 * decrease
 * dilute
 * increase
 * remain unchanged

That answer is incorrect.
Correct answer:
increase

This technique is sometimes known as bootstrapping as the target company can raise earnings per share through financial engineering rather than operating improvement.

________ refers to the capitalizing and subsequent amortization of costs rather than expensing them immediately.

 * Deferral of costs
 * Amortization
 * Front-end income loading
 * Depreciation
 * None of these answers

That answer is correct!

In theory, costs should only be capitalized if they are expected to benefit future periods. A problem arises with these "soft" costs when the future economic benefits are less than certain. Two types of costs that have received attention recently are: 1. Advertising costs - a recent SOP concluded that advertising costs should be expensed as incurred, except the cost of direct-response advertising, which can be capitalized and amortized over the expected period of benefits. 2. Start-up costs.

ABC Co., a U.S. based company has a subsidiary in the UK. The foreign subsidiary generates its revenue in its local currency, the British pound. Results are as follows:

Year	1	2
Revenues	20,000	22,000

The subsidiary is showing a revenue growth of 10%. If the average exchange rate was 1.50 in Year 1 and 1.56 in Year 2, what would the parent company report as revenue growth for the British subsidiary?

* 21.6%
* 14.4%
* not enough information available
* 53%
* 10%

That answer is incorrect.
Correct answer:
14.4%

The British subsidiary shows a 10% revenue growth rate (22,000/20,000). The parent company would show $30,000 (20,000 x 1.5) in Year 1 and $34,320 (22,000 x 1.56) in Year 2, thus a growth rate of 14.4% (34,320/30,000).

The greater the returns of the pension plan, the greater the assets of the pension plan, all other things equal. This statement is:

* sometimes, but not always true
* contradictory
* false
* true

That answer is incorrect.
Correct answer:
true

All other things equal, a greater return will obviously increase the pension plan balance.

If a company owns less than 100% of a subsidiary, the parent's consolidated statements include:

* All of these answers.
* None of these answers.
* The proportionate share of equity owned in the subsidiary.
* 100% of assets, liabilities, revenues and expenses of the subsidiary in its financial statements.
* The proportion of net assets of the subsidiary owned by other parties (reflected in a minority interest account).

That answer is correct!

If a company owns less than 100% of a subsidiary, the parent's consolidated statements include 100% of assets, liabilities, revenues and expenses of the subsidiary in its financial statements. The proportion of net assets of the subsidiary owned by other parties is reflected in a minority interest account, and recorded after the liabilities in the consolidated statements. The proportion of net income that belongs to other parties is reflected as a deduction entitled "minority interest expense" in the income statement.
The "parent-only" statement carries its investment in the subsidiary using the equity method. That is, the assets and liabilities of the subsidiary are included in a single investment account on the balance sheet of the parent company.

A (n) ________ is the payment of monetary benefits to employees after retirement.

 * contribution
 * severance package
 * stock option plan
 * pension plan
 * employment contract

That answer is incorrect.
Correct answer:
pension plan

The payment of benefits is usually dependent on meeting specific requirements such as age and number of years of service.

When the degree of ownership is between 20% and 50%, and the investing company has significant influence over the investee firm, which is the appropriate method to account for inter-corporate stock investments?

 * cost or market
 * equity
 * equity or consolidation
 * consolidation
 * market or equity

That answer is incorrect.
Correct answer:
equity

Significant influence means the equity method should be used. The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee. The different accounting methods reflect the degree to which the investee is viewed as being under the control of the parent (investing) company.

Which of the following is translated at the current exchange rate under both the temporal and current rate methods?

* sales
* non-monetary assets
* monetary assets
* statement of cash flows
* translation gains or losses
* COGS and depreciation

That answer is incorrect.
Correct answer:
monetary assets

Monetary assets are translated at the current exchange rate under both the temporal and all current methods.

Which of the following is true when comparing the temporal and all current methods?

I. The current rate method does a better job of preserving the trends and relationships of the functional currency of the subsidiary.

II. Under the current rate method, the relationship between all the income statement items remains the same as under the local currency.

III. The gain/loss recorded in the income statement under the temporal method is the same as the change in the cumulative translation account recorded under the current rate method.

* II and III
* I only
* I and II
* II only
* III only

* I and III

That answer is incorrect.
Correct answer:
I and II

The gain/loss recorded in the income statement under the temporal method is not the same as the change in the cumulative translation account recorded under the current rate method.

Which of the following is true under U.S. GAAP?

* revaluation upwards of impaired assets is permitted
* dividends paid are financing outflows on the statement of cash flows
* the maximum amortization period for goodwill is 20 years
* pooling of interest is only allowed if one party cannot be identified as acquirer
* asset revaluation is allowed for all assets

That answer is incorrect.
Correct answer:
dividends paid are financing outflows on the statement of cash flows

All other selections apply to IAS.

A security analyst concludes that a company has increased reported earnings by changing assumptions in the company's pension and postretirement health plans.
Indicate which of the following would cause an increase in reported earnings.
a. Decreasing discount rate
b. Increasing discount rate
c. Decreasing estimate of the future rate of compensation increases
d. Increasing estimate of the future rate of compensation increases
e. Increasing estimated life expectancy of employees

* b, c, e
* a, d, e
* a, c, e
* a, d
* b, c
* b, d

That answer is incorrect.
Correct answer:
b, c

Increasing the estimated long-term return on pension assets will decrease pension cost and increase net income. Decreasing the future heath care inflation rate estimate will decrease the postretirement health plan cost and increase net income. Increasing the estimated life expectancy of employees will increase expected future benefits to be paid and, therefore, increase PBO and hence increase pension cost and decrease net income. (Note - although this last assumption is not specifically discussed anywhere in the readings - common sense and an understanding of pensions should lead you easily to the correct answer).

When the degree of ownership is between 20% and 50%, and the investing company does not have significant influence over the investee firm, which is the appropriate method to account for inter-corporate stock investments?

* equity
* market or equity
* equity or consolidation
* consolidation
* cost or market

That answer is incorrect.
Correct answer:
cost or market

There is no significant influence means the equity method should be not used, and the cost or market methods should be used. The ownership percentages are used only as rules of thumb to determine the degree of control a company has over its investee.

Company A purchases 500 shares (out of 2000 outstanding) of Company B for $100 per share at the beginning of year 1. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells its share of Company B for $120 per share during Year 2. Company A records its investment in company B on its balance sheet at the end of Year 1 at:

* $52,500
* $62,500
* $60,000
* none of these are correct
* $50,000
* $57,500
* $47,500

That answer is incorrect.
Correct answer:
$57,500

Using the equity method, the value of the purchased asset on Company A's books at acquisition and the first year of investment we get 500 @$100 + $20*500 - $5*500 = $50,000 +$10,000-$2,500 = $57,500.

Which of following is true with respect to the financial statements and ratios of a company that amortizes goodwill versus one that writes goodwill off directly to stockholders' equity?

* return on assets is higher
* return on equity is higher
* equity is lower
* assets will be lower
* future income will be lower

That answer is incorrect.

Correct answer:
future income will be lower

Equity and assets will be higher until all the goodwill is amortized. Net income will be lower until all the net income is amortized. Therefore, ROA and ROE will be lower until all the goodwill is amortized.

Chalker Industries maintains a defined benefit pension plan covering all its U.S. employees. The projected benefit obligation was determined using a discount rate of 8 percent. The assumed rate of compensation growth is 6 percent, and the assumed earnings on plan assets used for determining pension cost is 11 percent. The pension plan is currently overfunded.

If there was a decrease in the assumed rate of compensation growth the effect on Chalker's projected benefit obligation (PBO) and accumulated benefit obligation (ABO), respectively, in the following year would be:

* No effect, decrease
* Decrease, no effect
* Increase, no effect
* Decrease, Decrease
* No effect; no effect
* Increase, increase

That answer is incorrect.
Correct answer:
Decrease, no effect

If the assumed rate of compensation growth decreases then the PBO will be lower, but the ABO will be unaffected as the ABO ignores future expected pay increases.

Mike Smith, CFA, an analyst with Blue River Investments, is considering buying a Montrose Cable Company Corporate bond. The balance sheet and income statement are given below.

Balance Sheet (in thousands)
Current Assets $ 4,735
Fixed Assets 43,225
Total Assets $ 47,960
Current Liabilities $ 4,500
Long-term Debt 10,000
Total Liabilities $ 14,500

Income Statement (in thousands)
Revenue $18,500
Operating and Administrative expenses 14,050
Operating Income $ 4,450
Depreciation and Amortization 1,675
Interest Expense 942
Income before income taxes $ 1,833
Taxes 641
Net Income $ 1,192

Mike calculates the following three ratios:
EBITDA/Interest expense = 4.72
Long-term debt/equity = -0.30
Current assets/current liabilities = 1.05

Mike identifies three off-balance sheet items for Montrose:
1. Montrose has guaranteed the long-term debt (principal only) of an unconsolidated affiliate. This obligation has a present value of $995, 000.
2. Montrose has sold $500,000 of accounts receivable with recourse at a yield of 8 percent.
3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment is $1,000,000.

If Mike recalculates the Long-term debt/Equity to take into account the new operating leases the adjusted Long-term debt/Equity ratio would be:

* 0.41

* 0.47
* 0.30
* 0.48
* 0.21

That answer is incorrect.
Correct answer:
0.47

The operating leases restated as if they were capitalized leases. This means that the assets would be increased by $6,144K and liabilities would be increased by this amount too. However, some of the liability will be classified as short-term - the amount that is due to be repaid next year. This equals next year's lease payment ($1M) less the interest payment (10% x $6.144M) = $385,600. Therefore, the long-term liability is $6,144K - $385.6K = $5,758. The equity remains unchanged.

Company G's local currency is DM (also its functional currency). The parent is a U.S. company reporting in $.

@ 12/31/Year 1 $ per DM = .592
@ 12/31/Year 2 $ per DM = .610
Average Year 1 rate $ per DM = .588
Average Year 2 rate $ per DM = .605
Rate for Year 2 inventory $ per DM = .600

Company G	Year 1	Year 2
Net receivables	DM 350	DM 375
Inventory	DM 400	DM 410
Net Sales	DM 1,100	DM 1,300
COGS	DM 225	DM 275

Inventory turnover for Year 2 based on reporting currency is:

* none of these are correct
* 1.45
* .69

* .68
* 1.47

That answer is incorrect.
Correct answer:
.68

COGS is translated at the average rate for each year; inventory is translated at the period-end rate for each year; turnover = $COGS / $Average inventory = (275*.605) / ((400*.592)+(410*.610))/2 = .68.

Economic exposure:

* refers to the accounting exposure
* represents the amount by which the market value of a company could change because of a change in exchange in exchange rates
* is the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates
* results when changes in foreign currency exchange rates alter future revenues and expenses
* arises from the possibility of incurring future currency exchange gains or losses resulting from existing business transactions

That answer is incorrect.
Correct answer:
represents the amount by which the market value of a company could change because of a change in exchange in exchange rates

Economic exposure represents the amount by which the market value of a company could change because of a change in exchange in exchange rates. Transaction and operating exposure together define the economic exposure of a company.

The ________ method is intended to be used if the two shareholder groups merge their interests together through an exchange of equity securities.

* consolidation
* pooling of interests
* equity
* cost
* purchase

That answer is incorrect.
Correct answer:
pooling of interests

The nature of the pooling-of-interests method is clearly defined in Paragraph 12 of APB 16: "The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained."

Use the following information to calculate ABC Co.'s cost of sales using the temporal method.

Inventory 12/31/99   5,000 pounds
Inventory 12/31/00   6,000
Purchases for 2000   9,500

The average rate for 2000 was 1.53 and 12/31/00 rate was 1.56. The 12/31/99 inventory had a historical rate of 1.50 and the 12/31/00 inventory rate was 1.52. The goods were purchased at a rate of 1.53.

* 12,735
* not enough information is available
* 13,005
* 12,915
* 13,020

That answer is incorrect.
Correct answer:
12,915

Remember the inventory equation: EI + COGS = BI + Purchases. Rearranging gives COGS = BI + Purchases - EI. Therefore, (5000*1.50)+(9500*1.53)-(6000*1.52) = 13,155.

The information below comes from the 1997 financial statements of QuickBrush Company and SmileWhite Corporation:

QuickBrush (from the footnotes to the financial statements)
a. Goodwill: The company amortizes goodwill over 20 years.
b. P, P &E: The company uses straight-line depreciation method over the economic lives of the assets, which range from 5 to 20 years for buildings.
c. Accounts receivable: The company uses a bad debt allowance of 2 percent of accounts receivable.

