SS 08 Financial Reporting and Analysis: Inventories, Long-lived Assets, Income Taxes, and Non-current Liabilities Answers

Question #1 of 143

Question ID: 456301

All-Star Enterprises purchased a machine on January 1. The company uses straight-line depreciation for financial reporting and accelerated depreciation for tax purposes. Depreciation for tax purposes during the year was $36,000 greater than depreciation for financial reporting. Assuming a 30% tax rate will apply in the future, how much will be recorded as a deferred tax liability during the year?

- ✗ **A)** $36,000
- ✗ **B)** $25,200
- ✓ **C)** $10,800

Explanation

Deferred tax liability = $36,000 × 30% = $10,800.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #2 of 143

Question ID: 434299

A temporary difference between income tax expense and taxes payable result in a(n):

- ✓ **A)** deferred tax item.
- ✗ **B)** adjustment to the effective tax rate.
- ✗ **C)** gain or loss in comprehensive income.

Explanation

Taxes payable is defined as the taxes due to the government as determined by taxable income and the tax rate, while income tax expense is the amount recognized on the income statement. A temporary difference results in a deferred tax liability if income tax expense is greater than taxes payable, or a deferred tax asset if income tax expense is less than taxes payable. A permanent difference results in an adjustment to the firm's effective tax rate. Neither results in a gain or loss.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #3 of 143

Question ID: 434313

Compared to issuing a bond at par value, and holding all else equal, when a company issues a bond at a premium, its effect on the debt/equity ratio will be:

- ✗ **A)** no effect on the ratio over the life of the bond.
- ✓ **B)** a decreasing trend in the ratio over the life of the bond.
- ✗ **C)** an increasing trend in the ratio over the life of the bond.

Explanation

Net book value of debt decreases over the life of the bond because the premium amortizes. Stockholders' equity increases over the life of the bond because interest expense decreases each period. This results in a decreasing trend in the debt/equity ratio over the life of the bond, compared to the trend if a bond had been issued at par value.

References

Question From: Session 8 > Reading 31 > LOS k

Related Material:

- Key Concepts by LOS

Question #4 of 143

Question ID: 414625

An analyst compares two companies that are identical except that Company X uses finance leases and Company Y uses operating leases. The analyst would expect Company X's debt-to-equity ratio, relative to Company Y's, to be:

- ✗ **A)** the same.
- ✗ **B)** lower.
- ✓ **C)** higher.

Explanation

Lease capitalization adds both current and noncurrent liabilities to debt, resulting in a corresponding increase in the debt-to-equity and other leverage ratios. Thus, Company X's (Debt + Lease)/Equity is greater than Company Y's Debt/Equity.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #5 of 143

Question ID: 414594

Which of the following statements regarding zero-coupon bonds is *most* accurate?

✓ **A)** A company should initially record zero-coupon bonds at their discounted present value.

✗ **B)** Interest expense is a combination of operating and financing cash flows.

✗ **C)** The interest expense in each period is found by applying the discount rate to the book value of debt at the end of the period.

Explanation

The liability initially recorded for a zero-coupon bond is equal to the proceeds received, which is the present value of the principal repayment discounted at the company's normal borrowing rate. Interest expense is found by applying the discount rate to the book value of debt at the *beginning* of the period, and there is no cash outflow from operations for a zero coupon bond.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #6 of 143

Question ID: 414533

A tax loss carryforward is *best* described as the:

✓ **A)** net taxable loss that can be used to reduce taxable income in the future.

✗ **B)** net taxable loss that can be used to refund paid taxes from the previous year.

✗ **C)** difference of deferred tax liabilities and deferred tax assets.

Explanation

A tax loss carryforward is the net taxable loss that can be used to reduce taxable income in the future.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #7 of 143

Question ID: 414640

Which of the following statements regarding the effect of a finance lease on the lessee's statement of cash flows is *least* accurate?

✓ **A)** The rental expense serves to reduce the cash flow for financing because it is an investment expense.

✗ **B)** The change in the finance lease liability on the balance sheet is a cash flow from financing.

✗ **C)** The interest expense portion of the lease payments reduces cash flow from operations.

Explanation

In finance leases, there is only interest expense and principal repayment. Rental expense is only charged when the lease is an operating lease.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #8 of 143

Question ID: 414604

A zero coupon bond, compared to a bond issued at par, will result in higher:

✗ **A)** cash flows from financing (CFF).

✓ **B)** cash flows from operations (CFO).

✗ **C)** interest expense.

Explanation

The zero-coupon bond will have higher cash flows from operations, as the cash interest expense in this case is zero and no cash is paid until maturity. Candidates should remember that any bond issued at a discount will have more cash flow from operations and less cash flow from financing.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #9 of 143

Question ID: 434307

Habel Inc. owns equipment with a tax base of $400,000 and a carrying value of $600,000. Habel also has a tax loss carryforward of $200,000 that is expected to be utilized in the foreseeable future. Deferred tax items on the balance sheet are valued based on a tax rate of 30%. If the tax rate increases to 35%, the adjustments to the value of deferred tax items will *most likely* cause Habel's total liabilities-to-equity ratio to:

✗ **A)** decrease.

✓ **B)** increase.

✗ **C)** remain unchanged.

Explanation

The $200,000 difference between the tax base and the carrying value of the equipment gives rise to a taxable temporary difference that leads to a deferred tax liability of $60,000 ($200,000 × 30%). The tax loss carryforward of $200,000 leads to a deferred tax asset of $60,000 ($200,000 × 30%).

The increase in the tax rate from 30% to 35% will increase both the DTL and the DTA by $10,000 ($200,000 × 5%). Equity is unchanged. Therefore, the total liabilities-to-equity ratio will increase because of the increase in the deferred tax liability.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS

Question #10 of 143

Question ID: 467388

A bond is issued at the end of the year 20X0 with an 8% semiannual coupon rate, 5 years to maturity, and a par value of $1,000. The bond's yield at issuance is 10%. Using the effective interest method, if the yield has decreased to 9% at the end of the year 20X1, the balance sheet liability for the bond is *closest to*:

✗ **A)** 967.

✓ **B)** 935.

✗ **C)** 923.

Explanation

Using the effective interest method, the value of the liability is calculated using the bond's yield at issuance. At the end of 20x1 the bond will have 8 semiannual periods remaining until maturity.

N = 8; I/Y = 10 / 2 = 5; PMT = 8 / 2 × 1,000 = 40; FV = 1,000; CPT PV = −935.37.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #11 of 143

Question ID: 414643

Penguin Company is planning to lease a $5 million machine to produce goods for eventual sale. Penguin is able to structure the lease so as to classify it as either an operating or a finance lease. Advantages to Penguin of classifying this lease as an operating lease are *least likely* to include that:

- ✗ **A)** depreciation is not recorded.
- ✗ **B)** the lease is not reported as debt on Penguin's balance sheet, so leverage ratios are not increased.
- ✓ **C)** no disclosures of payments due under the lease are required.

Explanation

Cash payments due under an operating lease must be disclosed in the notes to the financial statements for each of the following five years and in aggregate. Operating leases are simpler to account for and the often adverse ratio implications of offsetting increases in assets and liabilities are avoided.

References

Question From: Session 8 > Reading 31 > LOS i

Related Material:

- Key Concepts by LOS

Question #12 of 143

Question ID: 414584

A firm purchased a piece of equipment for $6,000 with the following information provided:

- Revenue will be $15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining is used for tax purposes.

Calculate taxes payable for years 1 and 2.

	Year 1	Year 2
✓ **A)**	3,300	4,100
✗ **B)**	3,900	3,900
✗ **C)**	600	-200

Explanation

Using DDB:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Depreciation	4,000	1,333
Taxable Income	11,000	13,667
Taxes Payable	3,300	4,100

An asset with a 3-year life would have a straight line depreciation rate of 0.3333 per year. Using DDB the depreciation rate is twice this amount or 0.66667. $2,000 is the amount of depreciation left on the equipment in year 2 ($6,000 − $4,000). Therefore, the amount of depreciation in the 2nd year is (0.66667)(2,000) = $1,333

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #13 of 143

Question ID: 414606

A firm issues a $5 million zero coupon bond with a maturity of four years when market rates are 8%. Assuming semiannual compounding periods, the total interest on this bond is:

- ✗ **A)** $1,600,000.
- ✗ **B)** $1,200,000.
- ✓ **C)** $1,346,549.

Explanation

The interest paid on the bond will be the difference between the future value of the bond of $5,000,000 and the proceeds of the bond when it was originally issued.

First find the present value of the bond found by N = 8; FV = 5,000,000; I = 4; PMT = 0; CPT → PV = −3,653,451. This is the amount of money the bond generated when it was originally issued.

Then take the difference between the $5,000,000 future price and the $3,653,451 from the proceeds = $1,346,549 which is the interest paid on the bond.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #14 of 143

Question ID: 414593

When the market rate is greater than the coupon rate, the bond is called a:

- ✓ **A)** discount bond.
- ✗ **B)** par bond.
- ✗ **C)** premium bond.

Explanation

When the market rate is greater than the coupon rate, the bond will sell at a discount as investors will only buy the bond at a price which is less than fair value due to the coupon being lower than the market rate.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #15 of 143

Question ID: 414574

Deferred tax liabilities may result from:

- ✗ **A)** pretax income greater than taxable income due to permanent differences.
- ✗ **B)** pretax income less than taxable income due to temporary differences.
- ✓ **C)** pretax income greater than taxable income due to temporary differences.

Explanation

Deferred tax liabilities result from temporary differences that cause pretax income and income tax expense (on the income statement) to be greater than taxable income and taxes due (on the firm's tax form). Temporary differences that cause pretax income to be less than taxable income are recognized as deferred tax assets. Permanent differences do not result in deferred tax items; instead they cause the effective tax rate to differ from the statutory tax rate.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS

Question #16 of 143

Question ID: 414600

A bond is issued with the following data:

- $10 million face value.
- 9% coupon rate.
- 8% market rate.
- 3-year bond with semiannual payments.

Assuming market rates do not change, what will the bond's market value be one year from now and what is the total interest expense over the life of the bond?

	Value in 1-Year	Total Interest Expense
✗ **A)**	11,099,495	2,437,893

✓ **B)** 10,181,495 2,437,893

✗ **C)** 10,181,495 2,962,107

Explanation

To determine the bond's market value one year from now: FV = 10,000,000; N = 4; I = 4; PMT = 450,000; CPT → PV = $10,181,495.

To determine the total interest expense:

1. FV = 10,000,000; N = 6; I = 4; PMT = 450,000; CPT → PV = $10,262,107. This is the price the purchaser of the bond will pay to the issuer of the bond. From the issuer's point of view this is the amount the issuer will receive from the bondholder.
2. Total interest expense over the life of the bond is equal to the difference between the amount paid by the issuer and the amount received from the bondholder.

[(6)(450,000) + 10,000,000] - 10,262,107 = 2,437,893

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #17 of 143

Question ID: 414637

For a given lease payment and term, which of the following is *least accurate* regarding the effects of the classification of the lease as a finance lease as compared to an operating lease?

✓ **A)** The lessee's current ratio will be higher for a finance lease.

✗ **B)** The lessee's asset turnover will be lower for a finance lease.

✗ **C)** The lessee's debt-to-equity ratio will be higher for a finance lease.

Explanation

The lessee's current ratio will be lower because the current portion of the finance lease increases current liabilities, hence reducing the current ratio.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #18 of 143

Question ID: 414534

If a firm uses accelerated depreciation for tax purposes and straight-line depreciation for financial reporting, which of the following results is *least likely*?