SmileWhite (from the footnotes to the financial statements)
a. Goodwill: The company amortizes goodwill over 5 years.
b. P, P &E: The company uses an accelerated depreciation method over the economic lives of the assets, which range from 5 to 20 years for buildings.
c. Accounts receivable: The company uses a bad debt allowance of 5 percent of accounts receivable.

Which of the following best describes the effect of QuickBrush's bad debt allowance estimate:

* QuickBrush will have a lower quality of earnings than SmileWhite, all other things being equal.
* QuickBrush continually face an over reserved position.
* QuickBrush will have a higher quality of earnings than SmileWhite, all other things being equal.
* QuickBrush would be assured a higher net income if they used sales levels as a basis for bad debts.

That answer is correct!

QuickBrush uses a lower estimate of bad debts than SmileWhite, thus QuickBrush records a higher net income. SmileWhite is, however, more conservative and can be said to have a higher quality of earnings. The "all other things equal" is important - it implies that they have the same actual experience with respect to collections. If SmileWhite actually had more bad debts then it wouldn't necessarily have a higher quality of earnings.

Which of the following is not correct with regards to normalization of non-U.S. firms?

* all of the responses are correct
* goodwill amortization is absent when firms charge off acquisition goodwill immediately
* extraordinary and other nonrecurring items; classification rules vary in different jurisdictions
* depreciation, accelerated methods are rare outside the U.S.
* inventory methods, as LIFO is rare outside the U.S.

That answer is incorrect.
Correct answer:
depreciation, accelerated methods are rare outside the U.S.

Accelerated depreciation methods are more common outside of the United States, especially in tax conformity countries.

MasterToy, a U.S. based company, has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. Japan's currency is the yen. Under what circumstances would the temporal method be used for restating the financial results of a Nippon MT?
a. Nippon operates in a hyperinflationary economy
b. MasterToy operates in a hyperinflationary economy
c. Nippon's functional currency is the Yen
d. Nippon's functional currency is the dollar
e. Nippon's functional currency is the British pound

* a, d and e
* a, b, c, d and e
* b, c and d
* b, d and e
* a, c and e
* a, b, d and e

That answer is correct!

The temporal currency is used to convert the financial data from the local currency into the functional currency, and when a subsidiary operates in a hyperinflationary economy. In other words, whenever the functional currency is not the local currency.

Which of the following statements is not true regarding pension costs?

* The pension cost is not directly affected by the expected return on plan assets.
* If the actual returns are significantly different from the expected return, then the difference is amortized into the pension cost.
* The actual pension plan returns have no effect on the PBO, ABO or VBO.
* The pension cost is not directly affected by the actual return on plan assets.
* Ultimately, if the company experiences a greater (lower) rate of return than the expected rate of return for an extended period of time, the contributions to the pension plan will be smaller (larger) in the future.

That answer is correct!

Pension cost is determined by the expected return on plan assets.

Which of the following statements is not true regarding available-for-sale securities?

* None of these answers.
* Unrealized gains and losses are recorded on the income statement.

* The market method is used.
* These are securities (debt or equity) that are not classified as either trading or held-to-maturity.
* They may be recorded as current or non-current assets.

That answer is incorrect.
Correct answer:
Unrealized gains and losses are recorded on the income statement.

Available-for-Sale: These are securities (debt or equity) that are not classified as either trading or held-to-maturity. They may be recorded as current or non-current assets. Like trading securities, the market method is used; however, there is a little twist. The unrealized gains and losses are not recorded on the income statement. Instead, they are directly recorded in stockholders' equity.

Which of the following statements is true regarding trading securities?

* They are classified as current assets.
* All of these answers.
* The market method is used for these securities.
* None of these answers
* These are securities (debt or equity) that the company intends to hold only for a short period of time.

That answer is incorrect.
Correct answer:
All of these answers.

Trading: These are securities (debt or equity) that the company intends to hold only for a short period of time. The market method is used for these securities, and they are classified as current assets. Unrealized gains and losses are recorded on the income statement.

When the classification of securities is changed, the transfer between portfolios occurs at ________ and ________ are recognized in the income statement.

* the current market price; any unrealized gains
* the current market price; any unrealized losses
* the current market price; any unrealized gains or losses
* the amortized cost; any unrealized gains or losses

That answer is incorrect.
Correct answer:
the current market price; any unrealized gains or losses

This rule is intended to prevent a company from manipulating net income by reclassifying a trading security to available for sale (or held to maturity) just to prevent reporting an unrealized loss in the income statement. This rule, however, does not prevent all potential manipulation - such as reclassifying a security with unrealized gains from available-for-sale to trading and recognizing the unrealized gain in the income statement.

Which of the following is incorrect with respect to the temporal method of accounting for foreign exchange?

* dividends are translated at the rate that was in effect when they were issued
* income statement accounts are all translated at the average exchange for the year
* any translation gains and losses are reported on the income statement
* this method is used to convert the financial data from the local currency into the functional currency
* monetary items are translated at the current rate

That answer is incorrect.
Correct answer:
income statement accounts are all translated at the average exchange for the year

Cost of goods sold and depreciation are translated at their historical rates.

When the degree of ownership is less than 20%, and the investing company has significant influence over the investee firm, which is the appropriate method to account for inter-corporate stock investments?

* cost or market
* equity
* equity or consolidation
* market or equity
* consolidation

That answer is incorrect.
Correct answer:
equity

If the investing company has no significant influence then the cost or market method should be used. If they have significant influence (but less than controlling influence) then the equity method should be used. The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee - in this case the rule of thumb is not used, as we know the degree of influence.

________ securities are those (debt or equity) that the company intends to hold only for a short period of time.

* Available-for-sale
* All of these answers qualify
* Held-to-maturity
* Buy and hold
* Trading

That answer is incorrect.
Correct answer:
Trading

Marketable securities may be classified as trading, available-for-sale or held-to-maturity. Trading securities, by definition, are those, which the company only intends to hold for a short period of time.

Company A purchases 200 shares, or 25% of Company B for $100 per share at the beginning of Year 1. In Year 1, Company B has net income of $10,000, and pays dividends of $6,000. In Year 2, Company B has net income of $8,000, and pays dividends of $6,000. The net change in the "Investment in Company B" account in Year 2 is:

* an increase of $2,500
* a decrease of $1,500
* an increase of $0
* none of these answers
* a decrease of $500

That answer is incorrect.
Correct answer:
none of these answers

The net increase in Investment in Company B is $500 (increase of $2,000 for proportionate share of net income and decrease of $1,500 for dividend).

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M
1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M
BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:

Jan. 1, 1994 10,000 shares at $10 per share
Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

The book value (carrying value) of Simpson's investment in BC as of December 31, 1994 and 1995, respectively are:

* $100,000; $3,590,000
* $100,000; $3,290,000
* $110,000; $3,600,000
* $110,000; $3,590,000
* $100,000; $3,600,000

That answer is incorrect.
Correct answer:
$100,000; $3,600,000

In 1994 the cost method is used, as so the book value is simply the cost of the investment. This equals $10 x 10,000 shares = $100,000. In 1995 the equity method is the appropriate method. When calculated the balance for 1995 it is important to remember is that the equity method should be applied retroactively to 1994. Under the equity method the balance at the end of 1994 would be $110,000 ($100,000 + $20,000 (pro rata share of 1994 net income) - $10,000 (pro rata share of 1994 dividends)). At the end of 1995 the balance would be $3,600,000 ($110,000 (94 ending balance) + $3,190,000 (cost of new shares)+ $660,000 (pro rata share of 1995 net income) - $360,000 (pro rata share of 1995 dividends)).

Pension plan assets are not directly affected by changes in which of the following assumptions:

I. The discount rate
II. The rate of future compensation
III. The expected rate of return on plan assets

* I, II, and III
* I only

* I and II
* II and III
* None of these answers

That answer is correct!

Pension plan assets are not directly affected by changing any of the assumptions. Indirectly, they may be affected if changing assumptions changes the contributions a company makes to its pension plan (Remember - all other things equal - an increase in contributions increases plan assets).

Which category of marketable securities does not have to be marked to market?

* available-for-sale
* trading
* held-to-maturity
* all of these answers
* none of these answers

That answer is incorrect.
Correct answer:
held-to-maturity

The classification affects whether market value is recorded on the balance sheet. Held-to-maturity debt securities do not have to be marked to market, whereas all other securities have to be recorded at market value.

Which of the following is true regarding translated (current rate method) and local currency ratios?

* changes in the exchange rate have no effect on consolidated ratios
* those computed under the all current rate method may be different from both the local currency ratios and those computed from translated data
* ratios that combine income statement and balance sheet components remain identical
* for pure balance sheet and pure income statement rations, translation using the temporal method maintains local currency relationships
* ratios computed under the temporal method may be different from both the local currency ratios and those computed from translated data

That answer is incorrect.
Correct answer:
ratios computed under the temporal method may be different from both the local currency ratios and those computed from translated data

Ratios computed under the temporal method may be different from both the local currency ratios and those computed from translated data (using current rate method).

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. All of Nippon MT's operations and sales take place in Japan, transactions are denominated in Japanese yen, and the books and records are maintained in yen. The functional currency is the Yen. MasterToy, the parent company reports its earnings in U.S. dollars.

The exchange rates in Yen/US$ are:
December 31, 1998 150
December 31, 1997 130
1998 Average 140
1997 Average 120
Rate on date 1998 dividends paid 145
Rate on date of stock issue 100
Rate on date of fixed asset acquisition 100

How did the change in the value of the yen, relative to the U.S. dollar, in 1998 affect Nippon MT's earnings in the reporting currency?

* No effect on earnings

* Earnings were higher than if the exchange rate had not changed
* Earnings were lower than if the exchange rate had not changed
* Not enough information

That answer is incorrect.
Correct answer:
Earnings were lower than if the exchange rate had not changed

First, the current rate method is being used to translate statements. This means all the income statement items are translated using the average exchange rate for the year. As the yen declined in value against the dollar in 1998 this means that when stated in dollars, the revenue, expenses and net income would be lower than if the yen had not declined.

For the ________ method of accounting for intercorporate investments, the accounting steps are as follows:

1. Record the initial purchase at cost.
2. Record dividends when received (as income).
3. Adjust investment account to market value at balance sheet date.

* cost
* consolidation
* market
* cost or market
* equity

That answer is incorrect.
Correct answer:
market

The market method recognizes price changes every period, whether the security has been sold or not (that is, unrealized gains and losses are recognized).

When the degree of ownership is less than 20%, and the investing company has no significant influence over the investee firm, which is the appropriate method to account for inter-corporate stock investments?

* equity or consolidation
* equity
* consolidation
* cost or market
* market or equity

That answer is incorrect.
Correct answer:
cost or market

If the investing company has no significant influence then the cost or market method should be used. The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee. The different accounting methods reflect the degree to which the investee is viewed as being under the control of the parent (investing) company.

APB 16 lists twelve conditions that must be met in order for the pooling method to be used to account for an acquisition. The most critical of these is that:

* "in excess of 90% of the target firm's common stock must be acquired using common voting stock of the acquiring company."
* the newly combined company is prohibited from disposing of significant portions of the existing businesses of the combined companies (unless it results from duplicate facilities or excess capacity as a result of the merger).
* certain selective changes in equity ownership of the target company prior to merger are prohibited, such as stock repurchases and special dividends.
* both companies are not currently and have not been divisions or subsidiaries of another company for two years prior to the merger.

That answer is correct!

All the conditions provided under APB 16 must be met in order to use the pooling-of-interests method of accounting. If any one of the conditions is not met, then the purchase method is required. Therefore, the way an acquisition is structured will determine which method is used for accounting purposes.

The information below comes from the 1997 financial statements of QuickBrush Company and SmileWhite Corporation.

QuickBrush (from the footnotes to the financial statements)
a. Goodwill: The company amortizes goodwill over 20 years.
b. P, P &E: The company uses straight-line depreciation method over the economic lives of the assets, which range from 5 to 20 years for buildings.
c. Accounts receivable: The company uses a bad debt allowance of 2 percent of accounts receivable.