- ✗ **A)** Income tax expense will be greater than taxes payable.
- ✗ **B)** A temporary difference will result between tax and financial reporting.
- ✓ **C)** A permanent difference will result between tax and financial reporting.

Explanation

A permanent difference between tax and financial reporting is a difference that is expected to not reverse itself. Under normal circumstances, the effects of the different depreciation methods will reverse.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #19 of 143

Question ID: 596409

For analytical purposes, if a deferred tax liability is expected to not be reversed, it should be treated as a(n):

- ✓ **A)** an addition to equity.
- ✗ **B)** liability.
- ✗ **C)** immaterial amount and ignored.

Explanation

If deferred tax liabilities are expected to never reverse, they should be treated as equity for analytical purposes.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #20 of 143

Question ID: 414555

Laser Tech has net temporary differences between tax and book income resulting in a deferred tax liability of $30.6 million. According to U.S. GAAP, an increase in the tax rate would have what impact on deferred taxes and net income, respectively:

	Deferred Taxes	Net Income
✓ **A)**	Increase	Decrease

✗ **B)**	No effect	Decrease
✗ **C)**	Increase	No effect

Explanation

If tax rates rise then deferred tax liabilities will also rise. The increase in deferred tax liabilities will increase the current tax expense, and if expenses are increasing the net income will decrease.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #21 of 143

Question ID: 414607

When bonds are issued at a premium:

- ✗ **A)** earnings of the firm decrease over the life of the bond as the bond premium is amortized.
- ✗ **B)** coupon interest paid decreases each period as bond premium is amortized.
- ✓ **C)** earnings of the firm increase over the life of the bond as the bond premium is amortized.

Explanation

As bond premium is amortized, interest expense will be successively lower each period, thus increasing earnings over the life of the bond.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #22 of 143

Question ID: 414548

A company purchased a new pizza oven directly from Italy for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is accelerated to 35% in years 1 and 2, and 30% in year 3. For purposes of this exercise ignore all expenses other than depreciation.

What is the net income and depreciation expense for year one for financial reporting purposes?

Net Income	Depreciation Expense

✓ **A)**	$2,748	$2,535
✗ **B)**	$4,657	$2,748
✗ **C)**	$2,535	$3,169

Explanation

Net income in year 1 for financial reporting purposes will be $2,748 = [($7,192 − $2,535)(1 − 0.41)]

The annual depreciation expense on financial statements will be $2,535 = ($12,676 / 5 years)

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #23 of 143

Question ID: 479061

Firm 1 has a deferred tax liability and Firm 2 has a deferred tax asset. If the tax rate decreases, the balance sheet values of these deferred tax items will:

	Firm 1	Firm 2
✗ **A)**	increase.	increase.
✓ **B)**	decrease.	decrease.
✗ **C)**	increase.	decrease.

Explanation

A decrease in the future tax rate decreases the balance sheet value of either a deferred tax liability or a deferred tax asset.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS

Question #24 of 143

Question ID: 414547

Corcoran Corp acquired an asset on 1 January 2004, for $500,000. For financial reporting, Corcoran will depreciate the asset using the straight-line method over a 10-year period with no salvage value. For tax purposes the asset will be depreciated straight line for five years and Corcoran's effective tax rate is 30%. Corcoran's deferred tax liability for 2004 will:

- ✗ **A)** decrease by $50,000.
- ✗ **B)** decrease by $15,000.
- ✓ **C)** increase by $15,000.

Explanation

Straight-line depreciation per financial reports = 500,000 / 10 = $50,000

Tax depreciation = 500,000 / 5 = $100,000

Temporary difference = 100,000 − 50,000 = $50,000

Deferred tax liability will increase by $50,000 × 30% = $15,000

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #25 of 143

Question ID: 596408

When analyzing a company's financial leverage, deferred tax liabilities are *best* classified as:

- ✓ **A)** a liability or equity, depending on the company's particular situation.
- ✗ **B)** neither as a liability, nor as equity.
- ✗ **C)** a liability.

Explanation

The recommended analyst treatment of deferred tax liabilities is to treat them as liabilities if they are expected to reverse or as equity if they are not expected to reverse.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #26 of 143

Question ID: 414545

A firm buys an asset with an estimated useful life of five years for $100,000 at the beginning of the year. The firm will depreciate the asset on a straight-line basis with no salvage value on its financial statements and will use double declining balance depreciation for tax. The tax basis for this asset at the end of the first year is *closest* to:

- ✗ **A)** \$40,000.
- ✗ **B)** \$80,000.
- ✓ **C)** \$60,000.

Explanation

For tax, the asset's basis is reduced by the DDB depreciation (2/5 × 100,000 = 40,000) from \$100,000 to \$60,000.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS

Question #27 of 143

Question ID: 414576

Which of the following statements *best* justifies analyst scrutiny of valuation allowances?

- ✓ **A)** Changes in valuation allowances can be used to manage reported net income.
- ✗ **B)** Increases in valuation allowances may be a signal that management expects earnings to improve in the future.
- ✗ **C)** If differences in taxable and pretax incomes are never expected to reverse, a company's equity may be understated.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. Changes in the valuation allowance have a direct impact on reported income. Because management has discretion with regard to the amount and timing of a valuation allowance, changes in the valuation allowance give management significant opportunity to manage earnings.

References

Question From: Session 8 > Reading 30 > LOS g

Related Material:

- Key Concepts by LOS

Question #28 of 143

Question ID: 414581

While evaluating the financial statements of Omega, Inc., the analyst observes that the effective tax rate is 7% less than the statutory rate. The source of this difference is determined to be a tax holiday on a manufacturing plant located in South Africa. This item is *most* likely to be:

- ✗ **A)** sporadic in nature, but the effect is typically neutralized by higher home country taxes on the repatriated profits.
- ✓ **B)** sporadic in nature, and the analyst should try to identify the termination date and determine if taxes will be payable at that time.
- ✗ **C)** continuous in nature, so the termination date is not relevant.

Explanation

As the name suggests, a tax holiday is usually a temporary exemption from having to pay taxes in some tax jurisdiction. Because of the temporary nature, the key issue for the analyst is to determine when the holiday will terminate, and how the termination will affect taxes payable in the future.

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #29 of 143

Question ID: 414598

On December 31, 2004, Newberg, Inc. issued 5,000 $1,000 face value seven percent bonds to yield six percent. The bonds pay interest semi-annually and are due December 31, 2011. On its December 31, 2005, income statement, Newburg should report interest expense of:

- ✗ **A)** $300,000.
- ✗ **B)** $350,000.
- ✓ **C)** $316,448.

Explanation

Newberg, upon issuance of the bonds, recorded bonds payable of N = 2 × 7 = 14, PMT = $175,000, I/Y = 6/2 = 3, FV = $5,000,000, CPT PV = $5,282,402. Interest expense June 30, 2005, was $5,282,402 × (0.06 / 2) = $158,472. The coupon payment was $175,000, reducing bonds payable to $5,282,402 - ($175,000 - $158,472) = $5,265,874. Interest expense December 31, 2005, was $5,265,874 × (0.06 / 2) = $157,976. Total interest expense in 2005 was $158,472 + $157,976 = $316,448.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #30 of 143

Question ID: 414550

Unit Technologies uses accrual basis for financial reporting purposes and cash accounting for tax purposes. So far this year, Unit Technologies has recorded $195,000 in revenue for financial reporting purposes, but, on a cash basis, revenue was only $131,000. Assume expenses at 50 percent in both cases (i.e., $ 97,500 on accrual basis and $ 65,500 on cash basis), and a tax rate of 34%. What is the deferred tax liability or asset? A deferred tax:

- ✗ **A)** asset of $10,880.
- ✓ **B)** liability of $10,880.
- ✗ **C)** liability of $16,320.

Explanation

Since pretax income ($97,500) exceeds the taxable income ($65,500), United Technologies will have a deferred tax liability of $10,880 = [($97,500 − $65,500)(0.34)]

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #31 of 143

Question ID: 414608

Which of the following statements for a bond issued with a coupon rate above the market rate of interest is *least* accurate?

- ✓ **A)** The value of the bond will be amortized toward zero over the life of the bond.
- ✗ **B)** The bond will be shown on the balance sheet at the premium value.
- ✗ **C)** The associated interest expense will be lower than that implied by the coupon rate.

Explanation

The value of the bond's premium will be amortized toward zero over the life of the bond, not the value of the bond.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #32 of 143

Question ID: 414623

Compared to a finance lease, an operating lease is *most likely* to be favored when:

- ✗ **A)** management compensation is not based on returns on invested capital.

✓ **B)** the lessee has bond covenants relating to financial policies.

✗ **C)** at the end of the lease, the lessee may be better able to sell the asset than the lessor.

Explanation

If the lessee has bond covenants (e.g., debt-to-equity ratio) relating to its financial policies that it must follow, it is best to have an operating lease due to the fact that the operating lease will keep the asset off of the balance sheet resulting in less liabilities.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #33 of 143

Question ID: 485781

A health care company purchased a new MRI machine on 1/1/X3. At year-end the company recorded straight-line depreciation expense of $75,000 for book purposes and accelerated depreciation expense of $94,000 for tax purposes. Management estimates warranty expense related to corrective eye surgeries performed in 20X3 to be $250,000. Actual warranty expenses of $100,000 were incurred in 20X3 related to surgeries performed in 20X2. The company's tax rate for the current year was 35%, but a tax rate of 37% has been enacted into law and will apply in future periods. Assuming these are the only relevant entries for deferred taxes, the company's recorded changes in deferred tax assets and liabilities on 12/31/X3 are *closest to*:

	DTA	DTL
✓ **A)**	$55,500	$7,030
✗ **B)**	$55,500	$6,650
✗ **C)**	$52,500	$6,650

Explanation

DTL = (tax depreciation - financial statement depreciation) × future tax rate
= ($94,000 - $75,000) × 37% = $7,030.

DTA = (estimated warranty expense − actual warranty expense) × future tax rate
= ($250,000 − $100,000) × 37% = $55,500.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #34 of 143

Question ID: 434312

A company issues an annual-pay bond with the following characteristics:

Face value	$67,831
Maturity	4 years
Coupon	7%
Market interest rates	8%

What is the unamortized discount at the end of the first year?

- ✓ **A)** $1,750.
- ✗ **B)** $1,209.
- ✗ **C)** $538.

Explanation

Face value of bonds = $67,831
Proceeds from bond sale: I/Y = 8; N = 4; PMT = $67,831 × 0.07 = $4,748.17; FV = $67,831; CPT PV = $65,582
Unamortized discount at issuance = $67,831 − $65,582 = $2,249.

First year interest expense = $65,582 × 0.08 =$5,247
Coupon payment = $67,831 × 0.07 = $4,748
Change in discount = $5,247 − $4,748 = $499
Unamortized discount at end of first year = $2,249 − $499 = $1,750.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #35 of 143

Question ID: 414651

Other things equal, and ignoring issuance costs, a firm that raises cash by issuing a new bond is *most likely* to:

- ✗ **A)** increase its leverage ratios and increase its coverage ratios.
- ✓ **B)** increase its leverage ratios and decrease its coverage ratios.
- ✗ **C)** decrease its leverage ratios and increase its coverage ratios.

Explanation

Leverage ratios will increase because debt increases while equity remains unchanged, and (assuming equity is positive) debt increases proportionally by more than assets. Coverage ratios decrease because interest payments increase while EBIT is unchanged.

References

Question From: Session 8 > Reading 31 > LOS k

Related Material:

- Key Concepts by LOS

Question #36 of 143

Question ID: 414556

Year ending 31 December:	*2002*	*2003*	*2004*
Income Statement:			
Revenues after all expenses other than depreciation	$200	$300	$400
Depreciation expense	50	50	50
Income before income taxes	$150	$250	$350
Tax return:			
Taxable income before depreciation expense	$200	$300	$400
Depreciation expense	75	50	25
Taxable income	$125	$250	$375

Assume an income tax rate of 40% and zero deferred tax liability on 31 December 2001.

The deferred tax liability to be shown in the 31 December 2003, balance sheet and the 31 December 2004 balance sheet, is:

	2003	2004
✗ **A)**	$0	$10
✓ **B)**	$10	$0
✗ **C)**	$25	$20

Explanation

First, for 2003, remember that the deferred tax liability (DTL) is cumulative so, it includes the balance from prior years, (assume 2002 in this example since we have no other information).

DTL cumulative = (tax return depreciation - financial statement depreciation) × tax rate + DTL from previous year

- DTL for 2002: (75 - 50) × 0.4 + 0 = 10
- DTL for 2003: (50 - 50) × 0.4 + 10 = 10
- DTL for 2004: (25 - 50) × 0.4 + 10 = 0

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #37 of 143

Question ID: 498761

For a company which owns a majority of the equity of a subsidiary, whether to create a deferred tax liability for undistributed profits from the subsidiary depends on an "indefinite reversal criterion" under:

- ✗ **A)** IFRS, but not U.S. GAAP.
- ✗ **B)** both IFRS and U.S. GAAP.
- ✓ **C)** U.S. GAAP, but not IFRS.

Explanation

Undistributed profits from a subsidiary do not require the creation of a deferred tax liability under U.S. GAAP if the subsidiary meets the indefinite reversal criterion. For IFRS, there are circumstances where a DTL is not created but the test for this treatment is not called or equivalent to the indefinite reversal criterion detailed in U.S. GAAP.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #38 of 143

Question ID: 414562

Selected information from Kentucky Corp.'s financial statements for the year ended December 31 was as follows (in $ millions):

Property, Plant & Equip.	10	Deferred Tax Liability	0.6
Accumulated Depreciation	(4)		

The balances were all associated with a single asset. The asset was permanently impaired and has a present value of future cash flows of $4 million. After Kentucky writes down the asset, Kentucky's tax accounts will be affected as follows (the tax rate is 40%):

- ✗ **A)** deferred tax liability will be eliminated and deferred tax assets will increase $1.4 million.
- ✗ **B)** taxes payable will decrease $800,000.
- ✓ **C)** deferred tax liability will be eliminated and deferred tax assets will increase $200,000.

Explanation

A permanently impaired asset must be written down to the present value of its future cash flows. The asset's carrying value of ($10 − $4 =) $6 million must be reduced by $2 million to $4 million. An impaired value write-down reduces net income for accounting purposes, but not for tax purposes until the asset is sold or disposed of, so taxes payable do not decrease. At a 40% tax rate, the eventual writedown for tax purposes of $2 million will cause $800,000 of changes in deferred tax items. The $600,000 deferred tax liability associated with this asset is eliminated and a deferred tax asset of $200,000 is established.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #39 of 143

Question ID: 414647

The present value of benefits earned during the current period by participants in a defined benefit pension plan is *best* described as the plan's:

✓ **A)** service cost.

✗ **B)** past service cost.

✗ **C)** net pension liability.

Explanation

Service cost refers to the benefits earned in the current period by a defined benefit plan's participants. Past service costs are benefits awarded retroactively when a plan is initiated or changed. Net pension liability or net pension asset is the difference between the fair value of a defined benefit plan's assets and the firm's estimated obligation to pay benefits.

References

Question From: Session 8 > Reading 31 > LOS j

Related Material:

- Key Concepts by LOS

Question #40 of 143

Question ID: 414641

The Mader Corporation leases an asset for five years with lease payments of $10,000 per year. If Mader classifies the lease as a finance lease, which financial statements are affected at the end of the first year?

✗ **A)** Income statement only.

✗ **B)** Income statement and balance sheet only.

✓ **C)** Statement of cash flows, income statement, and balance sheet.

Explanation

The classification of a lease as a finance lease creates an asset, a debt obligation, financing cash flows (amortization of the loan), and operating cash flows (interest expense).

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #41 of 143

Question ID: 434306

A company purchased a new pizza oven for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the deferred tax liability as of the end of year three?

- ✗ **A)** $1,029.
- ✗ **B)** $780.
- ✓ **C)** $2,079.

Explanation

For tax purposes the machine is 100% depreciated at the end of year three, while for financial reporting it is only 60% depreciated.
The difference in depreciation is $12,676 × (1.00 − 0.60) = $5,070.
Deferred tax liability = difference in depreciation × tax rate = $5,070 × 0.41 = $2,079.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #42 of 143

Question ID: 414536

If timing differences that give rise to a deferred tax liability are not expected to reverse then the deferred tax:

- ✗ **A)** must be reduced by a valuation allowance.
- ✓ **B)** should be considered an increase in equity.
- ✗ **C)** should be considered an asset or liability.

Explanation

If deferred tax liabilities are expected to reverse in the future, then they should be classified as liabilities. If, however, they are not expected to reverse in the future, then they should be classified as equity.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #43 of 143

Question ID: 414636

If a lease is treated as a finance lease, as compared to being treated as an operating lease, the effect on the lessee's current ratio and the debt/equity ratio will be an:

	Current Ratio	Debt/Equity Ratio
✗ **A)**	Increase	Decrease
✗ **B)**	Increase	Increase
✓ **C)**	Decrease	Increase

Explanation

With finance leases the lessee's assets, current liabilities, and long-term liabilities will be greater than if the lease was an operating lease. With the debt to equity ratio, the liability is in the numerator, which results in an increase in the ratio. With the current ratio, current liabilities are increased and are in the denominator which results in a decrease in the ratio.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #44 of 143

Question ID: 414646

Which of the following is *least likely* disclosed in the financial statement footnotes of a lessee?

- ✗ **A)** A general description of the leasing arrangement.
- ✓ **B)** The lease interest rate.
- ✗ **C)** The lease payments to be paid in each of the next five years.

Explanation

The interest rate used by the lessee is not a required disclosure.

References

Question From: Session 8 > Reading 31 > LOS i

Related Material:

- Key Concepts by LOS

Question #45 of 143

Question ID: 414558

The Puchalski Company reported the following:

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income before taxes	$1,000	$1,000	$900	$800
Taxable income	$800	$900	$900	$1,000

Puchalski has no deferred tax asset or liability prior to Year 1. If the tax rate is 40%, what is the amount of the deferred tax asset or liability reported at the end of Year 3?

- ✓ **A)** Liability of $120.
- ✗ **B)** Asset of $120.
- ✗ **C)** Asset of $80.

Explanation

	Year 1	*Year 2*	*Year 3*
Income tax expense	$400	$400	$360
Taxes paid	$320	$360	$360
Deferred tax liability	$80	$120	$120

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #46 of 143

Question ID: 414615

Larry Purcell, an entry-level fixed income analyst at Knowlton & Smeades LLC, was discussing debt covenants with his supervisor, Andy Holzman. During the meeting Purcell made the following statements regarding bond covenants:

Statement 1: If a firm violates any of its debt covenants, the company will immediately go into bankruptcy and the creditors of the firm will take over the liquidation of its assets.

Statement 2: Debt covenants are important in evaluating a firm's credit risk and to better understand how the restrictions of the covenants can affect the firm's growth prospects and choice of accounting policies.

With respect to these statements:

- ✗ **A)** both are correct.
- ✓ **B)** only one is correct.
- ✗ **C)** both are incorrect.

Explanation

Lenders and other creditors use debt covenants in their lending agreements to restrict the activities of the debtor that could adversely impact the creditors' position. If any bond covenant is violated, the firm is in technical default on its debt. The creditors can demand payment of the debt, however, the terms are generally renegotiated. As such, the company does not automatically enter into bankruptcy and have its assets liquidated by the creditors.

References

Question From: Session 8 > Reading 31 > LOS d

Related Material:

- Key Concepts by LOS

Question #47 of 143

Question ID: 498763

A debt covenant is *most likely* to restrict a firm from:

- ✗ **A)** decreasing its common dividends.
- ✗ **B)** issuing new common shares.
- ✓ **C)** repurchasing common shares.

Explanation

Debt covenants exist to protect creditors. Repurchasing common shares is a use of cash that rewards equity investors but might harm creditors by reducing the firm's solvency. Decreasing dividends or issuing new shares would increase the cash available to repay creditors.

References

Question From: Session 8 > Reading 31 > LOS d

Related Material:

- Key Concepts by LOS

Question #48 of 143

Question ID: 414566

Given the following data regarding two firms under different scenarios, determine the amount of any deferred tax liability or asset.

> Firm 1:
>
> | *Tax Reporting* | | *Financial Reporting* | |
> |---|---|---|---|
> | Revenue | $500,000 | Revenue | $500,000 |
> | Depreciation | $100,000 | Depreciation | $50,000 |
> | Taxable income | $400,000 | Pretax income | $450,000 |

Taxes payable	$160,000	Tax expense	$180,000
Net income	$240,000	Net income	$270,000

Firm 2:

Tax Reporting		*Financial Reporting*	
Revenue	$500,000	Revenue	$500,000
Warranty expense	$0	Warranty expense	$10,000
Taxable income	$500,000	Pretax income	$490,000
Taxes payable	$200,000	Tax expense	$196,000
Net income	$300,000	Net income	$294,000

	Firm 1 Deferred Tax:	Firm 2 Deferred Tax:
✗ **A)**	$20,000 Asset	$6,000 Liability
✗ **B)**	$30,000 Asset	$6,000 Asset
✓ **C)**	$20,000 Liability	$4,000 Asset

Explanation

A deferred tax liability and asset is created when an income or expense item is treated differently on financial statements than it is on the company's tax returns.

A deferred tax liability is when that difference results in greater tax expense on the financial statements than taxes payable on the tax return.

The deferred tax liability for firm 1 = $180,000 tax expense - $160,000 taxes payable = $20,000

A deferred tax asset is when that difference results in lower taxes payable on the financial statements than on the tax return.

The deferred tax asset for firm 2 = $200,000 taxes payable - $196,000 tax expense = $4,000

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #49 of 143

Question ID: 414628

Which of the following statements about the impact of leases on the financial statements of the lessee is *least* accurate?

- ✗ **A)** Net income is lower in the early years of a finance lease than an operating lease.
- ✓ **B)** Cash flow from investing is higher for a finance lease than an operating lease.
- ✗ **C)** A finance lease results in higher liabilities compared to an operating lease.

Explanation

Cash flow from investing is *not* affected by a lease being either a finance or an operating lease. Finance leases reduce cash flow from operations by only the portion of the lease payment attributed to interest expense. Cash flow from financing is reduced by the rest of the finance lease payment which is the principal part of the payment.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #50 of 143

Question ID: 485783

A company issues 5% semiannual coupon, 3-year, $1,000 par value bonds on January 1, 20X0, when the market interest rate is 13.3%. The sale proceeds are $800. Under the effective interest rate method, what amount of interest expense per $1,000 par value will the company record for the year ending December 31, 20X1?

- ✓ **A)** $116.29.
- ✗ **B)** $106.40.
- ✗ **C)** $66.29.