SmileWhite (from the footnotes to the financial statements)
a. Goodwill: The company amortizes goodwill over 5 years.
b. P, P &E: The company uses an accelerated depreciation method over the economic lives of the assets, which range from 5 to 20 years for buildings.
c. Accounts receivable: The company uses a bad debt allowance of 5 percent of accounts receivable.

Which of the following best describes the effect of QuickBrush's goodwill amortization policy:

* QuickBrush will have a lower quality of earnings than SmileWhite, all other things being equal.
* SmileWhite needs to be more conservative in their goodwill amortization practices.
* QuickBrush does not meet does not meet the requirements for goodwill amortization under GAAP.
* QuickBrush will have a higher quality of earnings than SmileWhite, all other things being equal.

That answer is correct!

QuickBrush amortizes its goodwill over a longer period than SmileWhite, and thus records a higher net income. SmileWhite is, however, more conservative and can be said to have a higher quality of earnings.

Scents, Ltd. had the following year-end figures:

Beginning of the year net monetary liability was 16,000 British pounds
The monetary liability at year-end was 18,000 British pounds
The exchange rate at year-end was 1.56 $/pound
The exchange rate at the beginning of the year was 1.50 $/pound
The average exchange rate for the year was 1.53 $/pound

The translation gain or loss is calculated as:

* 1,140 loss
* 1,020 gain
* 1,020 loss
* 1,140 gain
* 1,080 gain

That answer is incorrect.
Correct answer:
1,020 loss

Note there is a net monetary liability and the foreign currency (the pound) has appreciated relative to the reporting currency (the dollar) - this means that there will be a translation loss. The translation gain or loss is: (Beg. Year net monetary liability)(the change in exchange rate) + (the change in net monetary liability)(the ending exchange rate - the average rate for the period) = (16,000)(1.56-1.50) + (2,000)(1.56-1.53) = 1,020

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells its share of Company B for $120 per share during Year 2. Under the market method, when the investment in Company B is sold at the end of Year 2, the following is recognized in A's income statement:

* a realized gain of $4,000
* a realized gain of $4,500
* none of these is correct
* a realized gain of $3,000
* a realized loss of $500
* an unrealized loss of $500

That answer is incorrect.
Correct answer:
a realized loss of $500

From $125 per share at the end of Year 1 to $120 per share is a loss of $5 per share or $500 loss.

Telluride has a wholly owned foreign subsidiary, Fuente, Ltd., whose functional currency is the local currency (LC). The relevant exchange rates (LC/US$) for Fuente are:

Purchase of Fixed assets at their historic rate 1.10
January 1, 1999 = 1.03
Average for 1999 = 0.95
December 31, 1999 = 0.87
Selected data from 1999 financial statements of Fuente are:
Accounts receivable = 3.8LC
Fixed Assets, net = 35.6LC
Long Term Debt = 19.6LC
Revenue = 47.1LC
Interest expense = 3.4LC

If the all-current rate method is used, which of the following statements is correct:

* The return on assets will be the same in the reporting currency than in the local currency
* The accounts receivable turnover will be different in the reporting currency than in the local currency
* The debt/assets will be different in the reporting currency as in the local currency
* The net profit will be different in the reporting currency than in the local currency

That answer is incorrect.

Correct answer:
The accounts receivable turnover will be different in the reporting currency than in the local currency

Under the all current rate method, all income statement items are translated at the average rate for the year and balance sheet accounts are translated at year end rates. Accounts receivable turnover has income statement account in the numerator and balance sheet in the denominator. Therefore, after translation the ratio will be different. Return on assets has income statement account in the numerator and balance sheet in the denominator. Therefore, after translation the ratio will be different.

Which of the following is a true statement of the size relationship between Accumulated Benefit Obligation (ABO), Vested Benefit Obligation (VBO), and Projected Benefit Obligation (PBO)?

* PBO is greater than or equal to VBO is greater than or equal to ABO
* ABO is greater than or equal to PBO is greater than or equal to VBO
* ABO is greater than or equal to VBO is greater than or equal to PBO
* VBO is greater than or equal to ABO is greater than or equal to PBO
* PBO is greater than or equal to ABO is greater than or equal to VBO

That answer is incorrect.
Correct answer:
PBO is greater than or equal to ABO is greater than or equal to VBO

Projected Benefit Obligation (PBO): Same as ABO only including expected future pay increases. This value can be considered the going concern value of the plan. Accumulated Benefit Obligation (ABO): Estimate of the employer obligation based on current compensation levels, but including non-vested employees as well. This value can be considered to be a liquidation value of the plan. Vested Benefit Obligation (VBO): Estimate of the employer's pension obligations based upon current compensation for benefits vested to employees.

Company A invests $500 in Company B which represents 20% of B. Company B reports net income of $100 in Year 1 and pays a dividend of $10. Company B has net income of $200 in Year 2 and pays dividends of $10. How much will Company A record as an Investment in Company B on its balance sheet as of December 31, Year 2:

* none of these is correct
* $556
* $564
* $560
* $518
* $500

That answer is incorrect.
Correct answer:
$556

$500 + (.20*$100)-(.20*$10)+(.20*$200)-(.20*$10) = $556.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M
1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M
BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:
Jan. 1, 1994 10,000 shares at $10 per share
Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership
Simpson assumed significant influence over BC's management in 1995.

The effect of these investments on Simpson's reported net income for 1994 and1995, respectively are (ignore taxes):

 * Increase $10,000, increase $360,000
 * No effect, no effect
 * No effect, increase $360,000
 * Increase $10,000, increase $660,000
 * Increase $20,000, increase $660,000

That answer is incorrect.
Correct answer:
Increase $10,000, increase $660,000

For 1994, the cost method is used. Under this method Simpson will record the dividends received as income. Total dividends are $1M and Simpson owns 1% of the stock and the dividends will therefore be $10,000. In 1995, the equity method is used and Simpson will record its pro rata share of BC's net income. In 1995 Simpson owns 30% of the outstanding stock and will therefore record $660,000 as income ($2.2M x 30%).

Unrealized gains and losses from the ________ portfolio are recognized in the income statement.

 * none of these answers
 * available-for-sale
 * trading
 * held-to-maturity
 * all of these answers

That answer is incorrect.
Correct answer:
trading

The classification of marketable securities will affect where and if unrealized gains or losses are recognized in the income statement. Only unrealized gains and losses from the trading portfolio are recognized in the income statement.

Which of the following are common causes of a decline in the quality of earnings?

* Early/aggressive revenue recognition - this is generally accompanied by an increase in accounts receivable
* One-time transactions resulting in a recognized gain, such as the sale of real estate.
* All of these answers.
* Switching to more liberal (less conservative) accounting principles. For example, switching from LIFO to FIFO in an inflationary environment, or changing from accelerated depreciation to straight-line depreciation. This would also include capitalizing costs that were previously expensed.
* Changing to less conservative accounting estimates, such as decreasing estimates of warrantee costs, bad debts, etc.

That answer is incorrect.
Correct answer:
All of these answers.

One of the objectives of a quality of earnings analysis is to determine when there has been a decline in the quality of earnings. All of the above items are some of the more common causes of a decline in earnings quality.

A company's cash flows are directly affected by which of the following changes in pension plan assumptions?

I. The discount rate
II. The rate of future compensation
III. The expected rate of return on plan assets

* I, II, and III
* I only
* II and III
* I and II

* None of these answers

That answer is incorrect.
Correct answer:
None of these answers

The company's cash flows are not directly affected by changing any of the assumptions (the discount rate, the rate of future compensation or the expected rate of return on plan assets). Indirectly, they may be affected if changing assumptions changes the contributions a company makes to its pension plan.

The pooling method is usually preferred under which of the following conditions?

* acquiring company does not wish to increase its leverage or has limited borrowing power.
* none of these are correct
* reduction of future charges to earnings due to inclusion of the target's "off-balance-sheet" obligations
* all of these are correct
* shareholders of the acquirer do not wish to dilute their voting control or equity interest by issuing additional shares
* target is "asset rich" allowing write-ups, tax reduction, and a quick recovery of the investment

That answer is correct!

Purchase method acquisitions can substantially increase the acquiring company's debt load as compare with the result under a stock transaction.

Company A purchases 500 shares, or 25% of Company B for $100 per share on January 2 of Year 1. Company B has net income of $22,000 and pays dividends of $10,000. In Year 2 Company B has net income of $20,000 and pays dividends of $10,000. The income statement effect for Company A in Year 1 is:

* an increase in income of $5,500
* a decrease in income of $4,500

* an increase in common equity of $3,000
* an increase in income of $2,500
* an increase in income of $3,000

That answer is correct!

Company A's net income reflects 25% of Company B's net income of $25,000, or $5.500. The reason that the dividend is not included as part of income is that the dividend is part of the proportionate share of net income, which is already included as part of income. Receipt of dividends decreases the "Investment in Company B." as the distribution of dividends by Company B has decreased B's equity, and Company A's share of equity had decreased accordingly.

A pension is ________ when the market value of pension assets exceeds the PBO.

* overvalued
* optimal
* underfunded
* marked-up
* overfunded

That answer is incorrect.
Correct answer:
overfunded

An overfunded pension plan will generally imply decreased funding to the plan in future (lower cash outflows). Companies are not allowed to withdraw assets from the plan without terminating it. It is important to recognize that the funded status of the pension plan depends upon the PBO, which in turn depends upon assumptions used. The funded status also depends upon the fair value of the plan's assets. Given that the market can be volatile, a plan that is marginally overfunded can easily become underfunded and vice-versa. The analyst should carefully analyze assumptions used in assessing funding status.

Under a defined contribution pension plan:

* there are no guarantees of the final benefit payments to be received by the employee.
* retirees receive a specified amount for each year worked.
* retirees receive an amount based upon some formula that is a function of the employee's earnings during specified years.
* an employer promises a specific monetary amount to its employees upon retirement.
* the plan sponsor (employer) bears the investment risk with respect to defined benefit plans.

That answer is correct!

Under a defined contribution pension plan, the employer guarantees contributions made to the pension plan which may be fixed or variable. In either case, the amount of the contribution required by the firm is known at the time, and therefore, there is no risk/uncertainty on the part of the firm. There are no guarantees of the final benefit payments to be received by the employee, and the employee bears the risk associated with the performance of the pension.

Which category (ies) of marketable securities is (are) recorded at market value?

* held-to-maturity and trading
* trading
* available-for-sale
* held-to-maturity
* trading and available-for-sale

That answer is incorrect.
Correct answer:
trading and available-for-sale

The classification affects whether market value is recorded on the balance sheet. Trading and available-for-sale are marked to market each accounting period. Held-to-maturity debt securities do not have to be marked to market, whereas all other securities have to be recorded at market value.

Which of the accounting methods result in identical net income and net worth?

 * the consolidation and the equity methods
 * the cost and the consolidation methods
 * the cost and the equity methods
 * all three methods produce identical net income and net worth
 * none of the methods results in identical net income and net worth

That answer is correct!

The consolidation and the equity method produce identical net income and net worth.

Which category of marketable securities does not record unrealized gains and losses in the income statement?

 * available-for-sale
 * liquid
 * trading
 * none of these answers

That answer is correct!

Available-for-Sale: These are securities (debt or equity) that are not classified as either trading or held-to-maturity. They may be recorded as current or non-current assets. Like trading securities, the market method is used; however, there is a little twist. The unrealized gains and losses are not recorded on the income statement. Instead, they are directly recorded in stockholders' equity.

When there is no significant influence over the investee firm, then the ________ method is used.

 * equity
 * consolidation
 * cost
 * cost or market
 * market
That answer is incorrect.
Correct answer:
cost or market

The cost and market methods treat the investing and investee companies as separate entities. The investment is recorded at cost, and any future cash flows received (dividends for stock or interest income for bonds) are reported as investment income.

What is the formula for deriving the benefit obligation closing balance?

 * Benefit Obligation Opening Balance + Service Cost - Interest Cost + (-) Actuarial Losses (Gains) +/- Prior Service Cost - Benefits Paid
 * Benefit Obligation Opening Balance - Service Cost + Interest Cost + (-) Actuarial Losses (Gains) +/- Prior Service Cost - Benefits Paid
 * Benefit Obligation Opening Balance + Service Cost + Interest Cost + (-) Actuarial Losses (Gains) +/- Prior Service Cost +Benefits Paid
 * Benefit Obligation Opening Balance - Service Cost - Interest Cost + (-) Actuarial Losses (Gains) +/- Prior Service Cost + Benefits Paid
 * Benefit Obligation Opening Balance + Service Cost + Interest Cost + (-) Actuarial Losses (Gains) +/- Prior Service Cost - Benefits Paid
That answer is incorrect.
Correct answer:
Benefit Obligation Opening Balance + Service Cost + Interest Cost + (-) Actuarial Losses (Gains) +/- Prior Service Cost - Benefits Paid

Service and interest costs are added to the opening balance and benefits paid are subtracted.