Explanation

Based on a semiannual interest rate of 6.65% (13.30% / 2):

Period	Interest Expense	Coupon Payment	Discount Amortization	Bond Carrying Value
0	0.00			$800.00
1	53.20	25.00	28.20	828.20
2	55.08	25.00	30.08	858.28
3	**57.08**	25.00	32.08	890.36
4	**59.21**	25.00	34.21	$924.57

Interest expense for Year 2 is $57.08 + $59.21 = $116.29.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #51 of 143

Question ID: 414644

Which of the following statements regarding finance and operating leases is *least* accurate?

- ✗ **A)** During the life of an operating lease, the rent expense equals the lease payment.
- ✓ **B)** For financial reporting of finance and operating leases, no entry is required on the lessee's balance sheet at the inception of the lease.
- ✗ **C)** Asset turnover is higher for the lessee with an operating lease than a finance lease.

Explanation

If the lease is an operating lease there is no entry made on the balance sheet for the lessee. For finance leases, the leased asset and liability are recognized on the balance sheet by the amount equal to the present value of the minimum lease payments using as the discount rate the lower of the lessor's implicit rate or the lessee's incremental borrowing rate.

References

Question From: Session 8 > Reading 31 > LOS i

Related Material:

- Key Concepts by LOS

Question #52 of 143

Question ID: 414610

On December 31, 20X3 Okay Company issued 10,000 $1000 face value 10-year, 9% bonds to yield 7%. The bonds pay interest semi-annually. On its financial statements (prepared under U.S. GAAP) for the year ended December 31, 20X4, the effect of this bond on Okay's cash flow from operations is:

- ✗ **A)** -$700,000.
- ✗ **B)** -$755,735.
- ✓ **C)** -$900,000.

Explanation

The coupon payment is a cash outflow from operations. ($10,000,000 × 0.09) = $900,000.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #53 of 143

Question ID: 414575

Which of the following situations will *most likely* require a company to record a valuation allowance on its balance sheet?

✗ **A)** A firm has differences between taxable and pretax income that are never expected to reverse.

✗ **B)** To report depreciation, a firm uses the double-declining balance method for tax purposes and the straight-line method for financial reporting purposes.

✓ **C)** A firm is unlikely to have future taxable income that would enable it to take advantage of deferred tax assets.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. If a firm is unlikely to have future taxable income, it would be unlikely to ever use its deferred tax assets, and therefore must record a valuation allowance.

References

Question From: Session 8 > Reading 30 > LOS g

Related Material:

- Key Concepts by LOS

Question #54 of 143

Question ID: 434304

A company purchased a new pizza oven for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the tax payable for year one?

✗ **A)** $1,909.

✓ **B)** $1,130.

✗ **C)** $779.

Explanation

Tax payable for year 1 is = [$7,192 − ($12,676 × 0.35)] × 0.41 = $1,130.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #55 of 143

Question ID: 414583

Year:	*2002*	*2003*	*2004*
Income Statement:			
Revenues after all expenses other than depreciation	$200	$300	$400
Depreciation expense	50	50	50
Income before income taxes	$150	$250	$350
Tax return:			
Taxable income before depreciation expense	$200	$300	$400
Depreciation expense	75	50	25
Taxable income	$125	$250	$375

Assume an income tax rate of 40%.

The company's income tax expense for 2002 is:

- ✓ **A)** $60.
- ✗ **B)** $0.
- ✗ **C)** $50.

Explanation

Effective tax rate = Income tax expense / pretax income

Income tax expense = Effective tax rate × pretax income

= $150(0.40)

= $60

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #56 of 143

Question ID: 414616

Which of the following provisions would *least likely* be included in the bond covenants? The borrower must:

- ✗ **A)** maintain insurance on the collateral that secures the bond.
- ✓ **B)** maintain a debt-to-equity ratio of no less than 2:1.
- ✗ **C)** not increase dividends to common shareholders while the bonds are outstanding.

Explanation

A lender wants to prohibit the borrower from becoming more leveraged. This can be done by requiring a leverage ratio that is no more than a specified amount. Reducing leverage would be beneficial to the lender by lowering risk.

References

Question From: Session 8 > Reading 31 > LOS d

Related Material:

- Key Concepts by LOS

Question #57 of 143

Question ID: 414535

Which of the following *best* describes valuation allowance? Valuation allowance is a reserve:

✗ **A)** created when deferred tax assets are greater than deferred tax liabilities.

✗ **B)** against deferred tax liabilities based on the likelihood that those liabilities will be paid.

✓ **C)** against deferred tax assets based on the likelihood that those assets will not be realized.

Explanation

Valuation allowance is a reserve against deferred tax assets based on the likelihood that those assets will not be realized. Deferred tax assets reflect the difference in tax expense and taxes payable that are expected to be recovered from future operations.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #58 of 143

Question ID: 434300

An analyst has gathered the following tax information:

	Year 1	*Year 2*
Pretax Income	$60,000	$60,000
Taxable Income	$50,000	$65,000

The current tax rate is 40%. Assume the tax rate is reduced to 30% and the change is enacted at the beginning of Year 2.

In year 1, what are the taxes payable and what is the deferred tax liability (DTL)?

	Taxes payable	DTL
✓ **A)**	$20,000	$3,000
✗ **B)**	$24,000	$1,500

✗ **C)** $20,000 $1,500

Explanation

Taxes payable = taxable income × current tax rate = $50,000 × 40% = $20,000.
Taxes payable will be based on the current tax rate of 40%.

DTL = (pretax income − taxable income) × 30%
= ($60,000 − 50,000) × 30% = $3,000.
Deferred tax assets and liabilities must reflect the impact of a change in tax rates or tax laws.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #59 of 143

Question ID: 460647

A firm needs to adjust its financial statements for a change in the tax rate. Taxable income is $80,000 and pretax income is $120,000. The current tax rate is 50%, and the new tax rate is 40%. The effect on taxes payable of adjusting the tax rate is *closest to*:

✗ **A)** $4,000.
✓ **B)** $8,000.
✗ **C)** $16,000.

Explanation

"Pretax income" denotes earnings before taxes for financial reporting. "Taxable income" is earnings before taxes for computing taxes payable, where taxes payable refers to the actual tax liability to the government. Since taxable income is $80,000, the difference in taxes payable is ($80,000)(0.5) - ($80,000)(0.4) = $8,000.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #60 of 143

Question ID: 414645

Classifying a lease as an operating lease for a lessee, as opposed to a finance lease, will result in:

	Current Ratio	Debt/Equity Ratio	Asset Turnover Ratio
✗ **A)**	Lower	Lower	Higher
✓ **B)**	Higher	Lower	Higher
✗ **C)**	Higher	Lower	Lower

Explanation

For a lessee using operating leases, the current ratio will be higher, the debt/equity ratio will be lower, and the asset turnover will be higher than they would be with finance leases. With operating leases, assets and liabilities are lower.

References

Question From: Session 8 > Reading 31 > LOS i

Related Material:

- Key Concepts by LOS

Question #61 of 143

Question ID: 414553

A firm purchased a piece of equipment for $6,000 with the following information provided:

- Revenue will increase by $15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining balance is used for tax purposes.

Calculate the incremental income tax expense for financial reporting for years 1 and 2.

	Year 1	Year 2
✗ **A)**	$600	-$200
✗ **B)**	$3,300	$4,100
✓ **C)**	$3,900	$3,900

Explanation

Using SL:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000

Dep.	2,000	2,000
Pretax income	13,000	13,000
Tax Expense	3,900	3,900

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #62 of 143

Question ID: 414617

In analyzing disclosures related to the financing liabilities of a company, which of the following disclosures would be *least* helpful to the analyst?

✓ **A)** The present value of the future bond payments discounted at the coupon rate of the bonds.

✗ **B)** The interest expense for the period as provided on the income statement or in a footnote.

✗ **C)** Filings with the Securities and Exchange Commission (SEC) that disclose all outstanding securities and their features.

Explanation

When analyzing disclosures related to financing liabilities, analysts would review the balance sheet and find the present value of the promised future liability payments. These payments would then be discounted at the rate in effect at issuance (i.e., the yield to maturity), not the coupon rate of the bonds.

References

Question From: Session 8 > Reading 31 > LOS e

Related Material:

- Key Concepts by LOS

Question #63 of 143

Question ID: 414631

In a direct-financing lease, the implicit rate is such that the present value of the minimum lease payments:

✗ **A)** is lower than the cost of the leased asset.

✓ **B)** equals the cost of the leased asset.

✗ **C)** equals the sale price of the leased asset.

Explanation

In a direct-financing lease, the implicit rate is such that the present value of the MLPs equals the cost of the leased asset. Thus, at lease inception the total assets do not change and no gain is recognized.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #64 of 143

Question ID: 434311

An firm is issuing a bond with the following characteristics:

- Face value = $10.0 million
- Annual coupon = 5.6%
- Market yield at issuance = 6.5%
- 5 year maturity

Ignoring flotation costs, at issuance the bond will increase:

✗ **A)** liabilities by $10.0 million.

✓ **B)** assets by $9.626 million.

✗ **C)** cash flow from investing by $9.626 million.

Explanation

Proceeds raised are the present value of the bond: FV = 10,000,000; PMT = 560,000; I/Y = 6.5; N = 5; CPT PV = 9,625,989. At issuance, the firm will receive cash flow from *financing* of $9.626 million. Assets (cash) and liabilities (long-term debt) will increase by this amount.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #65 of 143

Question ID: 414597

Interest expense is reported on the income statement as a function of:

✗ **A)** the unamortized bond discount.

✓ **B)** the market rate.

✗ **C)** the coupon payment.

Explanation

Interest expense is always equal to the book value of the bond at the beginning of the period multiplied by the market rate at issuance.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #66 of 143

Question ID: 414648

An employer offers a defined benefit pension plan and a defined contribution pension plan. The employer's balance sheet is *most likely* to present an asset or liability related to:

- ✗ **A)** both of these pension plans.
- ✓ **B)** the defined benefit plan.
- ✗ **C)** the defined contribution plan.

Explanation

Only a defined benefit plan has a funded status that would appear on the balance sheet as an asset or liability. Employer payments into a defined contribution plan are recognized as expenses in the period incurred.

References

Question From: Session 8 > Reading 31 > LOS j

Related Material:

- Key Concepts by LOS

Question #67 of 143

Question ID: 456302

Samson Therapeutics records all leases as operating leases. Compared to recording capital leases, this results in lower:

- ✗ **A)** inventory.
- ✓ **B)** leverage.
- ✗ **C)** expenses.

Explanation

Finance (capital) leases are recorded on the balance sheet, and by recording all leases as operating leases, the company can reduce its leverage. Lease accounting has no effect on inventory. "Expenses" is not the best answer as operating leases will result in higher expenses in the later years relative to the finance (capital) lease.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #68 of 143

Question ID: 414630

According to U.S. GAAP, which of the following would *least likely* require a lessee to capitalize a lease?

- ✗ **A)** The lease term is 75% or more of the estimated life of the leased asset.
- ✗ **B)** The present value of the minimum lease payments is 90% or more of the fair value of the leased asset.
- ✓ **C)** The lessee has an option to purchase the asset for its fair market value at the end of the lease.

Explanation

Under U.S. GAAP, a lease must be capitalized if it contains a bargain purchase option, not just a purchase option.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #69 of 143

Question ID: 414559

Graphics, Inc. has a deferred tax asset of $4,000,000 on its books. As of December 31, it became more likely than not that $2,000,000 of the asset's value may never be realized because of the uncertainty of future income. Graphics, Inc. should:

- ✗ **A)** reverse the asset account permanently by $2,000,000.
- ✗ **B)** not make any adjustments until it is certain that the tax benefits will not be realized.
- ✓ **C)** reduce the asset by establishing a valuation allowance of $2,000,000 against the asset.

Explanation

If it becomes more likely than not that deferred tax assets will not be fully realized, a valuation allowance that reduces the asset and also reduces income from continuing operations should be established.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #70 of 143

Question ID: 414629

Which of the following is *least likely* one of the criteria under U.S. GAAP for classifying a lease as a finance lease? The:

- ✗ **A)** lease contains a bargain purchase option.
- ✗ **B)** term of the lease is 75% or more of the estimated economic life of the leased property.
- ✓ **C)** lessor retains ownership of the property at the end of the lease term.

Explanation

If the lease transfers ownership of the property to the lessee at the end of the lease term, the lessee will classify the lease as a finance lease.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #71 of 143

Question ID: 414605

Which of the following statements is *least* accurate? When a bond is issued at a discount:

- ✗ **A)** the interest expense will increase over time.
- ✓ **B)** cash flows from financing will be increased by the par value of the bond issue.
- ✗ **C)** the interest expense will be equal to the coupon payment plus the amortization of the discount.

Explanation

Upon issuance, cash flow from financing will be increased by the amount of the proceeds.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #72 of 143

Question ID: 414589

Proceeds from issuing a bond are recorded on the statement of cash flows as an inflow from:

- ✗ **A)** investing (CFI).
- ✓ **B)** financing (CFF).
- ✗ **C)** operations (CFO).

Explanation

Cash from financing (CFF) is increased by the amount of the proceeds.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #73 of 143

Question ID: 414588

Assuming all else equal, if the coupon rate offered on a bond is less than the corresponding market rate of interest, the bond will be issued at:

- ✗ **A)** par.
- ✓ **B)** a discount.
- ✗ **C)** a premium.

Explanation

If the coupon rate is less than the market rate, the bond must be sold at a discount so the effective rate on the bond equals the market rate.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #74 of 143

Question ID: 434310

A company issues an annual-pay bond with a face value of $135,662, maturity of 4 years, and 7% coupon, while market interest rates for its bonds are 8%. What is the unamortized discount at the end of the first year?

- ✗ **A)** $1,209.
- ✗ **B)** $538.
- ✓ **C)** $3,495.

Explanation

Face value of bonds = $135,662.

Proceeds from bond sale: I/Y = 8.00%; N = 4; PMT = $135,662 × 0.07 = $9,496.34; FV = $135,662; CPT PV = $131,169

Unamortized discount at issuance = $135,662 − $131,169 = $4,493.

First year interest expense = $131,169 × 0.08 = $10,494.

Coupon payment = $135,662 × 0.07 = $9,496.

Change in discount = $10,494 − $9,496 = $998.

Discount at the end of first year = $4,493 − $998 = $3,495.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #75 of 143

Question ID: 414586

A tax rate that has been substantively enacted is used to determine the balance sheet values of deferred tax assets and deferred tax liabilities under:

✓ **A)** IFRS only.

✗ **B)** U.S. GAAP only.

✗ **C)** both IFRS and U.S. GAAP.

Explanation

Under IFRS, a tax rate that has been enacted or substantively enacted is used to measure deferred tax items. Under U.S. GAAP, only a tax rate that has actually been enacted can be used.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #76 of 143

Question ID: 434308

Christophe Inc. is an electronics manufacturing firm. It owns equipment with a tax basis of $800,000 and a carrying value of $600,000 as the result an impairment charge. It also has a tax loss carryforward of $300,000 that is expected to be utilized within the next year or two. The tax rate on these items is 40% but the tax rate will decrease to 35%. Which of the following is *closest to* the effect on the income statement of the change in tax rate?

✗ **A)** Decrease income tax expense by $5,000.

✓ **B)** Increase income tax expense by $25,000.

✗ **C)** Increase income tax expense by $5,000.

Explanation

The $200,000 difference between the tax base and the carrying value of the equipment gives rise to a deductible temporary difference that leads to a deferred tax asset (DTA) of $80,000 ($200,000 × 40%). The tax loss carryforward of $300,000 also leads to a DTA but for $120,000 ($300,000 × 40%).

The decrease in the tax rate from 40% to 35% will reduce the DTA of the equipment by $10,000 ($200,000 × 5%). It will reduce the DTA of the tax loss carryforward by $15,000 ($300,000 × 5%). In total, the DTA will decrease by $25,000. The decrease in the value of the DTA will increase income tax expense by $25,000 in the period when the DTA is decreased.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS

Question #77 of 143

Question ID: 414627

Which of the following statements that classify a lease as a finance lease under U.S. GAAP is *least* accurate?

- ✓ **A)** The present value of the lease payments is at least 80% of the fair market value of the asset.
- ✗ **B)** Title is transferred at the end of the lease period.
- ✗ **C)** A bargain purchase option exists.

Explanation

For a lease to be classified as a finance (capital) lease the present value of the lease payments must be at least 90% of the fair market value of the asset.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #78 of 143

Question ID: 485782

A firm has deferred tax assets of $315,000 and deferred tax liabilities of $190,000. If the tax rate increases, adjusting the value of the firm's deferred tax items will:

- ✓ **A)** decrease income tax expense.
- ✗ **B)** increase income tax expense.
- ✗ **C)** have no effect on income tax expense.

Explanation

An increase in the tax rate increases the values of both DTAs and DTLs. Because the firm's DTAs are greater than its DTLs, the net effect of adjusting their values for an increase in the tax rate will be to decrease income tax expense.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS

Question #79 of 143

Question ID: 414602

Nomad Company issued $1,000,000 face value 2-year zero coupon bonds on December 31, 20X2 to yield 8% interest. Bond proceeds were $857,339. In 20X3 Nomad recorded interest expense of $68,587. In 20X4 Nomad recorded interest expense of $74,074 and paid out $1,000,000 to redeem the bonds. Based on these transactions only, Nomad's Statement of Cash Flows would show cash flow from operations (CFO) of:

- ✓ **A)** zero in all years.
- ✗ **B)** -$142,661 in 20X4.
- ✗ **C)** -$68,587 in 20X3 and -$74,074 in 20X4.

Explanation

All of the cash flows for zero coupon bonds are included in cash flow from financing activities and none in cash flow from operations.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #80 of 143

Question ID: 414639

If a lessee enters into a finance lease rather than an operating lease, it can expect to have a:

- ✓ **A)** higher debt-to-equity ratio.
- ✗ **B)** lower debt-to-equity ratio.
- ✗ **C)** higher return on assets.

Explanation

Leasing the asset with an operating lease avoids recognition of the debt on the lessee's balance sheet. Having fewer assets and liabilities on the balance sheet than would exist if the assets were purchased increases profitability ratios (e.g., return on assets) and decreases leverage ratios (e.g., debt-to-equity ratio). In the case of a finance lease, the assets are reported on the balance sheet and are depreciated.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #81 of 143

Question ID: 652916

Permanent differences between taxable and pretax income:

✓ **A)** are considered as changes in the effective tax rate.

✗ **B)** can be deferred in some cases.

✗ **C)** are not addressed specifically in the financial statements.

Explanation

The permanent differences are never deferred but are considered increases or decreases in the effective tax rate. The financial statements include an effective tax rate reconciliation that addresses permanent differences between pretax and taxable income. If the only difference between the taxable and pretax incomes were a permanent difference, then tax expense would simply be taxes payable.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS

Question #82 of 143

Question ID: 414587

Under IFRS, deferred tax assets and deferred tax liabilities are classified on the balance sheet as:

✓ **A)** noncurrent items.

✗ **B)** current items.

✗ **C)** either current or noncurrent items.

Explanation

Under IFRS, deferred tax assets and liabilities are classified as noncurrent. Under U.S. GAAP, deferred tax items may be current or noncurrent, depending on how the underlying asset or liability is classified.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #83 of 143

Question ID: 414531

Which of the following statements about tax deferrals is NOT correct?

- ✗ **A)** A deferred tax liability is expected to result in future cash outflow.
- ✓ **B)** Taxes payable are determined by pretax income and the tax rate.
- ✗ **C)** Income tax paid can include payments or refunds for other years.

Explanation

Taxes payable are the taxes due to the government and are determined by taxable income and the tax rate. Note that pretax income is income before tax expense and is used for financial reporting. Taxable income is the income based upon IRS rules that determines taxes due and is used for tax reporting.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #84 of 143

Question ID: 598674

Assume a city issues a $5 million semiannual-pay bond to build a new arena. The bond has a coupon rate of 8% and will mature in 10 years. When the bond is issued its yield to maturity is 9%. Interest expense in the second semiannual period is *closest to:*

- ✗ **A)** $80,000.
- ✓ **B)** $210,830.
- ✗ **C)** $106,550.

Explanation

Step 1: Compute the proceeds raised (i.e., the present value of the bond): Since the yield is above the coupon rate the bond will be issued at a discount.

FV = $5,000,000; N = (10 × 2) = 20; PMT = (0.08 / 2)(5 million) = $200,000; I/Y = (9 / 2) = 4.5; CPT → PV = -$4,674,802

Step 2: Compute the interest expense at the end of the first period.

= (0.045)(4,674,802) = $210,366

Step 3: Compute the interest expense at the end of the second period.

= (new balance sheet liability)(current interest rate)

= $4,674,802 + $10,366 = $4,685,168 new balance sheet liability

(0.045)(4,685,168) = $210,833

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #85 of 143

Question ID: 414560

An analyst gathered the following information about a company:

- Taxable income = $100,000.
- Pretax income = $120,000.
- Current tax rate = 20%.
- Tax rate when the reversal occurs will be 10%.

What is the company's tax expense?

✓ **A)** $22,000.

✗ **B)** $24,000.

✗ **C)** $10,000.

Explanation

Deferred tax liability = (120,000 − 100,000) × 0.1 = 2,000

Tax expense = current tax rate × taxable income + deferred tax liability

0.2 × 100,000 + 2,000 = 22,000

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #86 of 143

Question ID: 434303

An analyst gathers the following data for Alice Company:

- Alice Company reported a pretax income of $400,000 in its income statement for the period ended December 31, 20X2.
- Included in its pretax income are: (1) interest received on tax-free municipal bonds $50,000 and (2) rent expense of $20,000. Only $10,000 was paid in cash for rent during 20X2.
- Alice follows cash basis for tax reporting.
- Alice's tax rate is 40%.

Based on the information provided, which of the following is *most* accurate with respect to deferred tax during 20X2? Alice's deferred tax:

✓ **A)** asset will increase by $4,000.
✗ **B)** will remain unchanged.
✗ **C)** liability will increase by $4,000.

Explanation

Because only $10,000 of the rent expense will be allowed for Alice's tax reporting, a deferred tax asset of $10,000 × 40% = $4,000 will result.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #87 of 143

Question ID: 414650

A firm is more solvent if it has:

✗ **A)** high leverage and coverage ratios.
✗ **B)** low leverage and coverage ratios.
✓ **C)** low leverage ratios and high coverage ratios.

Explanation

Low leverage ratios suggest the firm has relatively little debt compared to its equity and assets. High coverage ratios suggest the firm generates enough earnings to meet its interest payments.

References

Question From: Session 8 > Reading 31 > LOS k

Related Material:

- Key Concepts by LOS

Question #88 of 143

Question ID: 414632

For a finance lease, the amount recorded initially by the lessee as a liability will *most likely*:

- ✓ **A)** equal the present value of the minimum lease payments at the beginning of the lease.
- ✗ **B)** equal the total of the minimum lease payments.
- ✗ **C)** be less than the fair value of the leased asset.