Under the intrinsic value method of accounting for stock options issued as compensation:

* The compensation cost recognized equals the value of options calculated using an option-pricing model at the issuance date.
* The compensation cost recognized on the balance sheet equals the excess of the market price of stock over the exercise price at the measurement date.
* None of these answers.
* The compensation cost recognized equals the value of options calculated using an option-pricing model at the measurement date.
* The compensation cost recognized in the income statement equals the excess of the market price of stock over the exercise price at the measurement date.

That answer is incorrect.
Correct answer:
The compensation cost recognized in the income statement equals the excess of the market price of stock over the exercise price at the measurement date.

Under the intrinsic value method, the compensation cost recognized in the income statement equals the excess of the market price of stock over the exercise price at the measurement date. The measurement date is the date when both the number of stock options and exercise prices are known. If the intrinsic value method is used, the footnotes should disclose the pro forma net income and earnings per share under the fair value method.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells its share of Company B for $120 per share during Year 2. Using the cost method, Company A reports its investment in Company B on its balance sheet at the end of Year 1 at:

* $10,000
* none of these are correct
* $15,000
* $13,000

 * $12,500
 * $15,000
That answer is correct!

Under the cost method, assets are reported at cost. Market value changes are not recognized until there is an actual transaction.

Garden Scents, Inc. is a U.S. based multinational corporation. They have overseas operations in England (Scents, Ltd.) and in France (Le Jardin). The functional currency of Le Jardin is the franc. The British subsidiary is just a sales outlet for the French subsidiary. Preparing financial statements for Garden Scents would begin as follows:

 * Le Jardin's financial statements are remeasured using the temporal method from francs to U.S. dollars.
 * Scent's financial results are translated from pounds to US$
 * Le Jardin translates its financial statements to pounds, and then they are remeasured into dollars
 * Scents, Ltd.'s financial results are remeasured using the temporal method from Pounds Sterling to its functional currency, francs. The remeasured statements are then translated using the current rate from francs into dollars.
 * Scent's financial results are translated from pounds to francs, and then remeasured into dollars
That answer is incorrect.
Correct answer:
Scents, Ltd.'s financial results are remeasured using the temporal method from Pounds Sterling to its functional currency, francs. The remeasured statements are then translated using the current rate from francs into dollars.

If the subsidiary is nothing more than a foreign sales outlet for the parent company's products and services, then the functional currency is the (reporting) currency. If the subsidiary's main operations are not in its local currency but another currency, then the other currency is the functional currency (but the functional currency is not necessarily the parent currency), such as in the case of Scents Ltd. Therefore, Scent's financial statements are remeasured into francs first, and then translated into U.S. dollars.

Which of the following does is incorrect with respect to the temporal method of accounting for foreign exchange?

 * this method is used when a subsidiary operates in a hyperinflationary economy
 * dividends are translated at the rate that was in effect when they were issued
 * any translation gains and losses are reported on the income statement
 * balance sheet accounts are translated at the current rate
 * this method is used to convert the financial data from the local currency into the functional currency

That answer is incorrect.
Correct answer:
balance sheet accounts are translated at the current rate

The temporal method translates the balance sheet accounts either at the current rate of the historical rate depending upon their characteristics.

Company A purchases 200 shares, or 25% of Company B for $100 per share at the beginning of Year 1. In Year 1, Company B has net income of $10,000, and pays dividends of $6,000. In Year 2, Company B has net income of $8,000, and pays dividends of $6,000. The following is reflected on A's books, with respect to its investment in Company B, at the end of Year 1.

 * A's retained earnings increase by $1,500
 * A's net income increases by $1,000
 * A records dividend income of $1,500 in income statement
 * A's total assets increase by $2,500
 * Investment in B is $20,000

That answer is incorrect.
Correct answer:
A's total assets increase by $2,500

A's assets increase by $2,500 (Investment increases by $20,000, cash decreases by $20,000, Investment increases by $2,500 for proportionate share of B's net income, cash increases $1,500 for dividend and Investment goes down by $1,500)

________ is the present value of benefits earned by the employees during the current period.

* Interest cost
* Vested benefit obligation
* The discount rate
* Service cost
* Prior service cost

That answer is incorrect.
Correct answer:
Service cost

The service cost is a principal component of pension cost. Service cost is sensitive to all the assumptions that affect the PBO. Service cost trends should generally track employee age and compensation trends.

The category of ________ securities has the following balance sheet and income statement classifications:

Balance Sheet: Cost (Amortized)
Income Statement: Dividends and Interest, Realized gains and losses

* held-to-maturity
* none of these answers
* trading
* available-for-sale

That answer is correct!

Held-to-maturity: This only applies to debt securities that management intends and has the ability to hold to maturity. These debt securities are recorded using the (amortized) cost method. Price fluctuations in this case should not matter, since the price at maturity is known (i.e., the par value).

The two allowable methods for a company to account for stock options issued as compensation are:

* at the time the options are granted or at the time the options are exercised
* as bonuses or as regular income
* the intrinsic value method and the deferred compensation method
* the purchase method and the pooling of interests method
* the intrinsic value method and the fair value method

That answer is incorrect.
Correct answer:
the intrinsic value method and the fair value method

Under the current accounting standard, SFAS 123, a company can use either the intrinsic value method or the fair value method.

Which of the following does not apply to the all current rate method of accounting for foreign exchange?

* this method is used when the foreign subsidiary operates in a hyperinflationary economy
* this method is used when the foreign subsidiary's functional currency is the local currency
* all assets and liabilities are translated at the current rate
* translation gains are reported in the balance sheet as a cumulative translation adjustment
* The operations of the subsidiary are deemed independent of the parent

That answer is correct!

Translation gains are reported in the balance sheet as a cumulative translation adjustment under the all current rate method.

Which of the following does not apply to the temporal method of accounting for foreign exchange?

* translation gains are reported in the balance sheet as a cumulative translation adjustment
* the operations of the subsidiary are considered an integral part of the parent
* this method is used when the functional currency of the foreign subsidiary is the parent's currency
* the foreign subsidiary's debt reported on the balance sheet is remeasured using the exchange rate in effect at the time the debt was incurred
* non-monetary assets are translated using the historical rate

That answer is correct!

Translation gains are reported in the balance sheet as a cumulative translation adjustment under the all current rate method.

What is the appropriate method used to report intercorporate equity investments when the investing company owns 15% of the investee company?

* lower of cost or market
* none of these answers
* consolidation
* cost or market
* equity

That answer is incorrect.
Correct answer:
cost or market

The consolidation method is appropriate when degree of ownership is >50%. The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee. The different accounting methods reflect the degree to which the investee is viewed as being under the control of the parent (investing) company.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M
1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M

BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:
Jan. 1, 1994 10,000 shares at $10 per share
Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership
Simpson assumed significant influence over BC's management in 1995.

The effect of these investments on Simpson's reported sales for 1994 and 1995, respectively are:

* Increased $0.5M, increased $18M
* Increased $0.5M, no effect
* No effect, increased $18M
* No effect, no effect

That answer is incorrect.
Correct answer:
No effect, no effect

The cost method is the appropriate method for 1994, as Simpson does not have significant influence and because there is no ready market for the stock. Under the cost method Simpson does not recognize sales of the investee. In 1995, the equity method is the appropriate method. Under this method they will not recognize sales of the investee either. Therefore, there is no effect on Simpson's reported sales in 1994 or 1995 of the purchase of BC stock.

Company A invests $500 in Company B which represents 20% of B. Company B reports net income of $100 in Year 1 and pays a dividend of $10. Company B has net income of $200 in Year 2 and pays dividends of $10. How does Company A account for its investment on its income statement at the end of Year 1?

* investment income of $100
* investment income of $20
* dividend income of $10
* dividend income of $2
* there is no effect on the income statement

That answer is incorrect.
Correct answer:
investment income of $20

Company owns 20% of B. A will report $20 on its income statement.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M
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Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

How would Simpson account for its inter-corporate investment in BC during 1996 (pick best answer)?

* Partial consolidation, as it owned less than 100% prior to 1996
* Full equity method, as it now owns 100%
* Consolidated method, as it now owns 100%
* Market method, as it now owns 100% and can assign a market value to the stock
* Equity method, as it has significant influence over BC

That answer is incorrect.
Correct answer:
Consolidated method, as it now owns 100%

Generally 100% ownership requires consolidation. Partial consolidation only applies if you own less than 100% and is used only in certain industries at present. There is no such thing as the full equity method.

Under the ________ method:

1. The balance sheet, income statement and statement of cash flows (SCF) of the combined company are calculated simply by adding the statements of the two combining companies together.

2. Prior years' financial statements must be restated as if the companies had always been combined.

* equity
* pooling-of-interests
* purchase
* consolidation

* cost
That answer is incorrect.
Correct answer:
pooling-of-interests

The nature of the pooling-of-interests method is clearly defined in Paragraph 12 of APB 16: "The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained."

Mike Smith, CFA, an analyst with Blue River Investments, is considering buying a Montrose Cable Company Corporate bond. The balance sheet and income statement are given below.

Balance Sheet (in thousands)
Current Assets $ 4,735
Fixed Assets   43,225
Total Assets $ 47,960
Current Liabilities $ 4,500
Long-term Debt   10,000
Total Liabilities $ 14,500

Income Statement (in thousands)
Revenue $18,500
Operating and Administrative expenses   14,050
Operating Income $ 4,450
Depreciation and Amortization   1,675
Interest Expense   942
Income before income taxes $ 1,833
Taxes   641
Net Income $ 1,192

Mike calculates the following three ratios:
EBITDA/Interest expense = 4.72

Long-term debt/equity = -0.30
Current assets/current liabilities = 1.05

Mike identifies three off-balance sheet items for Montrose:
1. Montrose has guaranteed the long-term debt (principal only) of an unconsolidated affiliate. This obligation has a present value of $995, 000.
2. Montrose has sold $500,000 of accounts receivable with recourse at a yield of 8 percent.
3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment is $1,000,000.

If Mike recalculates the EBITDA/Interest ratio to take into account the new operating lease the adjusted EBITDA/Interest ratio would be:

 * 3.45
 * 4.78
 * 3.10
 * 4.57
 * 4.53
 * 4.72

That answer is correct!

The operating lease should be treated as a capital lease. The interest expense for the first year will be increased by the interest expense of $614K ($6,144K x 10%). EBITDA includes the rental expense of $1,000,000. If the lease is capitalized then a portion of this represents the interest expense (614K) and EBITDA should be increased by the 614K.

Increases in the following pension plan assumptions have what impact on the vested benefit obligation (VBO)?

 * Discount rate: VBO decreases; Compensation rate: VBO decreases; Expected return on assets: no effect.
 * Discount rate: VBO decreases; Compensation rate: VBO increases; Expected return on assets: no effect.
 * Discount rate: VBO increases; Compensation rate: no effect; Expected return on assets: no effect.

 * Discount rate: VBO decreases; Compensation rate: no effect; Expected return on assets: no effect.
 * Discount rate: VBO decreases; Compensation rate: no effect; Expected return on assets: VBO decreases.
That answer is incorrect.
Correct answer:
Discount rate: VBO decreases; Compensation rate: no effect; Expected return on assets: no effect.

The higher the discount rate, the lower the present value of the pension obligations (VBO, ABO, and PBO). The rate of compensation growth affects the PBO, but not the ABO, since the ABO does not take into account future salary growth. The rate of compensation growth affects the PBO, but not the ABO, since the ABO does not take into account future salary growth.

Dividends are recorded when received (as income) when using which accounting method?

 * both the cost and the market methods
 * market
 * dividends are not reported on the income statement under any method
 * cost
 * equity
 * both the cost and the equity methods
That answer is correct!

Dividends are recorded when received (as income) under both the cost and the market methods.

Under the ________ method, the parent company includes its pro rata share of each asset and liability account of the affiliate in the corresponding account of the parent.

 * equity
 * proportionate consolidation
 * none of these answers
 * consolidation
 * expanded equity

That answer is incorrect.
Correct answer:
proportionate consolidation

Proportionate consolidation involves recording the pro rata share of each asset, liability, revenue and expense account of the subsidiary. For example (assuming 40% ownership of the joint venture), the parent includes 40% of the cash, inventories, receivables, and so forth of the joint venture in the parent's cash, inventories, and receivables. Similarly, the parent includes 40% of the revenues and 40% of each expense category in its income statement. This method would be an alternative to the equity method.

Company A invests $500 in Company B which represents 20% of B. Company B reports net income of $100 in Year 1 and pays a dividend of $10. Company B has net income of $200 in Year 2 and pays dividends of $10. How much will Company A record as an Investment in Company B on its balance sheet as of December 31, Year 1?

 * $518
 * $500
 * none of these is correct
 * $556
 * $542
 * $538

That answer is correct!

$500 +.20($100) - .20($10) = $518.

Increases in the following pension plan assumptions have what impact on total pension costs?

 * Discount rate: total pension cost usually decreases; Compensation rate: total pension cost decreases; Expected return on assets: total pension cost decreases.
 * Discount rate: total pension cost usually decreases; Compensation rate: total pension cost increases; Expected return on assets: total pension cost decreases.
 * Discount rate: total pension cost usually decreases; Compensation rate: total pension cost increases; Expected return on assets: total pension cost increases.
 * Discount rate: no effect; Compensation rate: no effect; Expected return on assets: no effect.
 * Discount rate: total pension cost usually increases; Compensation rate: total pension cost increases; Expected return on assets: total pension cost decreases.

That answer is incorrect.
Correct answer:
Discount rate: total pension cost usually decreases; Compensation rate: total pension cost increases; Expected return on assets: total pension cost decreases.

The service cost generally dominates the interest cost effect, which means the higher the discount rate the lower the pension cost, and vice-versa Because the growth rate is used to calculate service cost and interest cost, a higher growth rate also increases the pension cost, and vice versa. The higher the expected long-term rate of return on plan assets, the lower the pension cost, and the higher net income, and vice-versa.

________ is the increase in future pension payments due to the passage of time.

 * Prior service cost
 * None of these answers
 * Interest cost
 * Service cost

* The discount rate
That answer is incorrect.
Correct answer:
Interest cost

Interest cost equals the product of the beginning of period PBO and the discount rate used to calculate beginning of year PBO. Interest cost (t)= PBO (t-1) x Discount rate (t-1).

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Simpson Corporation bought BC shares for cash, as follows:
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Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

The book value (carrying value) of Simpson's investment in BC as of December 31, 1994 and 1995, respectively are:

* $110,000; $3,590,000
* $100,000; $3,590,000
* $110,000; $3,600,000
* $100,000; $3,290,000
* $100,000; $3,600,000

That answer is incorrect.
Correct answer:
$100,000; $3,600,000

In 1994 the cost method is used, as so the book value is simply the cost of the investment. This equals $10 x 10,000 shares = $100,000. In 1995 the equity method is the appropriate method. What is important to remember is that the equity method should be applied retroactively to 1994. Under the equity method the balance at the end of 1994 would be $110,000 ($100,000 + $20,000 (pro rata share of 1994 net income) -$10,000 (pro rata share of 1994 dividends)). At the end of 1995 the balance would be $3,600,000 ($110,000 (94 ending balance) + $3,190,000 (cost of new shares)+ $660,000 (pro rata share of 1995 net income) - $360,000 (pro rata share of 1995 dividends)).

The ________ method requires that:

1. All identifiable assets and liabilities (tangible and intangible) of the target company are recognized in the combined statements at fair value. Assets and liabilities that were not recognized in the financial statements of the target company may be recognized.

2. An asset account, called goodwill, is created and equals the excess of the purchase price over the fair market value of the target's net assets (i.e., assets less liabilities).

3. The income statement includes the operating results of the target company after the date of acquisition only.

4. Operating results prior to the merger are not restated, although pro forma data on a combined basis may be disclosed. As a result, pre-and post-merger income (and cash flow and balance sheet) statements are not comparable.

* cost
* equity
* pooling of interests
* consolidation
* purchase

That answer is incorrect.
Correct answer:
purchase

Conceptually, the purchase method of accounting is identical to the purchase of any asset. One firm (the acquirer) purchases the assets and liabilities of another firm (the target). The acquisition results in a change in control, and requires a new accounting basis for the acquired assets and liabilities. As with normal accounting for purchases of assets, the consideration given (purchase price) and net assets received are recorded at fair market value.

Which of the following is not true of securities classified as available-for-sale?

* they are presented on the balance sheet as current or non-current assets
* dividends and interest are reported in the income statement
* they are recorded using the market method
* realized gains and losses are reported directly in the income statement
* an end-of-period adjustment is made to record any unrealized gains or losses

That answer is incorrect.
Correct answer:
realized gains and losses are reported directly in the income statement

The unrealized gains and losses are not recorded on the income statement. Instead, they are directly recorded in stockholders' equity.

When comparing the proportionate consolidation and equity methods, which of the following statement(s) is (are) true?

I. The parent's stockholders' equity and net income recorded are identical regardless of which method is used.

II. Recorded assets and liabilities are higher using the equity method.

III. Return on equity will be the same using both methods, as net income and stockholders' equity are unchanged.

IV. Debt ratios will normally be higher using proportionate consolidation, and times interest earned (interest coverage ratio) will be lower.

* I, II, and III
* I, III, and IV
* All of these answers
* I and III
* II, III and IV

That answer is incorrect.
Correct answer:
I, III, and IV

Recorded assets and liabilities are higher using proportionate consolidation.

When one company acquires another company and uses the purchase method to account for the business combination, the ________ of the target's assets (tangible and intangible) and liabilities acquired must be recognized in the financial statements of the acquiring company.

* purchase price
* higher of cost or market value
* none of these answers
* net book value
* fair market value

That answer is incorrect.
Correct answer:
fair market value

Any excess of the purchase price over the fair market value of the net assets acquired is classified as goodwill.

________ only applies to debt securities that management intends and has the ability to hold to maturity.

* Buy and hold
* Available for sale
* "Liquid"
* Held-to-maturity
* Trading

That answer is incorrect.
Correct answer:
Held-to-maturity

These debt securities are recorded using the (amortized) cost method. Price fluctuations in this case should not matter, since the price at maturity is known (i.e., the par value).

Mike Smith, CFA, an analyst with Blue River Investments, is considering buying a Montrose Cable Company Corporate bond. The balance sheet and income statement are given below.

Balance Sheet (in thousands)
Current Assets $ 4,735
Fixed Assets   43,225
 Total Assets $ 47,960
Current Liabilities $ 4,500
Long-term Debt   10,000
 Total Liabilities $ 14,500

Income Statement (in thousands)
Revenue $18,500
Operating and Administrative expenses   14,050
Operating Income $ 4,450
Depreciation and Amortization   1,675
Interest Expense   942
Income before income taxes $ 1,822
Taxes   641
Net Income $ 1,192

Mike calculates the following three ratios:
EBITDA/Interest expense = 4.72
Long-term debt/equity = -0.30
Current assets/current liabilities = 1.05

Mike identifies three off-balance sheet items for Montrose:
1. Montrose has guaranteed the long-term debt (principal only) of an unconsolidated affiliate. This obligation has a present value of $995, 000.
2. Montrose has sold $500,000 of accounts receivable with recourse at a yield of 8 percent.
3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment will be $1,000,000.

If Mike recalculates the current assets/current liabilities to take into account the new operating leases the adjusted current assets/current liabilities ratio would be:

* 1.05
* 0.97
* 1.04
* 0.82
* 0.93

That answer is incorrect.
Correct answer:
0.97

The operating leases restated as if they were capitalized leases. This means that the assets would be increased by $6,144K. However, the assets would be considered fixed assets and current assets would remain unchanged. Liabilities would be increased by $6,144K. However, only some of the liability will be classified as short-term - the amount that is due to be repaid next year. This equals next year's lease payment ($1M) less the interest payment (10% x $6.144M) = $385,600.

________ is the increase/decrease in the benefit obligation allocated to periods of employment prior to the amendment.

* Actuarial gains/losses
* Service cost
* Prior service cost
* Interest cost
* Benefits paid

That answer is incorrect.
Correct answer:
Prior service cost

Pension plan amendments may increase (or decrease) previously specified pension benefit obligations. Prior service cost is the increase/decrease in the benefit obligation allocated to periods of employment prior to the amendment.

Which of the following would give the best estimate of the expected dollar return on assets used in the calculation of the pension expense?

* The expected return on assets equals the expected rate of return multiplied by the cost of plan assets.
* The expected return on assets equates to the actual return on assets calculated to arrive at plan assets.
* The expected return on assets equals the expected rate of return multiplied by the fair value of plan assets.
* The expected return on assets equals the actual rate of return divided by the fair value of plan assets.

That answer is incorrect.
Correct answer:
The expected return on assets equals the expected rate of return multiplied by the fair value of plan assets.

If the actual return on assets was used; the pension cost would be very volatile, as it would reflect the returns on the investments. To dampen the effect of volatile investment returns on pension cost, the expected return is used. The difference between the expected and the actual return on assets is deferred and accumulated on the assumption that the differences will balance out over time.

When the current rate method is used, the following ratios will be the same in the local currency and in the reporting currency:

I. Gross margin
II. Debt-to-equity
III. Inventory turnover

 * II only
 * I and II only
 * I, II, and III
 * All of these ratios differ in local currency and reporting currency.
 * I only

That answer is incorrect.
Correct answer:
I and II only

Under the current method, pure income statement ratios (gross margin) and pure balance sheet ratios (debt-to-equity) will remain unchanged after translation. Ratios that use both income statement and balance sheet items (inventory turnover) result in differing ratios when comparing local currency to reporting currency.

Under SFAS 87, differences arising from pension plan investment performance, plan amendments, and changes in assumptions are ________ in the reporting of pension costs.

 * allocated to each employee
 * vested
 * written-off
 * ignored
 * smoothed

That answer is incorrect.
Correct answer:
smoothed

As a result of this smoothing, accounting measures of periodic pension cost are often not reflective of economic reality. To evaluate the underlying cash flows and consequences of operating events, the analyst must unravel the smoothing and aggregating process.

It is assumed that the investor has significant influence when ownership reaches the ________ level.

* None of these answers- influence and ownership are not related
* 20%
* majority
* 75%
* 50%

That answer is incorrect.
Correct answer:
20%

Less than 20% is assumed to be no significant influence, while 20-50% is assumed to be significant influence. An investor may acquire less than a majority of the shares of an investee but own enough of an interest to have significant influence over the investee.

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Current Assets $ 4,735
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Current Liabilities $ 4,500
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Total Liabilities $ 14,500

Income Statement (in thousands)
Revenue $18,500
Operating and Administrative expenses 14,050
Operating Income $ 4,450
Depreciation and Amortization 1,675
Interest Expense 942
Income before income taxes $ 1,833
Taxes 641
Net Income $ 1,192

Mike calculates the following three ratios:
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Mike identifies three off-balance sheet items for Montrose:
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3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment will be $1,000,000.

If Mike recalculates the Long-term debt/Equity to take into account the sale of receivables the adjusted Long-term debt/Equity ratio would be:

* 0.30
* 0.29
* 0.33
* 0.31
* 0.21

That answer is correct!

The sale of the receivables should be taken into account. However, the adjusting entries would be to increase accounts receivable by $500K and increase short-term debt by the same amount. Neither of these adjustments will affect the long-term debt/equity ratio. Therefore the ratio will be unchanged.

Translation exposure:

 * arises from the possibility of incurring future currency exchange gains or losses resulting from existing business activities
 * results when changes in foreign currency exchange rates alter future revenues and expenses
 * the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates
 * represents the amount by which the market value of a company could change because of a change in exchange in exchange rates
 * is also referred to as cash flow exposure

That answer is incorrect.
Correct answer:
the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates

It focuses on the effect of currency changes on the book value of assets and liabilities of a company. The book values of the assets do not normally equal their market values. That is, the book values do not equal the discounted future expected cash flows.

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. Although, all transactions are denominated in Japanese yen, and the books and records are maintained in yen, the functional currency is the dollar. MasterToy, the parent company reports its earnings in U.S. dollars.

The exchange rates in Yen/US$ are:
December 31, 1998   150
December 31, 1997   130
1998 Average   140

1997 Average 120
Rate on date 1998 dividends paid 145
Rate on date of stock issue 100
Rate on date of fixed asset acquisition 100

What are the appropriate exchange rates for sales, depreciation expense and dividends respectively, when preparing consolidated financial statements for 1998?

* 140,100,100
* 150,140,145
* 150,100,145
* 140,100,145
* 140, 140,140
* 140,140,145

That answer is correct!

Under the temporal method monetary items income statement accounts (except cost of goods sold and depreciation) are translated at the average exchange rate for the year. Cost of goods sold and depreciation are translated at their historical rates. Dividends are translated at the rate that was in effect when they were issued.
Any translation gains and losses are reported on the income statement.

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If Mike recalculates the Long-term debt/Equity to take into account the guarantee on the long-term debt, the adjusted Long-term debt/Equity ratio would be:

 * 0.29
 * 0.21
 * 0.30
 * 0.33
 * 0.32
That answer is incorrect.
Correct answer:
0.33

The guarantee of long-term debt should be taken into account. The long-term debt will increase but the $995,000 but the equity will be unaffected.

Assigning a significant portion of the purchase price to "in-progress R&D", results in:

 * lower earnings in the year of acquisition, but also results in lower goodwill (less assets) and higher future net income (due to decreased goodwill amortization)
 * lower earnings in the year of acquisition, but also results in higher goodwill (less assets) and higher future net income (due to increased goodwill amortization)
 * lower earnings in the year of acquisition, but also results in higher goodwill (more assets) and higher future net income (due to decreased goodwill amortization)
 * higher earnings in the year of acquisition, but also results in higher goodwill (less assets) and higher future net income (due to decreased goodwill amortization)
 * higher earnings in the year of acquisition, but also results in lower goodwill (less assets) and higher future net income (due to decreased goodwill amortization)

That answer is correct!

This "in-process R&D" is immediately written off (i.e., expensed in the income statement). Therefore, earnings are lower in the first year, but the lower goodwill results in higher future net income.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells its share of Company B for $120 per share during Year 2. For Year 1 under the cost method, Company A would recognize income (resulting from this investment) the following:

 * $3,000
 * $250
 * none of these are correct
 * $2,500
 * $5,000
 * $500

That answer is incorrect.
Correct answer:

$500

Only the dividend is recognized.

Which of the following is true regarding trading securities.

* The unrealized gains and losses are not recorded on the income statement.
* None of these answers.
* They may be recorded as current or non-current assets.
* All of these answers.
* The unrealized gains and losses are recorded in stockholders' equity.

That answer is incorrect.
Correct answer:
None of these answers.

These answers are all true for Available-for-Sale securities. Trading securities are recorded as current assets, and all gains and losses - realized and unrealized are recognized in the income statement.

Which of the following is not true of securities classified as trading?

* they are recorded using the cost method
* they are presented on the balance sheet as current assets
* realized gains and losses are reported directly in the income statement
* dividends and interest are reported in the income statement
* the company intends to hold these securities only for a short period of time

That answer is correct!

The market method is used for these securities.

State the two types of pension plans.

* defined contribution and defined benefit plans
* variable contribution and defined benefit plans
* defined benefit and undefined benefit plans
* defined contribution and undefined contribution plans
* taxable and nontaxable undefined plans

That answer is correct!

Under a defined contribution pension plan the employer guarantees contributions made to the pension plan. Under defined benefit plans, an employer promises a specific monetary amount to its employees upon retirement.

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. All of Nippon MT's operations and sales take place in Japan, transactions are denominated in Japanese yen, and the books and records are maintained in yen. The functional currency is the Yen. MasterToy, the parent company reports its earnings in U.S. dollars.

The exchange rates in Yen/US$ are:
December 31, 1998 150
December 31, 1997 130
1998 Average 140
1997 Average 120
Rate on date 1998 dividends paid 145
Rate on date of stock issue 100
Rate on date of fixed asset acquisition 100

You calculate that the translated net income for 1998 equals $850; translated assets = $5,240; translated liabilities = $2,000; 1997 Retained Earnings = $2,000. Dividends paid in

1998 are 58,000 yen.
The accumulated translation adjustment as of December 31, 1998 is:

 * ($560)
 * ($960)
 * $2,450
 * $790
 * $570

That answer is incorrect.
Correct answer:
($960)

Retained Earnings at the end of 1998 = RE at the end of 1997 ($2,000)+ Net income for 1998 ($850)- Dividends paid in 1998 ($400) = $2,450. The Dividends paid in dollars = 58,000 x1/145 = $400. Accumulated Adjustment Account = Assets - Liabilities - RE - Capital Stock = $5,240 - $2,000 - $2,450 - $1,750 = ($960). Capital stock = 175,000 x 1/100 = 1,750.

French Co., a French Company, is a worldwide leader in widget production. The United States is FrenchCo's single largest market. Assume that: FrenchCo's production capacity is located in France, and all of its costs are incurred in francs; Additions to capacity require a lead time of more than one year; and FrenchCo borrows only in francs.

If the French Franc appreciates versus the U.S. dollar, what is the likely effect on FrenchCo's unit sales and profit margins in the year following the change in exchange rates?

 * Sales decrease and profit margins stay the same
 * Sales increase and profit margins stay the same
 * Sales decrease and profit margins decrease
 * Sales increase and profit margins increase
 * Sales and profit margins should be unchanged

That answer is incorrect.
Correct answer:
Sales decrease and profit margins decrease

If the franc becomes stronger against the dollar, then FrenchCo's widgets will become relatively more expensive in U.S. dollars, and demand for them should decline. There will be fixed costs, and as the sales volume decreases net income will decline more, as not all costs are variable. Therefore, profit margins should decrease.

Which of the following would get special treatment as an extraordinary item?

 * discontinued operations
 * strikes
 * gains and losses on the repurchase of debt
 * litigation
 * all of the responses qualify as extraordinary items
 * realized capital gains and losses on sale of assets

That answer is incorrect.
Correct answer:
gains and losses on the repurchase of debt

If a company extinguishes its debt early, any gain or loss that results must be reported as an extraordinary item.

What is the appropriate method used to report intercorporate equity investments when the investing company owns 15% of the investee company?

 * equity
 * lower of cost or market
 * consolidation
 * none of these answers
 * cost or market

That answer is incorrect.

Correct answer:
cost or market

The cost or market method is appropriate when degree of ownership is <20%. The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee. The different accounting methods reflect the degree to which the investee is viewed as being under the control of the parent (investing) company.

Operating exposure:

* represents the amount by which the market value of a company could change because of a change in exchange in exchange rates
* results when changes in foreign currency exchange rates alter future revenues and expenses
* cannot exist if the company has no overseas subsidiaries
* is the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates
* arises from the possibility of incurring future currency exchange gains or losses resulting from existing business transactions

That answer is incorrect.
Correct answer:
results when changes in foreign currency exchange rates alter future revenues and expenses

Operating exposure results when changes in foreign currency exchange rates alter future revenues and expenses - that is, future cash flows. A company can have operating exposure even if it has no overseas subsidiaries and if all contracts are denominated in its reporting currency.

Prior service cost is amortized over ________.

* the life of the pension plan
* none of these answers
* the average remaining service life of employees.
* twenty years
* ten years

That answer is incorrect.
Correct answer:
the average remaining service life of employees.

Prior service cost is not expensed as incurred, but is amortized over the average remaining service life of employees.

For the ________ method of accounting for intercorporate investments, the accounting steps are as follows:

1. Record the initial purchase at cost.
2. Record dividends when received (as income).
3. Record realized gain or loss in income statement only when security is sold.
4. If investment in investee is deemed to be permanently impaired, then investment should be written down (and loss recorded in income statement).

* cost
* consolidation
* market
* cost or market
* equity
* none of these answers

That answer is correct!

These steps represent the cost method

If an investee is profitable, and dividends paid are less than net income, the equity method results in a ________ investment account on the balance sheet.

 * smaller
 * poorer quality
 * larger
 * comparable
 * none of these answers

That answer is incorrect.
Correct answer:
larger

This is due to the difference in the proportionate share of the investee's income and dividend received. As a result the equity method, which gives higher net income and higher assets, will have better return on investment, interest coverage, and debt ratios.

When the degree of ownership is greater than 50% and the investing company has control over the investee firm, which is the appropriate method to account for inter-corporate stock investments?

 * market or equity
 * consolidation
 * equity
 * cost or market
 * equity or consolidation

That answer is incorrect.
Correct answer:
consolidation

The ownership percentages are used as rules of thumb to determine the degree of control a company has over its investee. The different accounting methods reflect the degree to which the investee is viewed as being under the control of the parent (investing) company.

Company A purchases 500 shares, or 25% of Company B for $100 per share on January 2 of Year 1. Company B has net income of $22,000 and pays dividends of $10,000. In Year 2 Company B has net income of $20,000 and pays dividends of $10,000. To record the purchase of Company B:

* total assets increase by $50,000
* total assets increase by $100,000
* equity for Company A increases by $50,000
* liabilities for Company B increase
* total assets change by $0

That answer is incorrect.
Correct answer:
total assets change by $0

Investment in Company B (asset) increases by $50,000 (500* $100) and cash (asset) decreases by $50,000. No change in total assets.

A security analyst concludes that a company has increased reported earnings by changing assumptions in the company's pension and postretirement health plans.
Indicate which of the following would cause an increase in reported earnings.
a. Decreasing estimated long-term return on pension assets
b. Increasing estimated long-term return on pension assets
c. Decreasing estimate of the future heath care inflation rate
d. Increasing estimate of the future health care inflation rate
e. Decreasing estimated life expectancy of employees

* a, d, e
* b, c, e
* a, d

 * a, c, e
 * b, d
 * b, c
That answer is incorrect.
Correct answer:
b, c, e

Increasing the estimated long-term return on pension assets will decrease pension cost and increase net income. Decreasing the future heath care inflation rate estimate will decrease the postretirement health plan cost and increase net income. Decreasing the estimated life expectancy of employees will decrease expected future benefits to be paid and, therefore, decrease PBO and hence decrease pension cost and increase net income. (Note - although this last assumption is not specifically discussed anywhere in the readings - common sense and an understanding of pensions should lead you easily to the correct answer).

Increases in the following pension plan assumptions have what impact on service cost?

 * Discount rate: service cost decreases; Compensation rate: service cost increases; Expected return on assets: no effect.
 * Discount rate: service cost increase; Compensation rate: service cost increases; Expected return on assets: no effect.
 * Discount rate: no effect; Compensation rate: no effect; Expected return on assets: no effect.
 * Discount rate: service cost increase; Compensation rate: service cost increases; Expected return on assets: service cost increases.
 * Discount rate: service cost decreases; Compensation rate: service cost decreases; Expected return on assets: no effect.
That answer is correct!

The higher the discount rate, the lower the present value of the pension obligations (VBO, ABO, and PBO). Since the discount rate is also used to calculate the service cost, it is also true that the higher the discount rate the lower the service cost will be.

Which category of marketable securities does not include equity securities?

 * all of these answers
 * trading
 * available-for-sale
 * held-to-maturity
 * none of these answers

That answer is incorrect.
Correct answer:
held-to-maturity

Only debt securities can have the classification of held-to-maturity

Which of the following is most incorrect regarding stock options issued as compensation?

 * The vast majority of companies use the fair value method.
 * Stock options are normally issued at-the-money and the intrinsic value method is used.
 * Stock options have a value at the time of issuance and result in a real cost to the company.
 * The use of the intrinsic value method results in overstated net income.
 * Stock options are an increasingly popular form of compensation.
 * Stock options are rarely recorded as a compensation expense in a company's income statement.

That answer is correct!

If an option is issued at-the-money or out-of-the-money, which is the case with most executive stock options, no compensation expense is recorded under the intrinsic value method. However, under the fair value method, a compensation cost would be recorded, because (as you know from option pricing), a stock option that is not in-the-money may still have value. Therefore, it should come as no great surprise that the vast majority of companies use the intrinsic value method.

When one company acquires another company and uses the purchase method to account for the business combination, any excess of the purchase price over the fair market value of the net assets acquired is ________.

 * non-taxable
 * subject to capital gains tax
 * classified as in-progress R&D
 * classified as goodwill
 * written-off

That answer is incorrect.
Correct answer:
classified as goodwill

Goodwill must be amortized over time, causing future net income to be decreased.

French Co., a French Company, is a worldwide leader in widget production. The United States is FrenchCo's single largest market. Assume that FrenchCo's production capacity is located in France, and all of its costs are incurred in francs; Additions to capacity require a lead-time of more than one year; and FrenchCo. borrows only in francs.

If the French franc appreciates versus the U.S. dollar, what is the likely effect on FrenchCo's unit sales and profit margin in the year following the change in exchange rates?

 * Sales and profit margin should be unchanged
 * Sales increase and profit margin stays the same
 * Sales increase and profit margin increases
 * Sales decrease and profit margin decreases
 * Sales decrease and profit margin stays the same

That answer is incorrect.
Correct answer:
Sales decrease and profit margin decreases

If the franc becomes stronger against the dollar, then FrenchCo's widgets will become relatively more expensive in U.S. dollars, and demand for them should decline. There will be fixed costs, and as the sales volume decreases net income will decline more, as not all costs are variable. Therefore, profit margins should decrease.

Company A purchases 200 shares, or 25% of Company B for $100 per share at the beginning of Year 1. In Year 1, Company B has net income of $10,000, and pays dividends of $6,000. In Year 2, Company B has net income of $8,000, and pays dividends of $6,000. Which of the following is true under the equity method for Company A?

I. Net income is higher than under the cost method
II. Investment in Company B is marked to market at the end of each accounting period
III. The ending balance (Year 1) for Investment in Company B is $21,000
IV. The ending balance (Year 2) for Investment in Company B is $22,000

* I only
* III and IV
* I and III
* II only
* III only
* II and IV
* I, II, III and IV
* I, II, and III

That answer is incorrect.
Correct answer:
I and III

The proportionate share of net income is larger than the dividend received, thus higher net income. The investment balance at the end of Year 1 = $20,000 + $2,500 (25% of $10,000 net income) - $1,500 (25% of dividend) = $21,000. At Year 2 = $21,000 + $2,000 - $1,500 = $21,500. Both the equity and cost methods ignore market value.

For noncyclical companies, normalizing earnings involves removing nonrecurring items such as which of the following from reported income?

 * accounting changes
 * catastrophes such as natural disasters or accidents
 * discontinued operations
 * impairment or "restructuring" charges
 * all of the responses are correct
 * strikes

That answer is incorrect.
Correct answer:
all of the responses are correct

All of the responses are correct.

Company A invests $500 in Company B which represents 20% of B. Company B reports net income of $100 in Year 1 and pays a dividend of $10. Company B has net income of $200 in Year 2 and pays dividends of $10. How does Company A account for the dividend received from Company B at the end of Year 1?

 * increase Investment in Company B by $10; increase in dividend income of $10
 * increase cash by $10; increase in dividend income of $10
 * increase cash by $2; increase in dividend income of $2
 * increase cash by $10; decrease Investment in Company B (asset) by $10
 * increase Investment in Company B by $2; increase in dividend income of $2
 * increase cash by $2; decrease Investment in Company B (asset) by $2

That answer is incorrect.
Correct answer:
increase cash by $2; decrease Investment in Company B (asset) by $2

These dividends are not included directly as part of A's income. Company A records dividends received as a reduction in the Investment in Company B account.

Which of the following statements is true regarding held-to-maturity securities?

* The equity method is used for these securities.
* These are securities (debt or equity) that the company intends to hold until maturity.
* The market method is used for these securities.
* None of these answers.
* All of these answers.

That answer is incorrect.
Correct answer:
None of these answers.

Held-to-maturity: This only applies to debt securities that management intends and has the ability to hold to maturity. These debt securities are recorded using the (amortized) cost method. Price fluctuations in this case should not matter, since the price at maturity is known (i.e., the par value).

Accounting exposure:

* represents the amount by which the market value of a company could change because of a change in exchange in exchange rates
* results when changes in foreign currency exchange rates alter future revenues and expenses
* the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates
* is also referred to as cash flow exposure
* arises from the possibility of incurring future currency exchange gains or losses resulting from existing business transactions

That answer is incorrect.
Correct answer:
the change in book value of assets, liabilities, revenues and expenses that results from changes in foreign currency exchange rates

Accounting exposure and translation exposure are the same thing. They focus on the effect of currency changes on the book value of assets and liabilities of a company. The book values of the assets do not normally equal their market values. That is, the book values do not equal the discounted future expected cash flows.

Mike Smith, CFA, an analyst with Blue River Investments, is considering buying a Montrose Cable Company Corporate bond. The balance sheet and income statement are given below.

Balance Sheet (in thousands)

Current Assets $ 4,735

Fixed Assets 43,225

Total Assets $ 47,960

Current Liabilities $ 4,500

Long-term Debt 10,000

Total Liabilities $ 14,500

Income Statement (in thousands)

Revenue $18,500

Operating and Administrative expenses 14,050

Operating Income $ 4,450

Depreciation and Amortization 1,675

Interest Expense 942

Income before income taxes $ 1,833

Taxes 641

Net Income $ 1,192

Mike calculates the following three ratios:

EBITDA/Interest expense = 4.72

Long-term debt/equity = -0.30

Current assets/current liabilities = 1.05

Mike identifies three off-balance sheet items for Montrose:

1. Montrose has guaranteed the long-term debt (principal only) of an unconsolidated affiliate. This obligation has a present value of $995, 000.
2. Montrose has sold $500,000 of accounts receivable with recourse at a yield of 8 percent.

3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment will be $1,000,000.

If Mike recalculates the current assets/current liabilities to take into account the guarantee of long-term debt the adjusted current assets/current liabilities ratio would be:

* 0.95
* 1.043
* 1.05
* 0.97
* 0.86

That answer is incorrect.
Correct answer:
1.05

The guarantee of long-term debt would not affect current liabilities or current ratio and therefore the debt would remain the same.

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If Mike recalculates the EBITDA/Interest ratio to take into account the sale of accounts receivable the adjusted EBITDA/Interest ratio would be:

* 4.72
* 4.78
* 4.53
* 3.45
* 4.57

That answer is incorrect.
Correct answer:
4.57

The accounts receivable should be treated as if they had not been sold, but rather a loan for $500,000 had been taken out at 8% rate of interest. This means that the interest expense would be $40,000 higher ($500,000 x 8%) and EBITDA would also be increased by $40,000. This is under the assumption that the proceeds of the loan would be invested and would provide interest income. It is assumed that it could be invested at 8%. Thus the adjusted numbers would be $4,490K for EBITDA and $982K for interest expense.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M
1996: Sales = $70M; Net Income = $2.5M; Dividends Paid = $1.5M
BC had 1,000,000 common shares outstanding during the entire period. There is no public market for BC shares.

Simpson Corporation bought BC shares for cash, as follows:
Jan. 1, 1994 10,000 shares at $10 per share
Jan. 1, 1995 290,000 shares at $11 per share, increasing ownership to 300,000 shares
Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

How would Simpson account for its inter-corporate investment in BC during 1996 (pick best answer)?

* Equity method, as it has significant influence over BC
* Partial consolidation, as it owned less than 100% prior to 1996
* Full equity method, as it now owns 100%
* Market method, as it now owns 100% and can assign a market value to the stock
* Consolidated method, as it now owns 100%

That answer is incorrect.
Correct answer:
Consolidated method, as it now owns 100%

Generally 100% ownership requires consolidation. Partial consolidation only applies if you own less than 100% and is used only in certain industries at present. There is no such thing as the full equity method.

The data below are derived from the annual report of Bailey Company (BC):

1994: Sales = $50M; Net Income = $2M; Dividends Paid = $1M
1995: Sales = $60M; Net Income = $2.2M; Dividends Paid = $1.2M

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Jan. 1, 1996 700,000 shares at $15 per share, resulting in 100 percent ownership.
Simpson assumed significant influence over BC's management in 1995.

The effect of these investment's on Simpson's cash flow for 1994 and 1995, respectively (ignoring cost of the investment and taxes) are:

* Increase by $10,000, increase by $660,000
* Increase by $20,000, increase by $360,000
* Increase by $20,000 increase by $660,000
* Increase by $10,000, increase by $360,000
* No effect, no effect
* Increase by $10,000, no effect

That answer is incorrect.
Correct answer:
Increase by $10,000, increase by $360,000

The cash received equals the dividend payment for both years.

When comparing the consolidation and equity methods, which of the following statement(s) is (are) not true?

I. Recorded assets and liabilities are higher using consolidation.

II. Under the consolidation method, the parent company only includes cash flows between parent and investee (e.g., dividends, additional investments, and redemptions). Conversely, under the equity method, the parent company includes all cash flows of the investee except those between parent and investee.

III. Consolidation and the equity method produce identical net income and net worth.

IV. Under consolidation, all the revenues, expenses, and cash flows of the subsidiary (Company S) are included in the corresponding accounts of the parent company (Company P). The 20% not owned by the parent company, the "minority interest," is subtracted out. In contrast, the equity method incorporates the parent's share of the subsidiary's net income as a one-line item.

V. Under the equity method, only the investment account and the net income are affected by investee results. Virtually every account in the parent company's financial statements is affected by consolidation.

* I and II
* None of these answers
* III and IV
* All of these answers
* II

That answer is incorrect.
Correct answer:
II

Under the equity method, the parent company only includes cash flows between parent and investee (e.g., dividends, additional investments, and redemptions). Conversely, under the consolidated method, the parent company includes all cash flows of the investee except those between parent and investee.

Increases in the following pension plan assumptions have what impact on expected return?

* Discount rate: expected return decreases; Compensation rate: expected return decreases; Expected return on assets: expected return decreases.
* Discount rate: expected return increases; Compensation rate: expected return increases; Expected return on assets: expected return increases.
* Discount rate: no effect; Compensation rate: no effect; Expected return on assets: no effect.

 * Discount rate: no effect; Compensation rate: no effect; Expected return on assets: expected return increases.
 * Discount rate: expected return increases; Compensation rate: expected return increases; Expected return on assets: no effect.

That answer is incorrect.

Correct answer:

Discount rate: no effect; Compensation rate: no effect; Expected return on assets: expected return increases.

Ultimately, if the company experiences a greater (lower) rate of return than the expected rate of return for an extended period of time, the contributions to the pension plan will be smaller (larger) in the future.

ABC Co. acquires 200 shares (out of 2000 shares outstanding) of XYZ Co. on Jan. 3, Year 1 @ $20 per share. Other data to consider for XYZ Co. for Year 2:

EPS	$ 2.00
Dividends per share	$ 0.50
Market value @ 12/31/Year 1	$25.00 per share

ABC sells all of its shares of XYZ on Jan 3, Year 2 for $28 per share. Compute the carrying value of the investment on 12/31/Year 1 given that ABC accounts for its investment in XYZ as a trading security:

 * $5,200
 * $4,100
 * $5,300
 * $5,000
 * none of these is correct
 * $4,000

That answer is incorrect.

Correct answer:

$5,000

200 share * $25 = $5,000(10% ownership and trading security: market method)

Pension plan actuarial gains and losses are deferred and accumulated. If the total deferrals are in excess of ________ of the larger of the PBO and the value of the plan assets, they must be amortized over the average remaining employee service life.

* 5%
* 15%
* 20%
* 3.5%
* 10%

That answer is incorrect.
Correct answer:
10%

This is done to smooth out pension cost over time.

The following is true about the consolidated cash flow statement under pooling accounting:

* subsequent depreciation and amortization is based on fair market value
* the acquirer's cash flow statement is not affected by the acquisition
* there is no need to restate previously issued cash flow statements on a combined basis
* the acquisition cost is accounted for as a cash outflow in the investing section
* it is simply the sum of the individual cash flow statements

That answer is incorrect.
Correct answer:
it is simply the sum of the individual cash flow statements

There is no evidence in the statement of cash flows to reflect the merger or acquisition, no acquisition costs in CFI, and no cash outflows reflected in CFF.

Under SFAS 87, which of the following is not a measure of the liability arising from its defined benefit pension plan?

 * participating benefit obligation
 * vested benefit obligation
 * accumulated benefit obligation
 * projected benefit obligation

That answer is correct!

The three measures are: Vested Benefit Obligation (VBO), Accumulated Benefit Obligation (ABO), and Projected Benefit Obligation (PBO).

Which of the following is incorrect with respect to U.S. GAAP?

 * asset revaluation is generally not allowed
 * all of the selections apply to U.S. GAAP
 * the maximum amortization period for goodwill is 40 years
 * revaluation upwards of impaired assets is not permitted
 * research costs are expensed as incurred
 * dividends paid are financing outflows on the statement of cash flows

That answer is incorrect.
Correct answer:
all of the selections apply to U.S. GAAP

All of the selections apply to U.S. GAAP.

Match the term (1, 2, 3) with its definition (I, II, III).

1. Vested Benefit Obligation (VBO)

2. Accumulated Benefit Obligation (ABO)

3. Projected Benefit Obligation (PBO)

I. Estimate of the employer obligation based on current compensation levels, but including non-vested employees as well. This value can be considered to be a liquidation value of the plan.

II. Estimate of the employer's pension obligations based upon current compensation for benefits vested to employees.

III. Same as ABO only including expected future pay increases. This value can be considered the going concern value of the plan.

* 1-II, 2 III, 3-I
* None of the definitions is correct
* 1-II, 2-I, 3-III
* 1-I, 2-II, 3-III
* 1-III, 2-I, 3-II

That answer is incorrect.
Correct answer:
1-II, 2-I, 3-III

Under SFAS 87, there are three measures of a company's liability resulting from its defined benefit pension plan. These are all present value calculations, differing only in their assumptions about the amount to be paid out in the future.

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Current Assets $ 4,735
Fixed Assets 43,225
Total Assets $ 47,960
Current Liabilities $ 4,500
Long-term Debt 10,000
Total Liabilities $ 14,500

Income Statement (in thousands)
Revenue $18,500
Operating and Administrative expenses 14,050
Operating Income $ 4,450
Depreciation and Amortization 1,675
Interest Expense 942
Income before income taxes $ 1,833
Taxes 641
Net Income $ 1,192

Mike calculates the following three ratios:
EBITDA/Interest expense = 4.72
Long-term debt/equity = -0.30
Current assets/current liabilities = 1.05

Mike identifies three off-balance sheet items for Montrose:
1. Montrose has guaranteed the long-term debt (principal only) of an unconsolidated affiliate. This obligation has a present value of $995, 000.
2. Montrose has sold $500,000 of accounts receivable with recourse at a yield of 8 percent.
3. Montrose is a lessee on a new non-cancelable operating leasing agreement to finance transmission equipment. The discounted present value of the lease payments is $6,144,000 using an interest rate of 10 percent. The annual payment will be $1,000,000.

If Mike recalculates the current assets/current liabilities to take into account the sale of receivables the adjusted current assets/current liabilities ratio would be:

* 0.97
* 1.052
* 0.82
* 1.047
* 0.95

That answer is incorrect.
Correct answer:

1.047

The sale of the receivables should be taken into account. The adjusting entry would be to increase accounts receivable by $500K and increase short-term debt by the same amount.

The ________ method is used for recording held-to-maturity debt securities.

 * debt method
 * consolidation
 * equity
 * none of these answers
 * cost or equity

That answer is incorrect.
Correct answer:
none of these answers

Held to maturity debt securities are recorded using the (amortized) cost method. Price fluctuations in this case should not matter, since the price at maturity is known (i.e., the par value).

Which of the following is/are remeasured/translated at an average exchange rate under both the temporal and the all current rate?

I. Sales
II. COGS and depreciation expense
III. Statement of cash flows
IV. Monetary assets

 * III only
 * II only
 * none of the items are remeasured/translated at an average exchange rate under both the temporal and the all current rate

* I only
* I, II, and III
* I and III

That answer is incorrect.
Correct answer:
I and III

Monetary assets are translated at the current exchange rate and COGS and depreciation are remeasured using historical exchange rates under the temporal method.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells its share of Company B for $120 per share during Year 2. The total return for Year 1 is:

* $3,000
* $2,500
* $5,000
* none of these are correct
* $500
* $4,500

That answer is correct!

(capital gain + dividend); (100 * $25) + (100 * $5) = $2,500

Under a flat plan, which of the following is true?

I. Retirees receive a specific amount for each year worked

II. Retirees receive an amount based upon some formula that is a function of the employee's earnings during specified years

III. There are no guarantees of the final benefit payments to be received by the employee.

* III only
* I only
* II only
* I, II, and III
* I and III

That answer is incorrect.
Correct answer:
I only

Flat plans are defined benefit plans where retirees receive a specific amount for each year worked. Therefore, an employer promises a specific monetary amount to its employees upon retirement and III is incorrect. Under a pay-related plan, retirees receive an amount based upon some formula that is a function of the employee's earnings during specified years; therefore, II does not apply to flat plans.

Three key pension plan assumptions, which are disclosed, are:

I. Employee turnover rates
II. The discount rate
III. The rate of compensation increase
IV. Expected long-term rate of return on plan assets
V. Employee mortality rates

* I, III, and IV
* II, III, and IV
* I, III, V
* I, II, and III
* II, III, and V

That answer is incorrect.
Correct answer:

II, III, and IV

In order to enhance comparability of pension plans, SFAS 87 provides that all companies must use the same actuarial method when calculating pension cost and the status of pension plans. However, within this method, firms are free to make a number of important assumptions. The assumptions used by a company may significantly affect the pension obligation and pension cost. Therefore, it is very important for the analyst to understand how assumptions affect these items.

Which of the following is/are true for U.S. based companies with subsidiaries operating in hyperinflationary economies?

I. Cumulative three-year inflation must exceed 100% to qualify as hyperinflationary

II. Subsidiaries must use the temporal method

III. Subsidiaries would translate all income statement accounts at an average rate

* all of the responses apply
* I and III
* I and II
* I only
* II and III

That answer is incorrect.
Correct answer:
I and II

Subsidiaries located in countries with hyperinflation (cumulative three-year inflation exceeding 100%) must use the temporal method. The logic to this requirement is as follows: If inflation is extremely high, then the local currency is depreciating rapidly relative to reporting currency. Therefore, when the current exchange rate is used to convert assets and liabilities into the reporting currency, they are rapidly decreasing in size in the reporting currency. However, the nominal value of such things as inventory and assets (nonmonetary assets) does not normally decrease in a hyper inflationary environment - they normally increase in value in nominal terms in line with the rate of inflation.

Which of the following would be incorrect if the equity method were being used to account for an investment?

* record the initial purchase at cost
* update the asset account to market value each accounting period
* record dividends received as a reduction in the investment account
* record the realized gain or loss when the security is sold
* record the proportionate share of investee's net income on the income statement and as an increase in the investment account

That answer is incorrect.
Correct answer:
update the asset account to market value each accounting period

The equity method does not recognize changes in market value.

MasterToy has a foreign subsidiary (Nippon MT) that makes and sells toys in Japan. All of Nippon MT's operations and sales take place in Japan, transactions are denominated in Japanese yen, and the books and records are maintained in yen. The functional currency is the Yen. MasterToy, the parent company reports its earnings in U.S. dollars.

The exchange rates in Yen/US$ are:
December 31, 1998 150
December 31, 1997 130
1998 Average 140
1997 Average 120
Rate on date 1998 dividends paid 145
Rate on date of stock issue 100
Rate on date of fixed asset acquisition 100

What are the appropriate exchange rates for sales, depreciation expense and dividends respectively, when preparing consolidated financial statements for 1998?

* 140,140,145
* 140,100,100
* 150,140,145
* 150,100,145
* 140, 140,140
* 140,100,145

That answer is correct!

Under the current rate method all income statement items are translated at average rate for 1998. Dividends are translated at the actual rate when paid.

Company A purchases 100 shares (out of 2000 outstanding) of Company B for $100 per share. Company B reports net income of $20 per share for Year 1 and declares a dividend of $5 per share on its common stock. The market value of the Company B shares increases to $125 per share at the end of Year 1. Company A sells all of its shares in Company B for $120 per share during Year 2. Under the cost method, the carrying value on the books at the time of sale is:

* $10,000
* $12,500
* $12,000
* none of these is correct
* 10,500

That answer is correct!

The carrying value of the investment remains at $10,000 (original cost) until the investment is sold.

The information below comes from the 1997 financial statements of QuickBrush Company and SmileWhite Corporation

QuickBrush (from the footnotes to the financial statements)
a. Goodwill: The company amortizes goodwill over 20 years.
b. P, P &E: The company uses straight-line depreciation method over the economic lives of the assets, which range from 5 to 20 years for buildings.
c. Accounts receivable: The company uses a bad debt allowance of 2 percent of accounts receivable.

SmileWhite (from the footnotes to the financial statements)
a. Goodwill: The company amortizes goodwill over 5 years.
b. P, P &E: The company uses an accelerated depreciation method over the economic lives of the assets, which range from 5 to 20 years for buildings.
c. Accounts receivable: The company uses a bad debt allowance of 5 percent of accounts receivable.

Which of the following best describes the effect of QuickBrush's depreciation policy:

* QuickBrush consistently records a lower net income.
* QuickBrush will have a higher quality of earnings than SmileWhite, all other things being equal.
* QuickBrush will have a lower quality of earnings than SmileWhite, all other things being equal.
* QuickBrush will always show a higher profit margin than SmileWhite.

That answer is incorrect.
Correct answer:
QuickBrush will have a lower quality of earnings than SmileWhite, all other things being equal.

QuickBrush uses straight-line depreciation, whereas SmileWhite uses accelerated depreciation, and thus QuickBrush records a higher net income. SmileWhite is, however, more conservative and can be said to have a higher quality of earnings.

Company G's local currency is DM (also its functional currency). The parent is a U.S. company reporting in $.

@ 12/31/Year 1 $ per DM = .592
@ 12/31/Year 2 $ per DM = .610
Average Year 1 rate $ per DM = .588
Average Year 2 rate $ per DM = .605
Rate for Year 2 inventory $ per DM = .600
Company G   Year 1   Year 2
Net receivables DM 350 DM 375
Inventory   DM 400 DM 410
Net Sales   DM 1,100 DM 1,300
COGS   DM 225 DM 275

Receivables turnover for Year 2 based on the reporting currency is:

* 3.47
* 3.6
* none of these are correct
* 3.52
* 3.27

That answer is incorrect.
Correct answer:
3.6

Receivables turnover = Net sales / Average net receivables = 3.6times.
Net sales = 1,300 x 0.605 = 786.5; Year 1 receivables = 350 x .592 = 207.2; Year 2 receivable = 375 x .610 = 228.75

Which of the following statements is true regarding held-to-maturity securities?

* These debt securities are recorded using the market method.
* These debt securities are recorded using the (amortized) cost method.
* This designation only applies to securities that have matured.
* None of these answers.

* These are securities (debt or equity) that the company intends to hold only for a short period of time.

That answer is incorrect.
Correct answer:
These debt securities are recorded using the (amortized) cost method.

Held-to-maturity: This only applies to debt securities that management intends and has the ability to hold to maturity. These debt securities are recorded using the (amortized) cost method. Price fluctuations in this case should not matter, since the price at maturity is known (i.e., the par value).

Which of the following is not a type of foreign exchange exposure?

* translation exposure
* transaction exposure
* economic exposure
* all of the responses are types of accounting exposure
* accounting exposure
* operating exposure

That answer is incorrect.
Correct answer:
all of the responses are types of accounting exposure

all of the choices represent types of foreign exchange exposure

Increases in the following pension plan assumptions have what impact on the projected benefit obligation (PBO)?

* Discount rate: PBO decreases; Compensation rate: PBO increases; Expected return on assets: PBO increases.

* Discount rate: PBO decreases; Compensation rate: PBO increases; Expected return on assets: no effect.
* Discount rate: PBO decreases; Compensation rate: PBO decreases; Expected return on assets: PBO decreases.
* Discount rate: PBO decreases; Compensation rate: PBO decreases; Expected return on assets: no effect.
* Discount rate: PBO increases; Compensation rate: PBO increases; Expected return on assets: no effect.

That answer is incorrect.
Correct answer:
Discount rate: PBO decreases; Compensation rate: PBO increases; Expected return on assets: no effect.

The higher the discount rate, the lower the present value of the pension obligations (VBO, ABO, and PBO). For the PBO, a higher compensation growth rate increases the obligation. Notice that the expected long-term rate of return on plan assets has no direct effect on the PBO and plan assets.

The following is true with regards to accounting for foreign currency translation using the all-current method:

I. Also referred to as remeasurement
II. Used to convert the local currency data into the functional currency
III. Used to convert the functional currency data into the parent company currency
III. Also referred to as translation

* III only
* I and II
* II only
* I, II, and III
* II and IV
* III and IV

That answer is incorrect.
Correct answer:
III and IV

Remeasurement applies to the temporal method, whereas the all-current method is known as the translation process, and is used to describe the conversion of the functional currency data into the parent company (reporting) currency.