Explanation

With a finance lease, both an asset and liability are reported on the lessee's balance sheet, with lease payments divided between interest and principal components. The future payments on principal and interest must be discounted to present value at the beginning of the lease.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #89 of 143

Question ID: 498764

A company has issued new 3-year bonds at par in each of the last five years. On the company's balance sheet, principal due on its bonds will appear as:

- ✗ **A)** long-term liabilities only.
- ✓ **B)** both current and long-term liabilities.
- ✗ **C)** current liabilities only.

Explanation

Bonds that will mature in the next year will appear on the balance sheet as "current portion of long-term debt," which is a current liability. Bonds that will mature later than the next year will appear as long-term debt.

References

Question From: Session 8 > Reading 31 > LOS e

Related Material:

- Key Concepts by LOS

Question #90 of 143

Question ID: 485784

Crawford Corp. and Vernon Corp. are lessors who have leased assets on identical terms to firms with similar credit ratings. Crawford reports its lease as a sales-type lease and Vernon reports its lease as a direct financing lease. It is *most likely* that:

- ✗ **A)** Crawford retains the leased asset on its balance sheet.
- ✓ **B)** both firms report under U.S. GAAP.
- ✗ **C)** Vernon reports under IFRS.

Explanation

For a lessor, under U.S. GAAP, a capital lease may be reported as either a sales-type or direct financing lease. This distinction is not made for a financing (capital) lease under IFRS.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #91 of 143

Question ID: 414611

At the beginning of 20X3, Creston Company issues $10 million face amount of 6% coupon bonds when the market rate of interest is 7%. The bonds mature in four years and pay interest annually. Assuming the effective interest rate method, what is the bond liability Creston will report at the end of 20X3?

- ✗ **A)** $9,661,279
- ✓ **B)** $9,737,568
- ✗ **C)** $10,346,511

Explanation

Under the effective interest rate method, the bond liability is equal to the present value of the remaining cash flows discounted at the market rate of interest at the issue date. At the end of this year, there are 3 annual payments of $600,000 and one payment of $10,000,000 remaining. Using your financial calculator, the present value is $9,737,568 (N = 3, I = 7, PMT = 600,000, FV = 10,000,000, Solve for PV).

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #92 of 143

Question ID: 414612

A firm can recognize a gain or loss on derecognition of a bond the firm has issued:

- ✗ **A)** either before maturity or at maturity.
- ✓ **B)** before maturity, but not at maturity.
- ✗ **C)** at maturity, but not before maturity.

Explanation

If a firm redeems a bond before maturity for a price that is different from the carrying value of the bond liability, the firm will recognize the difference as a gain or a loss. At maturity, the carrying value of the bond liability is equal to the face value of the bond, therefore the firm does not experience a gain or loss by repaying the face value.

References

Question From: Session 8 > Reading 31 > LOS c

Related Material:

- Key Concepts by LOS

Question #93 of 143

Question ID: 414546

Nespa, Inc., has a deferred tax liability on its balance sheet in the amount of $25 million. A change in tax laws has increased future tax rates for Nespa. The impact of this increase in tax rate will be:

- ✗ **A)** a decrease in deferred tax liability and an increase in tax expense.
- ✓ **B)** an increase in deferred tax liability and an increase in tax expense.
- ✗ **C)** a decrease in deferred tax liability and a decrease in tax expense.

Explanation

An increase in tax rates will increase future deferred tax liability, and the impact of the increase in liability will be reflected in the income statement of the year in which the tax rate change is effected.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #94 of 143

Question ID: 414565

A company purchases a new pizza oven for $12,675. It will work for 5 years and have no salvage value. The company will depreciate the oven over 5 years using the straight-line method for financial reporting, and over 3 years for tax reporting. If the tax rate for years 4 and 5 changes from 41% to 31%, the deferred tax liability as of the end of year 3 is *closest to:*

- ✓ **A)** $1,570
- ✗ **B)** $1,040
- ✗ **C)** $2,080

Explanation

At the end of year 3, the oven has a tax base of zero (it has been fully depreciated for tax reporting) and a carrying value on the balance sheet of $12,675 - 3(0.2)($12,675) = $5,070. The deferred tax liability, valued at the 31% tax rate that will apply when the temporary difference reverses, is ($5,070 - $0)(0.31) = $1,571.70.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #95 of 143

Question ID: 414544

Alter Inc. determines that it has $35,000 of accounts receivable outstanding at the end of 20X8. Based on past experience, it recognizes an allowance for bad debt equal to 10% of its credit sales. The tax base of Alter's accounts receivable at the end of 20X8 is *closest* to:

- ✓ **A)** $35,000.
- ✗ **B)** $3,500.
- ✗ **C)** $31,500.

Explanation

For tax purposes, bad debt expense cannot be deducted until the receivables are deemed worthless. Therefore, the tax base is $35,000 since no bad debt expense has been deducted on the tax return. Note that the carrying value would be $31,500 since bad debt expense is reflected on the income statement.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS

Question #96 of 143

Question ID: 414649

The difference between the fair value of a defined benefit pension plan's assets and its estimated benefit obligation is recognized:

- ✗ **A)** as an actuarial adjustment in other comprehensive income.
- ✗ **B)** on the income statement as pension expense.
- ✓ **C)** on the balance sheet as a net pension asset or liability.

Explanation

A net pension asset or net pension liability defined benefit plan is the difference between the fair value of the plan's assets and the estimated benefit obligation. A plan with a net pension asset is said to be overfunded, and a plan with a net pension liability is said to be underfunded.

References

Question From: Session 8 > Reading 31 > LOS j

Related Material:

- Key Concepts by LOS

Question #97 of 143

Question ID: 414618

Which of the following is *least likely* to be disclosed in the financial statements of a bond issuer?

- ✗ **A)** The amount of debt that matures in each of the next five years.
- ✓ **B)** The market rate of interest on the balance sheet date.
- ✗ **C)** Collateral pledged as security in the event of default.

Explanation

The market rate on the balance sheet date is not typically disclosed. The amount of principal scheduled to be repaid over the next five years and collateral pledged (if any) are generally included in the footnotes to the financial statements.

References

Question From: Session 8 > Reading 31 > LOS e

Related Material:

- Key Concepts by LOS

Question #98 of 143

Question ID: 627887

For a firm financed with common stock and long-term fixed-rate debt, an analyst should *most appropriately* adjust which of the following items for a change in market interest rates?

✓ **A)** Debt-to-equity ratio.

✗ **B)** Interest paid.

✗ **C)** Cash flow from financing.

Explanation

For the purpose of analysis, the value of debt should be adjusted for a change in interest rates. This will change the debt-to-equity ratio.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #99 of 143

Question ID: 500860

The primary purpose of bond covenants is to:

✗ **A)** clearly define the responsibilities of the borrower and the lender.

✓ **B)** protect bondholders from the actions of equity owners.

✗ **C)** define bond characteristics.

Explanation

The primary purpose of bond covenants is to protect bondholders from actions by the equity owners that would tend to reduce the value of their claims against the company. The other choices are purposes of a bond indenture.

References

Question From: Session 8 > Reading 31 > LOS d

Related Material:

- Key Concepts by LOS

Question #100 of 143

Question ID: 414620

Compared to a finance lease, an operating lease results in which of the following on the lessee's balance sheet?

✗ **A)** Higher liabilities.

✓ **B)** Lower liabilities.

✗ **C)** Higher assets.

Explanation

An operating lease results in an lower liabilities and lower assets compared to a finance lease. The lessee does not record an asset or liability on the balance sheet, but must disclose information about operating lease obligations in the financial statement notes. Lease payments are recognized as rental expense on the income statement.

References

Question From: Session 8 > Reading 31 > LOS f

Related Material:

- Key Concepts by LOS

Question #101 of 143

Question ID: 598978

Which of the following factors is *least likely* to cause a difference between a firm's effective tax rate and statutory rate?

- ✗ **A)** Tax credits.
- ✓ **B)** Deductible expenses.
- ✗ **C)** Non-deductible expenses.

Explanation

Permanent tax differences such as tax credits, non-deductible expenses, and tax differences between capital gains and operating income give rise to differences in the effective and statutory tax rates.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS

Question #102 of 143

Question ID: 414642

Which of the following statements regarding a direct financing lease is *least* accurate?

- ✗ **A)** The principal portion of the lease payment is a cash inflow from investing on the lessor's cash flow statement.
- ✗ **B)** The lessor recognizes no gross profit at the inception of the lease.
- ✓ **C)** Interest revenue on the lessor's income statement equals the implicit interest rate times the lease payment.

Explanation

Interest revenues are calculated by multiplying the implicit interest rate by net receivables at the beginning of the period.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #103 of 143

Question ID: 414537

Which of the following statements regarding deferred taxes is NOT correct?

- ✗ **A)** If deferred taxes are not expected to reverse in the future then they should be classified as equity.
- ✓ **B)** If deferred tax liabilities are not included in equity, debt-to-equity ratio will be reduced.
- ✗ **C)** Only those components of deferred tax liabilities that are likely to reverse should be considered a liability.

Explanation

When deferred tax liabilities are included in equity, it will reduce the debt-to-equity ratio (by increasing the denominator), in some cases considerably.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #104 of 143

Question ID: 598979

Deferred tax items should be measured based on the:

- ✗ **A)** statutory tax rate at the time when the temporary difference is recognized.
- ✗ **B)** firm's effective tax rate at the time when the temporary difference reverses.
- ✓ **C)** tax rate that will apply when the temporary difference reverses.

Explanation

Measurement of deferred tax items is based on the tax rate that will apply when the temporary difference reverses. In some cases this may depend on how a temporary difference is settled, which determines whether a capital gains tax rate or income tax rate will apply.

References

Question From: Session 8 > Reading 30 > LOS h

Related Material:

- Key Concepts by LOS

Question #105 of 143

Question ID: 414564

If a firm overestimates its warranty expenses, which of the following results is *least likely*?

- ✓ **A)** Income tax expense will be greater than taxes payable.
- ✗ **B)** A deferred tax asset will result.
- ✗ **C)** A timing difference will result between tax and financial reporting.

Explanation

Income tax expense will be less than taxes payable because the firm can only recognize warranty expense as they occur. Thus, if the warranty expenses are overestimated on the financial statements income tax expense will be less that taxes payable.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #106 of 143

Question ID: 414614

Ivo Company has a $10 million face value bond issue outstanding. These bonds include a call option that permits Ivo to redeem the bonds at any time for 101% of par. These bonds were issued at a premium and have a carrying value of $10,200,000. If Ivo calls the bonds, its income statement will reflect:

- ✗ **A)** a loss on redemption.
- ✗ **B)** neither a gain nor a loss on redemption.
- ✓ **C)** a gain on redemption.

Explanation

The firm can call the bonds for 101% of $10 million, or $10,100,000. Redeeming bonds for less than the carrying value of the bond liability results in a gain.

References

Question From: Session 8 > Reading 31 > LOS c

Related Material:

- Key Concepts by LOS

Question #107 of 143

Question ID: 414551

This year, Blue Horizon has recorded $390,000 in revenue for financial reporting purposes, but, on a cash basis, revenue was only $262,000. Assume expenses at 50% in both cases (i.e., $195,000 on accrual basis and $131,000 on cash basis), and a tax rate of 34%. What is the deferred tax liability or asset? A deferred tax:

- ✗ **A)** asset of $21,760.
- ✓ **B)** liability of $21,760.
- ✗ **C)** liability of $16,320.

Explanation

Since pretax income ($195,000) exceeds the taxable income ($131,000), Blue Horizon will have a deferred tax liability of $21,760 [($195,000 − $131,000)(0.34)].

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #108 of 143

Question ID: 414595

A $1,000 bond is issued with an 8% semiannual coupon rate and 5 years to maturity when market interest rates are 10%. What is the initial liability?

- ✗ **A)** 1023.
- ✗ **B)** 855.
- ✓ **C)** 923.

Explanation

FV = 1000; PMT = 80/2; N = 5 × 2; I/Y = 10/2; solve for PV = 923.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #109 of 143

Question ID: 414577

Which of the following statements *best* describes the impact of a valuation allowance on the financial statements? A valuation allowance:

- ✗ **A)** reduces reported income, increases liabilities, and reduces equity.
- ✗ **B)** increases reported income, reduces assets, and reduces equity.

✓ **C)** reduces reported income, reduces assets, and reduces equity.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. The establishment of a valuation allowance reduces reported income, offsets (reduces) assets, and reduces equity.

References

Question From: Session 8 > Reading 30 > LOS g

Related Material:

- Key Concepts by LOS

Question #110 of 143

Question ID: 414554

A firm purchased a piece of equipment for $6,000 with the following information provided:

- Revenue will increase by $15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining is used for tax purposes.

What will the firm report for deferred taxes on the balance sheet for years 1 and 2?

	Year 1	Year 2
✓ **A)**	$600	$400
✗ **B)**	$3,300	$4,100
✗ **C)**	$3,900	$3,900

Explanation

Using DDB:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Dep.	4,000	1,333
Taxable Inc	11,000	13,667
Taxes Pay	3,300	4,100

Using SL:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Dep.	2,000	2,000
Pretax Inc	13,000	13,000

Tax Exp 3,900 3,900

Deferred taxes year 1 = 3,900 - 3,300 = 600

Deferred taxes year 2 = 3,900 - 4,100 + previously deferred taxes = -200 + 600 = 400

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #111 of 143

Question ID: 414549

Kruger Associates uses an accrual basis for financial reporting purposes and cash basis for tax purposes. Cash collections from customers are $476,000, and accrued revenue is only $376,000. Assume expenses at 50% in both cases (i.e., $238,000 on cash basis and $188,000 on accrual basis), and a tax rate of 34%. What is the deferred tax asset or liability? A deferred tax:

✗ **A)** asset of $48,960.

✗ **B)** liability of $17,000.

✓ **C)** asset of $17,000.

Explanation

Since taxable income ($238,000) exceeds pretax income ($188,000), Kruger will have a deferred tax asset of $17,000 [($238,000 − $188,000)(0.34)].

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #112 of 143

Question ID: 434305

A company purchased a new pizza oven for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the deferred tax liability as of the end of year one?

- ✓ **A)** $780.
- ✗ **B)** $1,129.
- ✗ **C)** $1,909.

Explanation

Pretax Income = $7,192 − $2,535 = $4,657
Taxable Income = $7,192 − $4,437 = $2,755
Deferred Tax liability = ($4,657 − $2,755)(0.41) = $780.

Alternative solution:
Difference in depreciation at the end of year one is $12,676 × (0.35 − 0.20) = $1,901
Deferred tax liability = difference in depreciation × tax rate = $1,901 × 0.41 = $780.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #113 of 143

Question ID: 414561

For the year ended 31 December 2004, Pick Co's pretax financial statement income was $400,000 and its taxable income was $300,000. The difference is due to the following:

Interest on tax-exempt municipal bonds	$140,000
Premium expense on key person life insurance	$(40,000)
Total	$100,000

Pick's statutory income tax rate is 30 percent. In its 2004 income statement, what amount should Pick report as current provision for tax payable?

- ✗ **A)** $102,000.
- ✗ **B)** $120,000.
- ✓ **C)** $90,000.

Explanation

According to SFAS 109, Current provision = statutory rate × taxable income

30% = Taxes Payable / $300,000

= 0.30 × $300,000

= $90,000

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #114 of 143

Question ID: 414613

A company redeems $10,000,000 of bonds that it issued at par value for 101% of par or $10,100,000. In its statement of cash flows, the company will report this transaction as a:

- ✗ **A)** $10,000,000 CFF outflow and $100,000 CFO outflow.
- ✓ **B)** 10,100,000 CFF outflow.
- ✗ **C)** $10,100,000 CFO outflow.

Explanation

Cash paid to redeem a bond is classified as a cash flow from financing activities.

References

Question From: Session 8 > Reading 31 > LOS c

Related Material:

- Key Concepts by LOS

Question #115 of 143

Question ID: 414633

Compared to an operating lease, a lessee using a finance lease is *least likely* to have:

- ✓ **A)** higher cash flow from financing during the lease period.
- ✗ **B)** lower net income in the earlier years of the lease.
- ✗ **C)** a lower current ratio.

Explanation

Since a portion of the lease payment is treated as repayment of principal under a finance lease, cash flow from financing will be lower.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #116 of 143

Question ID: 414582

An analyst gathered the following information about a company:

- Pretax income = $10,000.
- Taxes payable = $2,500.
- Deferred taxes = $500.
- Tax expense = $3,000.

What is the firm's reported effective tax rate?

- ✗ **A)** 5%.
- ✗ **B)** 25%.
- ✓ **C)** 30%.

Explanation

Reported effective tax rate = Income tax expense / pretax income

= $3,000 / $10,000

= 30%

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #117 of 143

Question ID: 414596

A company issued a bond with a face value of $67,831, maturity of 4 years, and 7% annual-pay coupon, while the market interest rates are 8%.

What is the unamortized discount when the bonds are issued?

- ✗ **A)** $1,748.07.
- ✓ **B)** $2,246.65.
- ✗ **C)** $498.58.

Explanation

Coupon payment = ($67,831)(0.07) = $4,748.17.
Present value of bond: FV = $67,831, N = 4, I = 8, PMT = $4,748.17, CPT PV = $65,584.35.
Discount = $67,831 - $65,584.35 = $2,246.65.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #118 of 143

Question ID: 414624

A lessee *most likely* has an incentive to structure a lease as an operating lease rather than a finance lease when it:

✓ **A)** has a high debt-to-equity ratio.

✗ **B)** is very profitable.

✗ **C)** does not have debt covenants.

Explanation

A firm with a high debt-to-equity ratio is more likely to use an operating lease instead of a capital lease. Use of an operating lease avoids the recognition of debt on the lessee's balance sheet and will not increase the debt-to-equity ratio.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #119 of 143

Question ID: 414570

Enduring Corp. operates in a country where net income from sales of goods are taxed at 40%, net gains from sales of investments are taxed at 20%, and net gains from sales of used equipment are exempt from tax. Installment sale revenues are taxed upon receipt.

For the year ended December 31, 2004, Enduring recorded the following before taxes were considered:

- Net income from the sale of goods was $2,000,000, half was received in 2004 and half will be received in 2005.
- Net gains from the sale of investments were $4,000,000, of which 25% was received in 2004 and the balance will be received in the 3 following years.
- Net gains from the sale of equipment were $1,000,000, of which 50% was received in 2004 and 50% in 2005.

On its financial statements for the year ended December 31, 2004, Enduring should apply an effective tax rate of:

✗ **A)** 22.86% and increase its deferred tax asset by $1,000,000.

✓ **B)** 22.86% and increase its deferred tax liability by $1,000,000.

✗ **C)** 26.67% and increase its deferred tax liability by $1,000,000.

Explanation

Total taxes eventually due on 2004 activities were (($2,000,000 × 0.40) + ($4,000,000 × 0.20) =) $1,600,000. Permanent differences are adjusted in the effective tax rate, which is ($1,600,000 / $7,000,000 =) 22.86%. Of the $1,600,000 taxes due, (($2,000,000 × 0.50 × 0.40) + ($4,000,000 × 0.25 × 0.20) =) $600,000 were paid in 2004 and $1,000,000 ($1,600,000 − $600,000) is added to deferred tax liability.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS

Question #120 of 143

Question ID: 713913

A dance club purchases new sound equipment for $25,352. It will work for 5 years and has no salvage value. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. Annual revenues are constant at $14,384 over these five years. If the tax rate for years 4 and 5 changes from 41% to 31%, what is the deferred tax liability as of the end of year 3?

✗ **A)** $2,948.

✗ **B)** $1,039.

✓ **C)** $3,144.

Explanation

Straight-line depreciation = $25,352 / 5 = $5,070. Income (years 1, 2, and 3) using straight-line depreciation = $14,384 − $5,070 = $9,314.

Accelerated depreciation (years 1 and 2) = 0.35($25,352) = $8,873. Income (years 1 and 2) = $14,384 − $8,873 = $5,511.

Accelerated depreciation (year 3) = 0.3($25,352) = $7,606. Income (year 3) = $14,384 − $7,606 = $6,778.

Cumulative difference in income at end of year 3 = 3($9.314) − [2($5,511) + $6,778] = $10,142.

DTL value at new tax rate = 0.31($10,142) = $3,144.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #121 of 143

Question ID: 414543

In 20X8, Oliver Ltd. received $80,000 cash from a customer for goods that it could not deliver until the next year and established a liability for unearned revenue. Oliver reports under U.S. GAAP, faces a 40% tax rate, and is located in a tax jurisdiction where unearned revenue is taxed as received. On their balance sheet for 20X8, what change in deferred tax should Oliver record as a result of this transaction?

- ✓ **A)** A deferred tax asset of $32,000.
- ✗ **B)** There is no effect on deferred tax items from this transaction.
- ✗ **C)** A deferred tax liability of $32,000.

Explanation

Oliver has paid tax on the $80,000 revenue in 20X8, but has not recorded the revenue on it for financial statement purposes. This results in a temporary difference of $32,000, which is a deferred tax asset. The tax asset will be realized when the company recognizes the revenue on its financial statements in the subsequent period.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS

Question #122 of 143

Question ID: 414591

At the date of issuance the market interest rate was above the coupon rate. Bonds of this nature would sell for:

- ✗ **A)** premium.
- ✗ **B)** par.
- ✓ **C)** discount.

Explanation

When the contract rate on a bond is lower than the market rate, a bond will sell for a discount.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #123 of 143

Question ID: 414621

A firm is *most likely* to lease an asset rather than purchasing it if the asset:

✓ **A)** may be made obsolete by rapid technological advances.

✗ **B)** is costly to move from place to place.

✗ **C)** has a high salvage value relative to its cost.

Explanation

One of the motivations for leasing assets instead of purchasing them is that a leased asset that has been made obsolete by new technology can be returned to the lessor at the end of the lease. Neither of the other choices is a motivation for leasing assets instead of purchasing them.

References

Question From: Session 8 > Reading 31 > LOS f

Related Material:

- Key Concepts by LOS

Question #124 of 143

Question ID: 414541

For purposes of financial analysis, an analyst should:

✓ **A)** determine the treatment of deferred tax liabilities on a case-by-case basis.

✗ **B)** always consider deferred tax liabilities as stockholder's equity.

✗ **C)** always consider deferred tax liabilities as a liability.

Explanation

For financial analysis, an analyst must decide on the appropriate treatment of deferred taxes on a case-by-case basis. These can be classified as liabilities or stockholder's equity, depending on various factors. Sometimes, deferred taxes are just ignored altogether.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #125 of 143

Question ID: 414619

As compared to purchasing an asset, which of the following is least likely an incentive to structure a transaction as a finance lease?

✗ **A)** The terms of the lease can be negotiated to better meet each party's needs.

✗ **B)** Risk of obsolescence is reduced because the asset is returned to the lessor.

✓ **C)** The lease enhances the balance sheet by the lease liability.

Explanation

Operating leases enhance the balance sheet by excluding the lease liability. With a finance lease, an asset and a liability are reported on the balance sheet just like a purchase made with debt.

References

Question From: Session 8 > Reading 31 > LOS f

Related Material:

- Key Concepts by LOS

Question #126 of 143

Question ID: 702537

Which of the following financial ratios is *least likely* to be affected by classification of deferred taxes as a liability or equity?

✗ **A)** Return on equity (ROE).

✓ **B)** Return on assets (ROA).

✗ **C)** Leverage ratio.

Explanation

The ROA will not be affected by the classification of the deferred taxes. The total assets will remain the same regardless of whether the deferred taxes are classified as a liability or equity. Return on equity and the leverage ratio (assets/equity) would both be affected.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #127 of 143

Question ID: 414552

Camphor Associates uses accrual basis for financial reporting purposes and cash basis for tax purposes. Cash collections from customers is $238,000, and accrued revenue is only $188,000. Assume expenses at 50% in both cases (i.e., $119,000 on cash basis and $94,000 on accrual basis), and a tax rate of 34%. What is the deferred tax asset/liability in this case? A deferred tax:

✓ **A)** asset of $8,500.

✗ **B)** asset of $48,960.

✗ **C)** liability of $8,500.

Explanation

Since taxable income ($119,000) exceeds pretax income ($94,000), Camphor will have a deferred tax asset of $8,500 = [($119,000 − $94,000)(0.34)].

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #128 of 143

Question ID: 414530

Which of the following statements is CORRECT? Income tax expense:

✗ **A)** is the reported net of deferred tax assets and liabilities.

✗ **B)** is the amount of taxes due to the government.

✓ **C)** includes taxes payable and deferred income tax expense.

Explanation

Income tax expense is defined as expense resulting from current period pretax income. It includes taxes payable and deferred income tax expense. *Taxes payable* are the amount of taxes due the government.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #129 of 143

Question ID: 414542

At the end of 20X8, Martin Inc. estimates that $26,000 of warranty repairs will be required in the future on goods already sold. For tax purposes, warranty expense is not deductible until the work is actually performed. The firm believes that the warranty work will be required over the next two years. The tax base of the warranty liability at the end of 20X8 is:

✓ **A)** zero.

✗ **B)** $26,000.

✗ **C)** $13,000.

Explanation

The carrying value of the warranty liability is $26,000 (the same amount is recorded as a liability on the balance sheet and as an expense on the income statement). The tax base is equal to the carrying value less any amounts deductible in the future. Therefore, the tax base is $0 ($26,000 − $26,000) since the warranty expense will be deductible when the work is performed next year.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS

Question #130 of 143

Question ID: 498762

Under which financial reporting standards is the full amount of a deferred tax asset shown on the balance sheet, regardless of its probability of being realized fully?

- ✓ **A)** U.S. GAAP, but not IFRS.
- ✗ **B)** IFRS, but not U.S. GAAP.
- ✗ **C)** Neither IFRS nor U.S. GAAP.

Explanation

Under U.S. GAAP, the full amount of a DTA is shown on the balance sheet, with a contra account (valuation allowance) if it is likely that the full amount of the DTA will not be realized in the future. Under IFRS, the carrying value of a DTA is reduced to its expected recoverable amount if it is likely that the full amount of the DTA will not be realized in the future.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #131 of 143

Question ID: 414634

Under a finance lease (versus an operating lease) which of the lessee's financial ratios will be higher?

- ✗ **A)** Return on equity.
- ✗ **B)** Asset turnover.
- ✓ **C)** Debt/equity.

Explanation

The debt/equity ratio will be higher because the finance lease requires the creation of a long-term liability on the balance sheet.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #132 of 143

Question ID: 414638

Which of the following statements about leases is *least* accurate?

- ✗ **A)** In the first years of a finance lease, the lessee's debt to equity ratio is greater than it would have been if the firm had used an operating lease.
- ✓ **B)** In the first years of a finance lease, the lessee's current ratio is greater than it would have been had the firm used an operating lease.
- ✗ **C)** All else equal, when a lease is capitalized the lessee's income will rise over the term of the lease.

Explanation

From the lessee's perspective, if a lease is considered to be a *finance lease* instead of an operating lease, then the lessee's *current liabilities will be greater* until the lease has expired. This will result in a *lower current ratio* (larger denominator).

In the early years, the *capitalized lease expense* (interest plus depreciation) is greater than in the later years because interest expense decreases over time. Less expenses = more income.

In the first years of a finance lease the lessee's debt to equity ratio will be greater than if the firm had used an operating lease because in the case of the finance lease, the numerator is comprised of (debt + lease), while the numerator in the case of the operating lease is (debt) only. In addition, the greater capitalized lease expense flows through to decrease shareholder's equity (the denominator).

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #133 of 143

Question ID: 414635

On the lessee's cash flow statement, the principal portion of a finance lease payment is a:

- ✗ **A)** investing cash flow.
- ✗ **B)** operating cash flow.
- ✓ **C)** financing cash flow.

Explanation

The principal portion of a finance lease payment is a financing cash outflow for the lessee. The interest portion is an operating cash outflow.

References

Question From: Session 8 > Reading 31 > LOS h

Related Material:

- Key Concepts by LOS

Question #134 of 143

Question ID: 414603

For a given par value, which of the following debt issues will have the highest cash flows from financing?

- ✗ **A)** Zero-coupon bond.
- ✓ **B)** Bonds issued at premium.
- ✗ **C)** Bonds issued at discount.

Explanation

The bonds issued at premium will have the highest cash flows from financing.

References

Question From: Session 8 > Reading 31 > LOS b

Related Material:

- Key Concepts by LOS

Question #135 of 143

Question ID: 414622

The lessee has an incentive to classify a lease as an operating lease, rather than as a finance lease, because an operating lease:

- ✓ **A)** does not appear on the balance sheet.
- ✗ **B)** has payments that are less than a capital lease's payments.
- ✗ **C)** has no risk involved because the lessor assumes all risk.

Explanation

Having less assets and liabilities on the balance sheet than would exist if the asset were purchased increases profitability ratios (e.g., return on assets) and decreases leverage ratios (e.g., the debt to equity ratio).

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #136 of 143

Question ID: 434302

An analyst gathers the following data for Alice Company:

- Alice Company reported a pretax income of $400,000 in its income statement for the period ended December 31, 20X2.
- Included in its pretax income are: (1) interest received on tax-free municipal bonds $50,000 and (2) rent expense of $20,000. Only $10,000 was paid in cash for rent during 20X2.
- Alice follows cash basis for tax reporting.
- Alice's tax rate is 40%.

What is the income tax expense that Alice should report on its income statement for the year ended December 31, 20X2?

✗ **A)** $160,000.

✗ **B)** $132,000.

✓ **C)** $140,000.

Explanation

$400,000 - 50,000 = $350,000. $350,000 × 40% = $140,000.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #137 of 143

Question ID: 414585

Under U.S. GAAP, which of the following statements regarding the disclosure of deferred taxes in a company's balance sheet is *most* accurate?

✗ **A)** Current deferred tax liability and noncurrent deferred tax asset are netted, resulting in the disclosure of a net noncurrent deferred tax liability or asset.

✗ **B)** There should be a combined disclosure of all deferred tax assets and liablities.

✓ **C)** Current deferred tax liability, current deferred tax asset, noncurrent deferred tax liability and noncurrent deferred tax asset are each disclosed separately.

Explanation

Under U.S. GAAP, deferred tax assets and liabilities are classified as current or noncurrent, based on the underlying asset or liability. Under IFRS, deferred tax items are classified as noncurrent.

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #138 of 143

Question ID: 654848

The Puchalski Company reported the following:

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income before taxes	$1,000	$1,000	$900	$800
Taxable income	$800	$900	$900	$1,000

The differences between income before taxes and taxable income are the result of using accelerated depreciation for tax purposes on an asset purchased in Year 1. Puchalski had no deferred tax liability prior to Year 1. If the tax rate is 40%, what is the amount of the deferred tax liability reported at the end of Year 4?

- ✗ **A)** $120.
- ✗ **B)** $80.
- ✓ **C)** $40.

Explanation

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income tax expense	$400	$400	$360	$320
Taxes paid	$320	$360	$360	$400
Deferred tax liability	$80	$120	$120	$40

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #139 of 143

Question ID: 414590

Over time, the reported amount of the annual interest expense on a long-term bond issued at a discount will:

✗ **A)** decrease.

✓ **B)** increase.

✗ **C)** remain constant.

Explanation

A portion of the discount must be amortized to the interest expense each year. The amortized amount is debited to interest expense and credited to debt. So debt goes up. The interest expense is debt times the effective interest rate. Thus, interest expense will increase over time.

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #140 of 143

Question ID: 414592

A firm issues a $5 million zero coupon bond with a maturity of four years when market rates are 8%. Assume semi-annual compounding.

What is the firm's initial liability and the value of the liability in six months?

	Initial Liability	Liability in 6 months
✗ **A)**	$3,675,149	$3,675,149
✓ **B)**	$3,653,451	$3,799,589
✗ **C)**	$5,000,000	$5,000,000

Explanation

The initial liability is: N = 8, I/Y = 4%, PMT = 0, FV = $5,000,000, Compute PV = -$3,653,451.

The value of the liability 6 months is: [$3,653,451 + {0.04($3,653,451)}] = $3,799,589

References

Question From: Session 8 > Reading 31 > LOS a

Related Material:

- Key Concepts by LOS

Question #141 of 143

Question ID: 596410

Which of the following statements about deferred taxes is *most* accurate? Deferred tax liabilities:

✓ **A)** arise primarily due to differences between financial and tax accounting.

✗ **B)** should be treated as debt when calculating financial statement ratios.

✗ **C)** can relate to either permanent or temporary differences.

Explanation

Deferred tax liabilities result from temporary differences between financial accounting and tax accounting that cause income tax expense for a period to be larger than taxes due. Permanent differences do not result in deferred tax items. Whether to treat deferred tax liabilities as debt or equity depends on whether they are expected to reverse in the foreseeable future.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS

Question #142 of 143

Question ID: 414626

Under an operating lease (versus a finance lease) which of the following is higher for the lessee?

✗ **A)** Assets.

✗ **B)** Cash flow from operations.

✓ **C)** Cash flow from financing.

Explanation

The lessee's cash flows from financing will be higher for an operating lease because the payments made for an operating lease are operating cash outflows, not financing cash outflows. The payments made under a finance lease are split between interest paid and principal. The latter is charged to cash flow from financing.

References

Question From: Session 8 > Reading 31 > LOS g

Related Material:

- Key Concepts by LOS

Question #143 of 143

Question ID: 414572

Which of the following statements regarding differences in taxable and pretax income is CORRECT? Differences in taxable and pretax income that:

✓ **A)** result in deferred taxes are called temporary differences.

✗ **B)** increase or reduce the effective tax rate are called temporary differences.

✗ **C)** are not reversed for five or more years are called permanent differences.

<u>Explanation</u>

The permanent differences are never reversed, while there is no time limit on temporary differences to reverse. Permanent differences never result in tax deferrals; temporary differences always result in deferred tax assets or liabilities.

<u>References</u>

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS