Question 1
L2R19TB-AC025-1512
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium
By adjusting for employer contributions, the periodic pension cost can be expressed in the relationship with year ending and year beginning:

- pension benefit obligation.
- fair value of plan assets.
- funded status.

Rationale
pension benefit obligation.
Periodic pension cost can be determined by either summing the individual components of period pension cost or taking the change in the net pension liability or asset and adjusting for the employer's contribution. Based on the latter, the periodic pension cost can be expressed as:

$$\text{Periodic pension cost} = \text{Ending funded status} - \text{Employer contribution} - \text{Beginning funded status}$$

Rationale
fair value of plan assets.
Periodic pension cost can be determined by either summing the individual components of period pension cost or taking the change in the net pension liability or asset and adjusting for the employer's contribution. Based on the latter, the periodic pension cost can be expressed as:

$$\text{Periodic pension cost} = \text{Ending funded status} - \text{Employer contribution} - \text{Beginning funded status}$$

Rationale
funded status.
Periodic pension cost can be determined by either summing the individual components of period pension cost or taking the change in the net pension liability or asset and adjusting for the employer's contribution. Based on the latter, the periodic pension cost can be expressed as:

$$\text{Periodic pension cost} = \text{Ending funded status} - \text{Employer contribution} - \text{Beginning funded status}$$

Question 2
L2FR-PQ1814-1410
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Which of the following is *least likely* to result in an actuarial loss for a company following IFRS?

- (●) A decrease in the expected return on plan assets.
- ( ) A decrease in the discount rate.
- ( ) An increase in life expectancy.

Rationale

This Answer is Correct
The expected return on plan assets assumption plays no role in accounting for defined-benefit pension plans under IFRS.

Question 3
L2R19TB-AC019-1512
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium

An analyst reviews the disclosures pertaining to Company A's stock option compensation plan and compiles his notes in the table below.

($millions)	20X1	20X2	20X3
Compensation Expense	9.9	12.5	10.3

Additional notes: As of December 31, 20X3, $22.2 million of total pre-tax unrecognized compensation costs related to non-vested stock options is expected to be recognized over a weighted average period of 2.4 years.

The approximate compensation expense that Company A will recognize related to options will *most likely*:

- Total $22.2 by the end of 20X5.
- Be equal over the next three years.
- Increase if new options are granted over the next three years.

Rationale
Total $22.2 by the end of 20X5.
The company has $22.2 million of unrecognized compensation expense that has not yet vested with an average life of 2.4 years. This means the company will recognize compensation expense of $9.25 million ($22.2 million/2.4) in 20X4 and 20X5 (a total of $18.5 million by the end of 20X5). The remaining $3.7 million will be expensed in 20X6. Any additional options granted are likely to have various vesting timeframes and will likely increase compensation expense even more over the next three years.

Rationale
Be equal over the next three years.
The company has $22.2 million of unrecognized compensation expense that has not yet vested with an average life of 2.4 years. This means the company will recognize compensation expense of $9.25 million ($22.2 million/2.4) in 20X4 and 20X5 (a total of $18.5 million by the end of 20X5). The remaining $3.7 million will be expensed in 20X6. Any additional options granted are likely to have various vesting timeframes and will likely increase compensation expense even more over the next three years.

Rationale
Increase if new options are granted over the next three years.
The company has $22.2 million of unrecognized compensation expense that has not yet vested with an average life of 2.4 years. This means the company will recognize compensation expense of $9.25 million ($22.2 million/2.4) in 20X4 and 20X5 (a total of $18.5 million by the end of 20X5). The remaining $3.7 million will be expensed in 20X6. Any additional options granted are likely to have various vesting timeframes and will likely increase compensation expense even more over the next three years.

Question 4
L2FR-TB0019-1412
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium

A company that produces financial statements according to IFRS has awarded a bonus to senior management in the form of new shares in the company. The total number of shares granted is 10,000, and the fair value of the shares at that date is $510 per share. The senior managers are subject to a clawback provision, which dictates that they must work for the firm for a further three years before they have the right to take ownership.

Three years later the shares are worth $600. Which of the following amounts is closest to the compensation expense shown in the income statement of the company in the year of the stock grant?

- Nil.
- $1.7 million.
- $5.1 million.

Rationale

This Answer is Correct

The compensation expense should be based on the fair value of shares on the grant date and should be spread over the service period required to earn the stock grant. As such the company should recognize an expense of (10,000 $510) / 3 per year if they spread the expense evenly across years.

Question 5
L2R19TB-AC014-1512
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Ing Industries complies with IFRS. Ing's pension obligation will *most likely* increase if the company changes its pension assumptions by raising its:

- Discount rate.
- Compensation rate.
- Expected return on assets.

Rationale
Discount rate.
Changes in compensation rate have a direct relationship with changes in the pension obligation; an increase would result in an increase in the pension obligation. A discount rate increase results in a lower pension obligation. Since the company complies with IFRS, a change in the expected rate of return on assets has no effect.

Rationale
Compensation rate.
Changes in compensation rate have a direct relationship with changes in the pension obligation; an increase would result in an increase in the pension obligation. A discount rate increase results in a lower pension obligation. Since the company complies with IFRS, a change in the expected rate of return on assets has no effect.

Rationale
Expected return on assets.
Changes in compensation rate have a direct relationship with changes in the pension obligation; an increase would result in an increase in the pension obligation. A discount rate increase results in a lower pension obligation. Since the company complies with IFRS, a change in the expected rate of return on assets has no effect.

Question 6
L2R19TB-AC012-1512
LOS: LOS-6970
Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan's Obligations
Difficulty: medium

Company Z reports the following information for its defined benefit pension plan:

- present value of the company's defined benefit obligation is $7.5 million;
- fair value of the pension plan's assets is $8.0 million; and
- present value of available future refunds and reductions in future contributions is $0.1 million.

If the fair value of the pension plan's assets were overstated by $0.3 million, Company Z would *most likely* report a:

- (●) net pension asset of $0.1 million.
- ( ) net pension asset of $0.2 million.
- ( ) net pension liability of $0.2 million.

Rationale
net pension asset of $0.1 million.

The funded status is the present value of the company's defined benefit obligation less the fair value of the pension plan's assets. If the fair value is overstated by $0.3 million, the revised fair value of the pension plan's assets is $7.7 million and the funded status is:

$$\begin{aligned}\text{Funded status} &= \text{Pension obligation} - \text{Fair value of the plan assets} = \$7.5 - \$7.7 \\ &= \$.02 \text{ (overfunded)}\end{aligned}$$

But the asset that can be recorded is the lower of the funded status or the present value of future economic benefits. The PV of the future economic benefits is $0.1 million, which is lower than the funded status. Therefore, the net pension asset reported will be $0.1 million.

Rationale
net pension asset of $0.2 million.

The funded status is the present value of the company's defined benefit obligation less the fair value of the pension plan's assets. If the fair value is overstated by $0.3 million, the revised fair value of the pension plan's assets is $7.7 million and the funded status is:

$$\begin{aligned}\text{Funded status} &= \text{Pension obligation} - \text{Fair value of the plan assets} = \$7.5 - \$7.7 \\ &= \$.02 \text{ (overfunded)}\end{aligned}$$

But the asset that can be recorded is the lower of the funded status or the present value of future economic benefits. The PV of the future economic benefits is $0.1 million, which is lower than the funded status. Therefore, the net pension asset reported will be $0.1 million.

Rationale

net pension liability of $0.2 million.

The funded status is the present value of the company's defined benefit obligation less the fair value of the pension plan's assets. If the fair value is overstated by $0.3 million, the revised fair value of the pension plan's assets is $7.7 million and the funded status is:

$$\begin{aligned} \text{Funded status} &= \text{Pension obligation} - \text{Fair value of the plan assets} = \$7.5 - \$7.7 \\ &= \$.02 \text{ (overfunded)} \end{aligned}$$

But the asset that can be recorded is the lower of the funded status or the present value of future economic benefits. The PV of the future economic benefits is $0.1 million, which is lower than the funded status. Therefore, the net pension asset reported will be $0.1 million.

Question 7
L2R19TB-AC021-1512
LOS: LOS-6970
Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan’s Obligations
Difficulty: medium
At the end of 20X4, the fair value of Company A's pension plan's assets exceeded the present value of its defined benefit obligation but not by an amount greater than the present value of available future refunds and reductions in future contributions. If its uses IFRS, the company will *most likely* report a pension:

- (●) asset equal to the amount that the plan's assets exceed the pension obligation.
- ( ) asset equal to the present value of available future refunds and reductions in future contributions.
- ( ) liability equal to the difference between the overfunded amount and the present value of available future refunds and reductions in future contributions.

Rationale

✓ **asset equal to the amount that the plan's assets exceed the pension obligation.**
If the fair value of the pension plan assets is greater than pension obligation, there is a surplus and the plan is considered overfunded. Since the surplus is not greater than the amount of the asset ceiling (the present value of future economic benefits, such as reductions of future contributions or plan refunds), the amount of surplus is reported as a pension asset.

Rationale

✗ **asset equal to the present value of available future refunds and reductions in future contributions.**
If the fair value of the pension plan assets is greater than pension obligation, there is a surplus and the plan is considered overfunded. Since the surplus is not greater than the amount of the asset ceiling (the present value of future economic benefits, such as reductions of future contributions or plan refunds), the amount of surplus is reported as a pension asset.

Rationale

✗ **liability equal to the difference between the overfunded amount and the present value of available future refunds and reductions in future contributions.**
If the fair value of the pension plan assets is greater than pension obligation, there is a surplus and the plan is considered overfunded. Since the surplus is not greater than the amount of the asset ceiling (the present value of future economic benefits, such as reductions of future contributions or plan refunds), the amount of surplus is reported as a pension asset.

Question 8
L2R19TB-AC030-1512
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Declon Products Inc. (DPI) complies with U.S. GAAP and offers its employees a defined benefit (DB) pension plan. The compensation expense related to the pension for an accounting period would *most likely* be higher if the company had:

- Increased the amount of benefits paid during the period.
- Decreased the amount of employer contributions made during the period.
- Decreased the assumed expected return on plan assets at the beginning of the period.

Rationale

Increased the amount of benefits paid during the period.

A decrease in the expected return on plan assets will most likely increase compensation expense related to the pension plan. Under U.S. GAAP, the expected return on plan assets is used to calculate the return on plan assets, which is a reduction to pension cost charged to P&L. Benefits paid and employer contributions in the period both affect the company's cash flows, but have no direct effect on the same accounting period's pension expense.

Rationale

Decreased the amount of employer contributions made during the period.

A decrease in the expected return on plan assets will most likely increase compensation expense related to the pension plan. Under U.S. GAAP, the expected return on plan assets is used to calculate the return on plan assets, which is a reduction to pension cost charged to P&L. Benefits paid and employer contributions in the period both affect the company's cash flows, but have no direct effect on the same accounting period's pension expense.

Rationale

Decreased the assumed expected return on plan assets at the beginning of the period.

A decrease in the expected return on plan assets will most likely increase compensation expense related to the pension plan. Under U.S. GAAP, the expected return on plan assets is used to calculate the return on plan assets, which is a reduction to pension cost charged to P&L. Benefits paid and employer contributions in the period both affect the company's cash flows, but have no direct effect on the same accounting period's pension expense.

Question 9
L2R19TB-AC028-1512
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Compensation expense related to a company's post-employment health care plan would *most likely* increase if the company changed its assumptions to reflect that:

- The time frame in which the ultimate health care trend rate is expected to be reached is shortened and the ultimate health care trend rate remains fat.
- Near-term health care costs are expected to decrease and the time frame in which the ultimate health care trend rate is expected to be reached is shortened.
- The time frame in which the ultimate health care trend rate is expected to be reached remains unchanged, but both the ultimate health care trend rate and short-term medical costs are expected to rise.

Rationale

The time frame in which the ultimate health care trend rate is expected to be reached is shortened and the ultimate health care trend rate remains fat.

For their defined benefit post-employment health care plans, many companies use the ultimate health care trend rate assumption in estimating compensation expense. The reported compensation expense will rise if assumptions are changed to reflect an increase in short-term health care and medical costs, an increase the ultimate health care trend rate, and/or an extension of the time it takes for the company to reach the ultimate health care trend rate.

Rationale

Near-term health care costs are expected to decrease and the time frame in which the ultimate health care trend rate is expected to be reached is shortened.

For their defined benefit post-employment health care plans, many companies use the ultimate health care trend rate assumption in estimating compensation expense. The reported compensation expense will rise if assumptions are changed to reflect an increase in short-term health care and medical costs, an increase the ultimate health care trend rate, and/or an extension of the time it takes for the company to reach the ultimate health care trend rate.

Rationale

The time frame in which the ultimate health care trend rate is expected to be reached remains unchanged, but both the ultimate health care trend rate and short-term medical costs are expected to rise.

For their defined benefit post-employment health care plans, many companies use the ultimate health care trend rate assumption in estimating compensation expense. The reported compensation expense will rise if assumptions are changed to reflect an increase in short-term health care and medical costs, an increase the ultimate health care trend rate, and/or an extension of the time it takes for the company to reach the ultimate health care trend rate.

Question 10

L2FR-TB0014-1412

LOS: LOS-6970

Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan’s Obligations

Difficulty: medium

With regard to the different measures of a defined benefit plan's obligations under U.S. GAAP, which of the following is *most likely* to be accurate?

- (●) VBO < ABO < PBO.
- ( ) ABO < VBO < PBO.
- ( ) VBO < PBO < ABO.

Rationale

This Answer is Correct

The projected benefit obligation will estimate the present value of benefits earned by plan participants to date while factoring in future salary increases. The ABO (accumulated benefit obligation) will not factor in future salary increases and hence will be lower. The VBO (vested benefit obligation) will also exclude benefits that employees have not yet earned the right to take through meeting prespecified criteria and hence is likely to be the lowest measure.

Question 11
L2FR-TBX109-1502
LOS: LOS-7020
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: easy
A company that compensates senior management with restricted stock that requires the management to remain with the company for a specified period will recognize an expense:

- In the year of the grant.
- Over the required service period.
- In the year the restricted shares vest with management.

Rationale

This Answer is Correct
A compensation expense equal to the fair value of the shares at the grant date will be allocated over the relevant service period required to earn the right to receive the shares.

Question 12

L2FR-PQ1818-1410

LOS: LOS-7010

Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information

Difficulty: medium

For 2012, a company's contributions into its DB pension plan exceeded total periodic pension cost. The appropriate analytical adjustment would *most likely* require:

- (●) Reclassifying the excess contribution (net of tax) from an outflow relating to operating activities to an outflow relating to financing activities.
- ( ) Reclassifying the excess contribution (net of tax) from an outflow relating to financing activities to an outflow relating to operating activities.
- ( ) Reclassifying the excess contribution (net of tax) from an outflow relating to operating activities to an outflow relating to investing activities.

Rationale

This Answer is Correct

The excess contribution is similar to making a principal payment on a loan in excess of the scheduled principal payment. Therefore, it must be reclassified as a cash outflow from financing activities rather than an outflow from operating activities.

Question 13
L2R19TB-AC032-1512
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium
A company uses a valuation model to value stock options provided to employees. The compensation expense recorded by a company for these stock options will *most likely* rise if the company decreases the assumed:

- Volatility.
- Risk-free rate.
- Dividend yield.

Rationale
Volatility.
A decrease in the dividend yield will increase the value of the option and increase compensation expense. Compensation expense is likely to decline when it is assumed that volatility or the risk-free rate decrease.

Rationale
Risk-free rate.
A decrease in the dividend yield will increase the value of the option and increase compensation expense. Compensation expense is likely to decline when it is assumed that volatility or the risk-free rate decrease.

Rationale
Dividend yield.
A decrease in the dividend yield will increase the value of the option and increase compensation expense. Compensation expense is likely to decline when it is assumed that volatility or the risk-free rate decrease.

Question 14
L2R19TB-AC023-1512
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium
White Enterprises complies with U.S. GAAP. With respect to White's defined benefit post-employment plans, the periodic pension costs recognized in White's P&L *most likely* include:

- current service costs, interest expense on plan liabilities, and actual return on plan assets.
- current and past service costs, interest expense on plan liabilities, and expected return on plan assets.
- current service costs, amortization of past service costs, interest expense on plan liabilities, and expected return on plan assets.

Rationale
current service costs, interest expense on plan liabilities, and actual return on plan assets.
In contrast to IFRS, U.S. GAAP only recognizes current service costs in P&L. Past service costs are recognized in OCI and subsequently amortized to the P&L. Similar to IFRS, U.S. GAAP recognizes interest expense on plan liabilities using the discount rate used to determine the pension obligation. However in contrast to IFRS, U.S. GAAP uses the expected return on assets rather than the discount rate in recognizing return on plan assets.

Rationale
current and past service costs, interest expense on plan liabilities, and expected return on plan assets.
In contrast to IFRS, U.S. GAAP only recognizes current service costs in P&L. Past service costs are recognized in OCI and subsequently amortized to the P&L. Similar to IFRS, U.S. GAAP recognizes interest expense on plan liabilities using the discount rate used to determine the pension obligation. However in contrast to IFRS, U.S. GAAP uses the expected return on assets rather than the discount rate in recognizing return on plan assets.

Rationale
current service costs, amortization of past service costs, interest expense on plan liabilities, and expected return on plan assets.
In contrast to IFRS, U.S. GAAP only recognizes current service costs in P&L. Past service costs are recognized in OCI and subsequently amortized to the P&L. Similar to IFRS, U.S. GAAP recognizes interest expense on plan liabilities using the discount rate used to determine the pension obligation. However in contrast to IFRS, U.S. GAAP uses the expected return on assets rather than the discount rate in recognizing return on plan assets.

Question 15
L2FR-TB0015-1412
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium
Under IFRS, which of the following components of periodic pension cost is recognized in OCI?

- Service costs.
- Net interest expense.
- Remeasurement.

Rationale

This Answer is Correct
Service cost and net interest expense are recognized in the income statement. Remeasurement, which includes actuarial gains and losses and any differences between actual return on plan assets and the amount included in net interest expense, are recognized in OCI.

Question 16

L2FR-TB0013-1412

LOS: LOS-6960

Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan's Obligations

Difficulty: medium

All of the following types of postemployment benefits would need to be estimated by the sponsoring company during the current period *except:*

- (●) Defined-contribution pension plan.
- ( ) Defined-benefit pension plan.
- ( ) Other postretirement benefits.

Rationale

This Answer is Correct

For a defined-contribution pension plan there are no future benefits that a sponsoring company has to pay once they have fulfilled the promise of contribution to the pension plan.

Question 17
L2R19TB-ITEMSET-AC009-1512
LOS: LOS-6990
LOS: LOS-7020
LOS: LOS-7030
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium

Use the following information to answer the next three questions:

Nicola Stokes is an equity analyst in the process of doing a comprehensive analysis of Copper Enterprises, a U.S. GAAP-compliant firm. Copper is a U.S. manufacturer that provides all of its employees with a defined benefit pension plan and its senior management team with stock options as part of its compensation package. Copper has recently changed auditors and experienced high turnover among senior finance staff. Stokes has some concerns and as part of her review, she intends to test the sensitivity and validity of the assumptions the company used pertaining to its post-employment and share-based compensation plans.

Stokes, in Exhibit 1 below, has gathered three years of data on the assumptions used by Copper Enterprises for its defined benefit pension plan and stock option awards.

Exhibit 1: Selected Financial Information

	20X3	20X2	20X1
Assumptions – defined benefit plans			
Expected compensation rate increases	3.0%	2.8%	2.7%
Discount rate	4.0%	4.2%	4.6%
Expected rate of return on plan assets	7.0%	6.0%	5.0%
Inflation	1.5%	1.7%	3.0%
Assumptions – option valuation			
Expected life (in years)	6.60	6.65	6.67
Expected volatility	43.7%	42.3%	42.0%
Risk-free interest rate	2.0%	1.5%	1.0%
Dividend yield	1.6%	1.0%	1.0%

Use the information provided to answer the following three questions.

i.
In reviewing the defined benefit plan assumptions over the three-year period from 20X1 to 20X3, the assumption changes that Stokes would consider to have moved in a *more* conservative direction are the:

- (●) Discount rate and expected compensation rate increase.
- ( ) Discount rate and expected rate of return on plan assets.
- ( ) Expected rate of return on plan assets and expected compensation rate increase.

Rationale

This Answer is Correct

From 20X1 to 20X3, the compensation rate increased and the discount rate decreased. Both of these directional trends would be considered more conservative because they generally increase compensation expense and thus decrease net income. Stokes may likely question the trend in the assumption for expected rate of return on plan assets that increased significantly from 20X1 to 20X3 relative to other trends. Stokes

may question this trend particularly because a higher expected rate of return on plan assets decreases pension expense resulting in a higher reported income, which can be seen as aggressive.

Rationale

This Answer is Correct

From 20X1 to 20X3, the compensation rate increased and the discount rate decreased. Both of these directional trends would be considered more conservative because they generally increase compensation expense and thus decrease net income. Stokes may likely question the trend in the assumption for expected rate of return on plan assets that increased significantly from 20X1 to 20X3 relative to other trends. Stokes may question this trend particularly because a higher expected rate of return on plan assets decreases pension expense resulting in a higher reported income, which can be seen as aggressive.

Rationale

This Answer is Correct

From 20X1 to 20X3, the compensation rate increased and the discount rate decreased. Both of these directional trends would be considered more conservative because they generally increase compensation expense and thus decrease net income. Stokes may likely question the trend in the assumption for expected rate of return on plan assets that increased significantly from 20X1 to 20X3 relative to other trends. Stokes may question this trend particularly because a higher expected rate of return on plan assets decreases pension expense resulting in a higher reported income, which can be seen as aggressive.

ii.

To test the sensitivity of the stock option valuations over the three-year period, Stokes individually applies the 20X1 assumptions to the 20X3 data. Based on this test, the change that would Stokes would *most likely* find more aggressive than the others is the change in:

- (•) Dividend yield.
- ( ) Expected volatility.
- ( ) Risk-free interest rate.

Rationale

This Answer is Incorrect

The company has increased the dividend yield assumption from 20X1 to 20X3. A higher dividend yield will result in a lower estimated fair value for the options; hence, lowering compensation expense and raising net income. In contrast, increasing assumed volatility and assumed risk-free rate results in higher estimated fair value of stock options, increased compensation expense, and lower net income. Assumptions that create a higher reported income may be considered a more aggressive accounting stance, so increasing dividend yield is the more aggressive change.

iii.

Stokes notes that Copper Enterprises shortened the expected life in 20X3. The *most likely* effect of this change (considered alone) on the 20X3 is to raise the:

- (•) Net income.
- ( ) Total liabilities.
- ( ) Compensation expense.

Rationale

This Answer is Incorrect
The longer an option's life, the more valuable it is. By shortening the assumed life, the company reduced the estimated fair value of its stock options. The net effect was a reduction in compensation expense and an increase in net income.

Rationale

This Answer is Incorrect
The longer an option's life, the more valuable it is. By shortening the assumed life, the company reduced the estimated fair value of its stock options. The net effect was a reduction in compensation expense and an increase in net income.

Rationale

This Answer is Incorrect
The longer an option's life, the more valuable it is. By shortening the assumed life, the company reduced the estimated fair value of its stock options. The net effect was a reduction in compensation expense and an increase in net income.

Question 18
L2FR-PQ1817-1410
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium
Net interest expense (asset) under IFRS is *most likely* calculated as the discount rate times:

- Ending pension obligation.
- Beginning pension obligation.
- Beginning funded status.

Rationale

This Answer is Correct
Net interest expense under IFRS is calculated as the net pension liability (asset) times the discount rate.

Question 19

L2R19TB-AC017-1512

LOS: LOS-7000

Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information

Difficulty: medium

An analyst reclassifies the periodic costs of Company A and Company B between operating and non-operating expenses. Company A complies with IFRS and uses a discount rate of 4.0 percent. Company B complies with U.S. GAAP and uses an expected return of 4.5 percent. Both companies earn an actual return of 4.0 percent. The adjustment that would *most likely* result in the analyst's adjusted net earnings differing from the reported net earnings is the:

- Actual return adjustment for Company A.
- Actual return adjustment for Company B.
- Interest cost adjustment for both Company A and B.

Rationale

Actual return adjustment for Company A.

Because the rates are different, the actual return adjustment for Company B would result in the analyst's adjusted net earnings differing from the reported net earnings. For Company A, there would be no difference in net earnings because the discount rate and the actual return are the same. The interest cost adjustment does not change the net earnings because it is only a reclassification of an expense from net operating expense to interest expenses (or income).

Rationale

Actual return adjustment for Company B.

Because the rates are different, the actual return adjustment for Company B would result in the analyst's adjusted net earnings differing from the reported net earnings. For Company A, there would be no difference in net earnings because the discount rate and the actual return are the same. The interest cost adjustment does not change the net earnings because it is only a reclassification of an expense from net operating expense to interest expenses (or income).

Rationale

Interest cost adjustment for both Company A and B.

Because the rates are different, the actual return adjustment for Company B would result in the analyst's adjusted net earnings differing from the reported net earnings. For Company A, there would be no difference in net earnings because the discount rate and the actual return are the same. The interest cost adjustment does not change the net earnings because it is only a reclassification of an expense from net operating expense to interest expenses (or income).

Question 20
L2FR-TB0017-1412
LOS: LOS-7000
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium
An analyst is reviewing disclosures in the footnotes of the financial statements of a company that sponsors a postemployment health care plan. They estimate that the company has underestimated health care trend costs by about 1%. An adjustment to the accounts to reflect this view will *most likely* result in:

- (●) A higher debt-to-equity ratio.
- ( ) No change to the debt-to-equity ratio.
- ( ) A lower debt-to-equity ratio.

Rationale

This Answer is Correct

An increase in the health care cost trend rate will result in a higher benefit obligation and hence higher liabilities and lower equity. These impacts together will lead to a higher debt/equity ratio.

Question 21

L2R19TB-AC024-1512

LOS: LOS-6990

Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions

Difficulty: medium

Kris Lang, CFA, analyzes two peer companies and reviews the disclosures in the financial statement notes pertaining to both companies' defined benefit (DB) pension plans. Lang's finding that Company A is less conservative with regard to its DB pension plan accounting than Company B is *best* supported by the disclosure that Company A's:

- (●) Expected rate of compensation increase was lower than Company B's.
- ( ) Expected return on plan assets was lower than Company B's.
- ( ) Discount rate was lower than Company B's.

Rationale

✔ **Expected rate of compensation increase was lower than Company B's.**

The expected rate of compensation increase has a direct relationship with the level of the pension obligation, with a lower assumed of rate of increase for compensation, resulting in a lower pension obligation. A lower pension obligation will then make the pension costs lower and be reflected in a better funded status. Therefore, a lower expected rate of compensation increase is less conservative. A lower discount rate and lower expected return on assets relative to a peer could both be considered more conservative.

Rationale

✘ **Expected return on plan assets was lower than Company B's.**

The expected rate of compensation increase has a direct relationship with the level of the pension obligation, with a lower assumed of rate of increase for compensation, resulting in a lower pension obligation. A lower pension obligation will then make the pension costs lower and be reflected in a better funded status. Therefore, a lower expected rate of compensation increase is less conservative. A lower discount rate and lower expected return on assets relative to a peer could both be considered more conservative.

Rationale

✘ **Discount rate was lower than Company B's.**

The expected rate of compensation increase has a direct relationship with the level of the pension obligation, with a lower assumed of rate of increase for compensation, resulting in a lower pension obligation. A lower pension obligation will then make the pension costs lower and be reflected in a better funded status. Therefore, a lower expected rate of compensation increase is less conservative. A lower discount rate and lower expected return on assets relative to a peer could both be considered more conservative.

Question 22
L2FR-TB0016-1412
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Which of the following scenarios correctly describes the impact of an increase in the assumed expected return on plan assets on the PBO under IFRS versus U.S. GAAP

	IFRS	U.S. GAAP
	No change	No change
	No change	Lower
	Lower	Lower

- (●) Row A
- ( ) Row B
- ( ) Row C

Rationale

This Answer is Correct

Only U.S. GAAP makes an assumption regarding the expected return on plan assets, IFRS does not. Any assumption about expected return on plan assets under US GAAP would lower the periodic pension cost but would not impact on the PBO, which is a liability.

Question 23
L2FR-PQ1809-1410
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Which of the following will *most* likely result in an actuarial loss for a company's defined benefit pension plan?

- (●) An increase in the assumed rate for future compensation increases.
- ( ) An increase in the assumed discount rate.
- ( ) A decrease in assumed life expectancy.

Rationale

This Answer is Correct

An increase in the rate of future compensation increases results in a higher pension obligation and an actuarial loss.

An increase in the assumed discount rate and a decrease in assumed life expectancy will lower the pension obligation and result in actuarial gains.

Question 24
L2R19TB-ITEMSET-AC006-1512
LOS: LOS-6990
LOS: LOS-7010
LOS: LOS-7000
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium

Use the following information to answer the next three questions:

Josh Wynn, CFA, is an equity analyst reviewing the effect of defined benefit (DB) pension plan accounting on the financial statement reporting of Mill Corporation for the year 20X4. Mill Corporation complies with IFRS and has no other DB plans except for its pension plan. In his review, Wynn pays particular attention to the disclosures pertaining to the DB pension plan. Based on the information in the disclosures, Wynn makes adjustments to individual financial reports to account for the non-operating nature of certain components of pension cost.

Wynn compiles select information on Mill Corporation's defined benefit pension plan in Exhibit 1.

Exhibit 1: Mill Corporation Defined Benefit Pension Plan

	20X4
Benefit obligations, as of January 01, 20X4	8,500
Service cost	125
Interest cost	425
Benefits paid	(400)
Actuarial gain/loss	0
Benefit obligations, as of December 31, 20X4	8,650
Fair value of plan assets, as of January 01, 20X4	7,000
Actual return on plan assets	315
Employer contributions	200
Benefits paid	(400)
Fair value of plan assets, as of December 31, 20X4	7,115

Use the information provided to answer the following three questions.

i.
Based on the detail Wynn finds in the disclosures, the amounts he would expect to see reported on Mill's financial statements as of December 31, 20X4 would be *closest to* (€ millions) a net pension:

- Asset of 1,500 and a periodic pension cost of 235.
- Liability of 1,500 and a periodic pension cost of 165.
- Liability of 1,535 and a periodic pension cost of 235.

Rationale

This Answer is Correct

The net pension liability or asset is reported based on the funded status and determined as the difference between the fair value of the plan assets and the benefit obligation. For the year ended December 31, 20X4, the plan is underfunded (the benefit obligation exceeds the fair value of plan assets) and would report a net pension liability of 1,535 (8,650 – 7,115). The beginning funded status is 1,500 (8,500 – 7,000).

The periodic pension cost is 235 and can be determined as follows:

$$\begin{aligned}\text{Periodic pension cost} &= \text{Ending funded status} - \text{Employer contribution} - \text{Beginning funded status} \\ &= -1{,}535 - 200 - (-1{,}500) = -235\ (235\ \text{expense})\end{aligned}$$

Rationale

This Answer is Correct

The net pension liability or asset is reported based on the funded status and determined as the difference between the fair value of the plan assets and the benefit obligation. For the year ended December 31, 20X4, the plan is underfunded (the benefit obligation exceeds the fair value of plan assets) and would report a net pension liability of 1,535 (8,650 – 7,115). The beginning funded status is 1,500 (8,500 – 7,000).

The periodic pension cost is 235 and can be determined as follows:

$$\begin{aligned}\text{Periodic pension cost} &= \text{Ending funded status} - \text{Employer contribution} - \text{Beginning funded status} \\ &= -1{,}535 - 200 - (-1{,}500) = -235\ (235\ \text{expense})\end{aligned}$$

Rationale

This Answer is Correct

The net pension liability or asset is reported based on the funded status and determined as the difference between the fair value of the plan assets and the benefit obligation. For the year ended December 31, 20X4, the plan is underfunded (the benefit obligation exceeds the fair value of plan assets) and would report a net pension liability of 1,535 (8,650 – 7,115). The beginning funded status is 1,500 (8,500 – 7,000).

The periodic pension cost is 235 and can be determined as follows:

$$\begin{aligned}\text{Periodic pension cost} &= \text{Ending funded status} - \text{Employer contribution} - \text{Beginning funded status} \\ &= -1{,}535 - 200 - (-1{,}500) = -235\ (235\ \text{expense})\end{aligned}$$

ii.

Wynn *most likely* agrees with which statement regarding Mill's pension plan?

- The actual rate of return on plan assets exceeds the discount rate.
- An increase in the expected return will affect the plan's funded status.
- The remeasurement component of the plan's periodic pension cost is additive.

Rationale

This Answer is Incorrect

Under IFRS, the remeasurement component includes:

1. Actuarial gains and losses on the pension obligation arising from changes in actuarial assumptions.
2. Net return on plan assets, which is calculated as the actual return less (beginning fair value of plan assets x discount rate).

Since there are no actuarial gains or losses, remeasurement includes only the net return on plan assets. First, we need the discount rate used to determine the DB plan's benefit obligation. The interest cost shown for the obligation is 425, which is 5 percent of the beginning obligation of 8,500. This 5 percent is an input in our calculation of the net return on plan assets:

$$\begin{aligned}\text{Net return on plan assets} &= \text{Actual return} - (\text{Beginning plan assets} \times \text{Discount rate}) \\ &= 315 - (7{,}000 \times 0.05) = -35\end{aligned}$$

The negative sign indicates the actual return was less than the amount already accounted for in the net interest cost component of periodic cost, so it must be added to periodic pension cost. TIP: (assuming no actuarial gains or losses), if actual return < discount rate, the remeasurement will increase pension cost; if actual return > discount rate, the remeasurement will decrease pension cost.

Choice A is incorrect because the discount rate of 5 percent (425/8,500) is greater, not less than the actual return of 4.5 percent (315/7,000). Choice B is incorrect because Mills complies with IFRS and the expected return only applies to U.S. GAAP-compliant companies.

Rationale

This Answer is Incorrect

Under IFRS, the remeasurement component includes:

1. Actuarial gains and losses on the pension obligation arising from changes in actuarial assumptions.
2. Net return on plan assets, which is calculated as the actual return less (beginning fair value of plan assets x discount rate).

Since there are no actuarial gains or losses, remeasurement includes only the net return on plan assets. First, we need the discount rate used to determine the DB plan's benefit obligation. The interest cost shown for the obligation is 425, which is 5 percent of the beginning obligation of 8,500. This 5 percent is an input in our calculation of the net return on plan assets:

$$\begin{aligned}\text{Net return on plan assets} &= \text{Actual return} - (\text{Beginning plan assets} \times \text{Discount rate}) \\ &= 315 - (7{,}000 \times 0.05) = -35\end{aligned}$$

The negative sign indicates the actual return was less than the amount already accounted for in the net interest cost component of periodic cost, so it must be added to periodic pension cost. TIP: (assuming no actuarial gains or losses), if actual return < discount rate, the remeasurement will increase pension cost; if actual return > discount rate, the remeasurement will decrease pension cost.

Choice A is incorrect because the discount rate of 5 percent (425/8,500) is greater, not less than the actual return of 4.5 percent (315/7,000). Choice B is incorrect because Mills complies with IFRS and the expected return only applies to U.S. GAAP-compliant companies.

Rationale

This Answer is Incorrect

Under IFRS, the remeasurement component includes:

1. Actuarial gains and losses on the pension obligation arising from changes in actuarial assumptions.

2. Net return on plan assets, which is calculated as the actual return less (beginning fair value of plan assets x discount rate).

Since there are no actuarial gains or losses, remeasurement includes only the net return on plan assets. First, we need the discount rate used to determine the DB plan's benefit obligation. The interest cost shown for the obligation is 425, which is 5 percent of the beginning obligation of 8,500. This 5 percent is an input in our calculation of the net return on plan assets:

$$\begin{aligned}\text{Net return on plan assets} &= \text{Actual return} - (\text{Beginning plan assets} \times \text{Discount rate}) \\ &= 315 - (7{,}000 \times 0.05) = -35\end{aligned}$$

The negative sign indicates the actual return was less than the amount already accounted for in the net interest cost component of periodic cost, so it must be added to periodic pension cost. TIP: (assuming no actuarial gains or losses), if actual return < discount rate, the remeasurement will increase pension cost; if actual return > discount rate, the remeasurement will decrease pension cost.

Choice A is incorrect because the discount rate of 5 percent (425/8,500) is greater, not less than the actual return of 4.5 percent (315/7,000). Choice B is incorrect because Mills complies with IFRS and the expected return only applies to U.S. GAAP-compliant companies.

iii.

Wynn's made adjustments to Mill's financial statements based on information in the disclosures pertaining to periodic pension cost. His adjustments related to net interest would *most likely* result in a(n):

- Reduction in operating expenses of 425.
- Increase in operating profit of 75.
- Increase in pretax profit of 75.

Rationale

This Answer is Incorrect

Analysts may adjust the components of periodic pension cost to better reflect a company's operating performance. The net interest cost component of periodic cost is subtracted from operating expenses and added to interest expense (or similar line item) below operating profit as it is more representative of a financing cost. The net interest cost is not given in the table but can be calculated. First, we find the discount rate used to determine the DB plan's benefit obligation. The interest cost shown for the obligation is 425, which is 5 percent of the beginning obligation of 8,500. Therefore, the net interest component will be 5 percent of the funded status or 75 (1,500 net liability × 0.05) in net expense. Thus, if 75 is removed from pension cost and treated as interest cost, operating profit of 75.

Choice A is incorrect because it treats the interest on the benefit obligation as being the net interest. But the net interest is found on the funded status and the result in decrease in operating expenses of 75, not 425. Choice C treats the net interest as if it is completely adjusted out of the income statement. But it is just shifted from being in operating costs to being in interest cost. Hence, pretax profit is unchanged.

Rationale

This Answer is Incorrect

Analysts may adjust the components of periodic pension cost to better reflect a company's operating performance. The net interest cost component of periodic cost is subtracted from operating expenses and

added to interest expense (or similar line item) below operating profit as it is more representative of a financing cost. The net interest cost is not given in the table but can be calculated. First, we find the discount rate used to determine the DB plan's benefit obligation. The interest cost shown for the obligation is 425, which is 5 percent of the beginning obligation of 8,500. Therefore, the net interest component will be 5 percent of the funded status or 75 (1,500 net liability × 0.05) in net expense. Thus, if 75 is removed from pension cost and treated as interest cost, operating profit of 75.

Choice A is incorrect because it treats the interest on the benefit obligation as being the net interest. But the net interest is found on the funded status and the result in decrease in operating expenses of 75, not 425. Choice C treats the net interest as if it is completely adjusted out of the income statement. But it is just shifted from being in operating costs to being in interest cost. Hence, pretax profit is unchanged.

Rationale

This Answer is Incorrect

Analysts may adjust the components of periodic pension cost to better reflect a company's operating performance. The net interest cost component of periodic cost is subtracted from operating expenses and added to interest expense (or similar line item) below operating profit as it is more representative of a financing cost. The net interest cost is not given in the table but can be calculated. First, we find the discount rate used to determine the DB plan's benefit obligation. The interest cost shown for the obligation is 425, which is 5 percent of the beginning obligation of 8,500. Therefore, the net interest component will be 5 percent of the funded status or 75 (1,500 net liability × 0.05) in net expense. Thus, if 75 is removed from pension cost and treated as interest cost, operating profit of 75.

Choice A is incorrect because it treats the interest on the benefit obligation as being the net interest. But the net interest is found on the funded status and the result in decrease in operating expenses of 75, not 425. Choice C treats the net interest as if it is completely adjusted out of the income statement. But it is just shifted from being in operating costs to being in interest cost. Hence, pretax profit is unchanged.

Question 25
L2FR-PQ1821-1410
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium

Consider the following information:

Beginning pension obligation	$2,225
Ending pension obligation	$3,655
Benefits paid	$170
Beginning fair value of plan assets	$1,850
Actual return on plan assets	$250
Ending fair value of plan assets	$2,510

Given that there are no actuarial gains or losses for the period, periodic pension cost is *closest to*:

- $580
- $770
- $1,350

Rationale
This Answer is Correct

Periodic pension cost = Ending net pension liability – Beginning net pension liability + Employer contributions

Ending net pension liability = Ending pension obligation – Ending fair value of plan assets

$$= \$3,655 - \$2,510 = \$1,145$$

Beginning net pension liability = Beginning pension obligation – Beginning fair value of plan assets

$$= \$2,225 - \$1,850 = \$375$$

Employer contributions = Ending fair value of plan assets – Beginning fair value of plan assets – Actual return on plan assets + Benefits paid

$$= \$2,510 - \$1,850 - \$250 + \$170 = \$580$$

Periodic pension cost = Ending net pension liability – Beginning net pension liability + Employer contributions

$$= \$1,145 - \$375 + \$580 = \$1,350$$

Question 26
L2R19TB-AC026-1512
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium

An analyst compares two peer companies. Company A complies with U.S. GAAP and Company B complies with IFRS. The analyst considers making the following comparative adjustments:

1. Use the actual return for return on plan assets.
2. Use the discount rate for return on plan assets.
3. Include past service costs in P&L.
4. Exclude amortization of past service costs from prior periods.

Which of the adjustments listed above would the analyst *most likely* apply to Company A to better compare its reported financial results with Company B?

- Adjustments 1, 3, and 4 should be applied, but adjustment 2 should not be applied.
- Adjustments 2, 3, and 4 should be applied, but adjustment 1 should not be applied.
- Adjustments 2 and 3 should be applied, but adjustments 1 and 4 should not be applied.

Rationale
Adjustments 1, 3, and 4 should be applied, but adjustment 2 should not be applied.
To account for differences in DB pension plan reporting and improve comparability between peer companies, an analyst may adjust Company A's (U.S. GAAP-compliant) financial statements to reflect past service costs in P&L, exclude past service cost amortization, and use the discount rate instead of an expected rate of return.

Rationale
Adjustments 2, 3, and 4 should be applied, but adjustment 1 should not be applied.
To account for differences in DB pension plan reporting and improve comparability between peer companies, an analyst may adjust Company A's (U.S. GAAP-compliant) financial statements to reflect past service costs in P&L, exclude past service cost amortization, and use the discount rate instead of an expected rate of return.

Rationale
Adjustments 2 and 3 should be applied, but adjustments 1 and 4 should not be applied.
To account for differences in DB pension plan reporting and improve comparability between peer companies, an analyst may adjust Company A's (U.S. GAAP-compliant) financial statements to reflect past service costs in P&L, exclude past service cost amortization, and use the discount rate instead of an expected rate of return.

Question 27
L2FR-TBX110-1502
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: easy
Stock options issued as compensation to senior management are expensed:

- At intrinsic value in the period that the options are granted.
- At estimated fair value allocated over the period between the grant date and the vesting date.
- At estimated fair value allocated over the period between the grant date and the exercise date.

Rationale

This Answer is Correct
Compensation expense related to options grants is reported at fair value under both IFRS and U.S. GAAP and allocated over the service period between the grant date and the vesting date of the options.

Question 28
L2R19TB-AC013-1512
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Company A complies with IFRS and Company B complies with U.S. GAAP. Pertaining to their defined benefit (DB) pension plans for the current year, both use a discount rate of 5.0 percent and each expected to earn a return on plan assets of 5.5 percent. But, both only earned 5.0 percent. Neither reported actuarial gains or losses in the current year. Assuming the remeasurement component of periodic cost includes only amounts related to differences in plan asset returns, which company's periodic pension cost in the profit and loss statement or other comprehensive income had no impact from the remeasurement component?

- (●) Company A.
- ( ) Company B.
- ( ) Neither Company A or B.

Rationale

✔ **Company A.**

Since Company A complies with IFRS, it will use the actual return to report return on plan assets. For Company A, the discount rate and actual return are the same (5.0 percent). Therefore, the net return on plan assets is zero. Remember, the net return on plan assets = actual return − (plan assets × discount rate). Company B complies with U.S. GAAP, which applies the expected return for return on plan assets. There is a difference between expected and actual return, so Company B would report a remeasurement balance.

Rationale

✘ **Company B.**

Since Company A complies with IFRS, it will use the actual return to report return on plan assets. For Company A, the discount rate and actual return are the same (5.0 percent). Therefore, the net return on plan assets is zero. Remember, the net return on plan assets = actual return − (plan assets × discount rate). Company B complies with U.S. GAAP, which applies the expected return for return on plan assets. There is a difference between expected and actual return, so Company B would report a remeasurement balance.

Rationale

✘ **Neither Company A or B.**

Since Company A complies with IFRS, it will use the actual return to report return on plan assets. For Company A, the discount rate and actual return are the same (5.0 percent). Therefore, the net return on plan assets is zero. Remember, the net return on plan assets = actual return − (plan assets × discount rate). Company B complies with U.S. GAAP, which applies the expected return for return on plan assets. There is a difference between expected and actual return, so Company B would report a remeasurement balance.

Question 29
L2R19TB-AC034-1512
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium
With respect to stock options granted to employees, which change in the valuation assumptions used for the options will *least likely* cause a company's pre-tax income to increase?

- (●) Expected life rises from 4 to 5 years.
- ( ) Volatility declines from 25 to 21 percent.
- ( ) An increase of 50 basis points in the dividend yield on the shares that underlie the options.

Rationale

✔ **Expected life rises from 4 to 5 years.**

A longer estimated life will increase the fair value of the stock options granted to employees, which results in higher compensation expense and lower pre-tax earnings. Lower volatility and higher dividend yield both reduce the fair value of the stock options granted to employees, which results in lower compensation expense and higher pre-tax income.

Rationale

✘ **Volatility declines from 25 to 21 percent.**

A longer estimated life will increase the fair value of the stock options granted to employees, which results in higher compensation expense and lower pre-tax earnings. Lower volatility and higher dividend yield both reduce the fair value of the stock options granted to employees, which results in lower compensation expense and higher pre-tax income.

Rationale

✘ **An increase of 50 basis points in the dividend yield on the shares that underlie the options.**

A longer estimated life will increase the fair value of the stock options granted to employees, which results in higher compensation expense and lower pre-tax earnings. Lower volatility and higher dividend yield both reduce the fair value of the stock options granted to employees, which results in lower compensation expense and higher pre-tax income.

Question 30
L2R19TB-AC029-1512
LOS: LOS-7010
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium

An analyst reviews the disclosures pertaining to FX Industries' defined benefit pension plan and compiles the following select information:

Pension obligation, beginning	55,000
Pension obligation, ending	54,750
Plan assets, beginning	50,000
Plan assets, ending	51,300
Actual return on plan assets	3,000
Employer contributions	1,800
Service costs	500
Actuarial gain/loss	0
Discount rate used to determine pension obligation	5.0 percent
Expected rate of return on plan assets	6.0 percent

If FX complies with IFRS, then the analyst's estimate of the retirement benefits paid is *closest* to:

- 1,700
- 3,000
- 3,500

Rationale
1,700
There are two ways to find the retirement benefits paid:

1. Start with beginning pension obligation, add the service costs plus interest cost (discount rate × beginning obligation) plus any actuarial losses (subtract gains) and then subtract the ending pension obligation:

$$\text{Retirement benefits paid} = 55{,}000 + 500 + [0.05 \times 55{,}000] + 0.0 - 54{,}750 = 3{,}500$$

2. Start with beginning fair value of plan assets, add the actual return on plan assets plus employer contributions and then subtract the ending fair value of plan assets

$$\text{Retirement benefits paid} = 50{,}000 + 3{,}000 + 1{,}800 - 51{,}300 = 3{,}500$$

Rationale
3,000
There are two ways to find the retirement benefits paid:

1. Start with beginning pension obligation, add the service costs plus interest cost (discount rate × beginning obligation) plus any actuarial losses (subtract gains) and then subtract the ending pension

obligation:

$$\text{Retirement benefits paid} = 55{,}000 + 500 + [0.05 \times 55{,}000] + 0.0 - 54{,}750 = 3{,}500$$

2. Start with beginning fair value of plan assets, add the actual return on plan assets plus employer contributions and then subtract the ending fair value of plan assets

$$\text{Retirement benefits paid} = 50{,}000 + 3{,}000 + 1{,}800 - 51{,}300 = 3{,}500$$

Rationale

3,500

There are two ways to find the retirement benefits paid:

1. Start with beginning pension obligation, add the service costs plus interest cost (discount rate × beginning obligation) plus any actuarial losses (subtract gains) and then subtract the ending pension obligation:

$$\text{Retirement benefits paid} = 55{,}000 + 500 + [0.05 \times 55{,}000] + 0.0 - 54{,}750 = 3{,}500$$

2. Start with beginning fair value of plan assets, add the actual return on plan assets plus employer contributions and then subtract the ending fair value of plan assets

$$\text{Retirement benefits paid} = 50{,}000 + 3{,}000 + 1{,}800 - 51{,}300 = 3{,}500$$

Question 31
L2R19TB-AC020-1512
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium
An analyst tests the sensitivity of her stock option valuation model by changing one input to the model at a time. In each test, the estimated fair value of the stock options decreased, except for one. Which input change was *most likely* the exception?

- An increase in the dividend yield.
- An increase in the average volatility.
- A decrease in the estimated life of the option.

Rationale
An increase in the dividend yield.
Changes in volatility and the estimated life of the option have a direct relationship with the change in fair value of the stock option; an increase in volatility will increase, not decrease the fair value of the option. An increase in the dividend yield will decrease fair value (indirect relationship).

Rationale
An increase in the average volatility.
Changes in volatility and the estimated life of the option have a direct relationship with the change in fair value of the stock option; an increase in volatility will increase, not decrease the fair value of the option. An increase in the dividend yield will decrease fair value (indirect relationship).

Rationale
A decrease in the estimated life of the option.
Changes in volatility and the estimated life of the option have a direct relationship with the change in fair value of the stock option; an increase in volatility will increase, not decrease the fair value of the option. An increase in the dividend yield will decrease fair value (indirect relationship).

Question 32

L2FR-ITEMSET-TBB212-1412

LOS: LOS-6970

Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan's Obligations

Difficulty: medium

The next five questions relate to the following information contained in the disclosures of a company relating to its defined benefit pension plan.

Opening value of plan assets	10,000
Closing value of plan assets	9,000
Actual return on plan assets	–6.0%
Opening value of benefit obligation	10,000
Closing value of benefit obligation	10,550
Current service costs	250
Past service costs	100
Actuarial loss	500
Employer contribution	600

i.

Benefits paid during the period were closest to:

- 600
- 1,000
- 1,600

Rationale

This Answer is Correct

Change in plan assets = Actual return on plan assets + employer contributions – benefits paid.

Hence in this case:

(9,000 – 10,000) = (–0.06 × 10,000) + 600 – benefits paid.

Therefore benefits paid = –1,000.

ii.

The actuarial discount rate used is closest to:c

- 5%.
- 6%.
- 7%.

Rationale

This Answer is Correct

Change in benefit obligation = service costs + interest cost + actuarial loss – benefits paid.

Hence, in this case:

(10,550 – 10,000) = 250 + 100 + interest cost + 500 – 1,000.

Hence interest cost = 700

This must be equal to the discount rate multiplied by the opening benefit obligation, hence the discount rate × 10,000 = 700; therefore, the discount rate is 7%.

iii.
The total periodic pension cost is:

- 1,550.
- 2,150.
- 2,550.

Rationale

This Answer is Correct

Total periodic pension cost = change in net liability + employer contributions.

The opening funded status of the plan is zero since assets equal liabilities. The closing funded status of the plan is a net liability of 1,550, hence the total periodic pension cost is 1,550 + 600 = 2,150.

iv.
The net interest expense included in the pension expense in the income statement under IFRS is closest to:

- 0.
- 700.
- 1,300.

Rationale

This Answer is Correct

Under IFRS the net interest expense that affects the pension expense in the income statement is calculated as the discount rate multiplied by the opening net liability of the plan. Since the opening net liability of the plan is zero, the net interest expense for the period will be zero.

v.
The amount of periodic pension cost that would be reported in OCI under IFRS is closest to:

- 0.
- 1,800.
- 2,150.

Rationale

This Answer is Correct

The amount of periodic pension cost that would be reported in OCI consists of actuarial gains and losses and net return on plan assets. Here, the actuarial loss is 500. We know from the change in pension obligation that the discount rate is 7%, hence the return on plan asset incorporated in the net interest expense in the income statement in 0.07 x 10,000 = 700. The actual return on plan assets was –0.06 × 10,000 = –600 hence the difference is 1,300 lower. Hence, the total amount reported in OCI would be 500 + 1,300 = 1,800.

Question 33
L2FR-PQ1822-1410
LOS: LOS-7000
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium

Consider the following statements:

Statement 1: The higher the ultimate healthcare trend rate, the higher the associated periodic cost.

Statement 2: The longer the time taken to reach the ultimate healthcare trend rate, the lower the associated periodic cost.

Which of the following is *most* likely?

- (•) Only Statement 1 is correct.
- ( ) Only Statement 2 is correct.
- ( ) Both statements are correct.

Rationale

This Answer is Correct

The ultimate healthcare trend rate is typically lower than the current trend rate. Therefore, the longer the time taken to reach the ultimate healthcare trend rate, the **higher** the associated periodic cost.

Question 34

L2FR-TB0018-1412

LOS: LOS-7010

Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information

Difficulty: medium

If a sponsoring company's periodic contributions to a plan are exceeded by the total pension costs of the period, the excess can be viewed from an economic perspective as:

- Making a principal repayment on a loan.
- Making an interest payment on an outstanding loan.
- Receiving cash from a source of financing.

Rationale

This Answer is Correct

A sponsoring company that fails to contribute the periodic pension cost to its pension plan can economically be viewed as using the plan as a source of financing, since paying less than the periodic cost leaves the company with temporarily high cash balances, similar to a borrowing.

Question 35
L2R19TB-AC031-1512
LOS: LOS-6960
Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan's Obligations
Difficulty: medium

An analyst makes the following statement: "Company Z's executive compensation package may seem generous, but it is very competitive in today's market. Although executives are offered company shares outright, the shares are contingent upon the achievement of significant profitability targets. As well, Company Z contributes up to 4 percent of eligible earnings into an executive's pension plan. The executives bear the risk of the investment and the company can reasonably estimate its annual pension cost."

Company Z *most likely* offers its executives a defined:

- benefit pension plan and stock grants.
- contribution pension plan and stock grants.
- contribution pension plan and stock options.

Rationale
benefit pension plan and stock grants.
If shares are offered outright they are a stock grant not a stock option, regardless whether they are contingent on achieving a return target. The shares described here are performance shares. The pension plan described here is a defined contribution pension plan. Company Z specifies an amount it will contribute; it is not obligated beyond that amount to make further contributions.

Rationale
contribution pension plan and stock grants.
If shares are offered outright they are a stock grant not a stock option, regardless whether they are contingent on achieving a return target. The shares described here are performance shares. The pension plan described here is a defined contribution pension plan. Company Z specifies an amount it will contribute; it is not obligated beyond that amount to make further contributions.

Rationale
contribution pension plan and stock options.
If shares are offered outright they are a stock grant not a stock option, regardless whether they are contingent on achieving a return target. The shares described here are performance shares. The pension plan described here is a defined contribution pension plan. Company Z specifies an amount it will contribute; it is not obligated beyond that amount to make further contributions.

Question 36
L2FR-ITEMSET-PQ0Y01-1505
LOS: LOS-6970
Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan's Obligations
Difficulty: medium

The next three questions relate to the following information:

An analyst has collected the following information regarding the obligation of a defined benefit pension plan for an individual employee:

Value of benefits at retirement date	£253,844
Years of service at retirement	15
Years to retirement	5
Actuarial discount rate	7%

i.
The annual unit credit for this plan participant is *closest* to:

- £12,910.
- £16,923.
- £50,769.

Rationale
This Answer is Correct
Annual unit credit = Value at retirement date/Years of service = £253,844/15 = £16,923

ii.
The service cost for the forthcoming year is *closest* to:

- £12,910.
- £16,923.
- £50,769.

Rationale
This Answer is Correct

The service cost for the forthcoming year will be equal to the present value of the annual unit credit at the end of the year (i.e., four years from the retirement date).

Annual unit credit = Value at retirement date/Years of service = £253,844/15 = £16,923

Present value of annual unit credit = £16,923/1.07^4 = £12,910

iii.
The interest cost for the forthcoming year is *closest* to:

- £8,446.
- £16,923.
- £17,769.

Rationale

This Answer is Correct

The opening obligation will be the present value of 10 years' worth of annual unit credit.

Annual unit credit = Value at retirement date/Years of service = £253,844/15 = £16,923

Present value of 10 years' worth of annual unit credit = $(10 \times £16,923)/(1.07^5)$ = £120,658

Interest cost = Opening obligation × Discount rate = £120,658 × 0.07 = £8,446

Question 37

L2FR-PQ1828-1410
LOS: LOS-7020
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium

Which of the following assumptions relating to stock options granted to senior management would *most* likely result in a higher net income?

- A longer time to expiration.
- A higher risk-free rate.
- A higher dividend yield.

Rationale

This Answer is Correct

A longer time to expiration and a higher risk-free rate lead to a higher compensation expense and lower net income. A higher dividend yield assumption results in lower compensation expense and higher net income.

Question 38

L2FR-PQ1827-1410
LOS: LOS-7020
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium

A higher stock price-volatility assumption for valuing stock options granted to senior management would *most likely* result in a lower:

- Compensation expense.
- Net income.
- Deferred compensation expense.

Rationale

This Answer is Correct

The value of stock options is positively related to the volatility assumption. A higher volatility assumption leads to a higher compensation expense and lower net income.

Question 39

L2FR-PQ1812-1410

LOS: LOS-6980

Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP

Difficulty: medium

The accounting treatment of which of the following components of a company's defined-benefit periodic pension costs *least* likely differs between IFRS and U.S. GAAP?

- (•) Current service costs
- ( ) Past service costs
- ( ) Interest expense

Rationale

This Answer is Correct

Current service costs are recognized in the P&L under both IFRS and U.S. GAAP.

Past service costs are recognized in the P&L under IFRS, but are recognized in other comprehensive income under U.S. GAAP and then subsequently amortized to P&L over the service life of employees.

Interest expense is recognized directly in P&L under U.S. GAAP, while it is included in net interest income / expense under IFRS.

Question 40

L2FR-PQ1824-1410

LOS: LOS-6970

Lesson Reference: Lesson 1: Types of Post-Employment Benefit Plans and Measuring a Defined Benefit Pension Plan's Obligations

Difficulty: medium

If a company that follows U.S. GAAP uses a higher expected long-term return on plan assets assumption, its year-end pension obligation will *most likely* be:

- (●) The same.
- ( ) Lower.
- ( ) Higher.

Rationale

This Answer is Correct

The expected long-term return on assets assumption has no impact on the pension obligation.

Question 41
L2FR-PQ1813-1410
LOS: LOS-7020
LOS: LOS-7030
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium
An increase in which of the following assumptions relating to stock options granted to management *least likely* decreases net income?

- Higher volatility.
- Higher assumed dividend yield.
- Higher risk-free rate.

Rationale

This Answer is Correct

A higher assumed dividend yield lowers the value of stock options, resulting in lower compensation expense and higher income.

A higher assumed volatility and a higher risk-free rate result in higher compensation expense.

Question 42
L2FR-PQ1815-1410
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium

Consider the following statements:

Statement 1: Actuarial gains and losses are never recognized in P&L under IFRS.

Statement 2: An increase in the expected return on plan assets has no impact on overall total periodic pension cost under U.S. GAAP.

Which of the following is *most* likely?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are correct.

Rationale

This Answer is Correct

Actuarial gains and losses are part of the remeasurement component under IFRS, which is recognized in OCI. These gains and losses are not amortized into P&L under IFRS.

An increase in the expected return on plan assets will lower periodic pension expense (recognized in P&L) under U.S. GAAP, but have no impact on overall periodic pension cost.

Question 43
L2R19TB-AC033-1512
LOS: LOS-7020
Lesson Reference: Lesson 5: Share-Based Compensation
Difficulty: medium
As part of his overall compensation package, Richard Hock, CFA received share-based compensation in the form of company stock. However, if he leaves the company within the next three years, he must return the stock. The form of share-based compensation that *best* describes the type of stock that Hock received is:

- Restricted stock options.
- Performance shares.
- Restricted stock.

Rationale

Restricted stock options.

Restricted stock is a type of stock grant, which is outright stock but with restrictions. In this case, Hock must remain with the company at least three years to keep the stock. A stock option is not outright stock; it is an option to receive stock in the future at a specified price. Performance shares are another type of stock grant with restrictions, but they are generally based on achieving certain financial returns for the company.

Rationale

Performance shares.

Restricted stock is a type of stock grant, which is outright stock but with restrictions. In this case, Hock must remain with the company at least three years to keep the stock. A stock option is not outright stock; it is an option to receive stock in the future at a specified price. Performance shares are another type of stock grant with restrictions, but they are generally based on achieving certain financial returns for the company.

Rationale

Restricted stock.

Restricted stock is a type of stock grant, which is outright stock but with restrictions. In this case, Hock must remain with the company at least three years to keep the stock. A stock option is not outright stock; it is an option to receive stock in the future at a specified price. Performance shares are another type of stock grant with restrictions, but they are generally based on achieving certain financial returns for the company.

Question 44
L2R19TB-AC018-1512
LOS: LOS-7010
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium

An analyst reviews the annual report and pension fund disclosures for Company A. She notes that for the most recent year, Company A:

- paid benefits of $400,000;
- made its required contribution to the pension plan of $200,000; and
- reported total pension cost of $165,000.

Excluding income tax effects, the analyst *most likely* would adjust Company As cash flow statement for an increased outflow of:

- ○ $200,000 to financing activities rather than operating.
- ○ $35,000 to operating activities rather than financing.
- ● $35,000 to financing activities rather than operating.

Rationale
✗ **$200,000 to financing activities rather than operating.**
The difference between a company's periodic contribution and its periodic pension cost can been seen as a use or source of financing. In this question, Company As contributions were $35,000 more than its pension costs ($200,000 − $165,000); that amount is seen a use of funds and an increase in financing cash outflows. The amount of benefits the company pays is not a factor in this adjustment.

Rationale
✗ **$35,000 to operating activities rather than financing.**
The difference between a company's periodic contribution and its periodic pension cost can been seen as a use or source of financing. In this question, Company As contributions were $35,000 more than its pension costs ($200,000 − $165,000); that amount is seen a use of funds and an increase in financing cash outflows. The amount of benefits the company pays is not a factor in this adjustment.

Rationale
✓ **$35,000 to financing activities rather than operating.**
The difference between a company's periodic contribution and its periodic pension cost can been seen as a use or source of financing. In this question, Company As contributions were $35,000 more than its pension costs ($200,000 − $165,000); that amount is seen a use of funds and an increase in financing cash outflows. The amount of benefits the company pays is not a factor in this adjustment.

Question 45
L2R19TB-AC027-1512
LOS: LOS-7010
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium

After reviewing the disclosures pertaining to Mark, Inc.'s defined benefit pension plan, an analyst made adjustments to Mark's cash flow statement line items. The original and adjusted cash flows ($ millions) are as follows:

	Reported	Analyst Adjusted
Cash inflow from operating activities	185	210
Cash outflow from financing activities	170	195

The *most likely* reason for this adjustment is that Mark's periodic contribution:

- Was less than its periodic pension cost.
- Can be viewed as a source of financing.
- Is similar to the prepayment of a future obligation.

Rationale
Was less than its periodic pension cost.
The analyst made an adjustment that increased the outflow from financing activities which indicates a use of funds. With regards to DB pension plan cash flow adjustments, a use of funds would indicate that Mark's periodic contribution was in excess of its periodic pension cost. A contribution in excess of the current periodic pension cost is similar to making a prepayment on a future obligation.

Rationale
Can be viewed as a source of financing.
The analyst made an adjustment that increased the outflow from financing activities which indicates a use of funds. With regards to DB pension plan cash flow adjustments, a use of funds would indicate that Mark's periodic contribution was in excess of its periodic pension cost. A contribution in excess of the current periodic pension cost is similar to making a prepayment on a future obligation.

Rationale
Is similar to the prepayment of a future obligation.
The analyst made an adjustment that increased the outflow from financing activities which indicates a use of funds. With regards to DB pension plan cash flow adjustments, a use of funds would indicate that Mark's periodic contribution was in excess of its periodic pension cost. A contribution in excess of the current periodic pension cost is similar to making a prepayment on a future obligation.

Question 46
L2R19TB-AC015-1512
LOS: LOS-6990
Lesson Reference: Lesson 3: Effects of Changes in Key Assumptions
Difficulty: medium
Company A complies with U.S. GAAP. The assumption change pertaining to its DB pension plan that would *most likely* be considered the most aggressive is a(n):

- Decrease in the discount rate.
- Increase in the compensation rate.
- Increase in the expected return on assets.

Rationale
Decrease in the discount rate.
Under U.S. GAAP, an increase in the expected return on plan assets will decrease pension cost and increase net income. The other two changes would increase pension cost and decrease net income. The most aggressive action is the one resulting in higher net income.

Rationale
Increase in the compensation rate.
Under U.S. GAAP, an increase in the expected return on plan assets will decrease pension cost and increase net income. The other two changes would increase pension cost and decrease net income. The most aggressive action is the one resulting in higher net income.

Rationale
Increase in the expected return on assets.
Under U.S. GAAP, an increase in the expected return on plan assets will decrease pension cost and increase net income. The other two changes would increase pension cost and decrease net income. The most aggressive action is the one resulting in higher net income.

Question 47
L2R19TB-AC022-1512
LOS: LOS-6980
Lesson Reference: Lesson 2: Components of Periodic Pension Cost: IFRS versus U.S. GAAP
Difficulty: medium
The amount by which pension obligation increases as a result of plan amendments *best* describes:

- interest cost.
- benefits paid.
- past service cost.

Rationale
interest cost.
Past service cost (a component of periodic pension cost) is the change in the pension obligation related to employee service resulting from any changes or amendments to the DB pension plan. Interest cost is the discount rate used to find the pension obligation multiplied by the net pension liability (or asset). Benefits paid are a component of the benefit obligation that represents the actual amount paid out for benefits that period.

Rationale
benefits paid.
Past service cost (a component of periodic pension cost) is the change in the pension obligation related to employee service resulting from any changes or amendments to the DB pension plan. Interest cost is the discount rate used to find the pension obligation multiplied by the net pension liability (or asset). Benefits paid are a component of the benefit obligation that represents the actual amount paid out for benefits that period.

Rationale
past service cost.
Past service cost (a component of periodic pension cost) is the change in the pension obligation related to employee service resulting from any changes or amendments to the DB pension plan. Interest cost is the discount rate used to find the pension obligation multiplied by the net pension liability (or asset). Benefits paid are a component of the benefit obligation that represents the actual amount paid out for benefits that period.

Question 48
L2R19TB-AC016-1512
LOS: LOS-7000
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium
An analyst reviews the disclosures pertaining to Company A's postemployment health care plan. Which of the following assumption changes would an analyst *most likely* consider aggressive relative to Company A's peers?

- A change in short-term health costs from 3.8 to 5.0 percent.
- An increase in the ultimate health care trend rate of 100 basis points.
- A change in the year from 20X9 to 20X8 that the ultimate health care trend rate is assumed to be reached.

Rationale
A change in short-term health costs from 3.8 to 5.0 percent.
If the year that the ultimate health care trend rate is assumed to be reached is moved up by one year (earlier), then the obligation and pension expense will most likely decrease. As this change results in higher net income, this may be considered aggressive. The other changes result in both a higher obligation and expense (lower net income), a more conservative outcome.

Rationale
An increase in the ultimate health care trend rate of 100 basis points.
If the year that the ultimate health care trend rate is assumed to be reached is moved up by one year (earlier), then the obligation and pension expense will most likely decrease. As this change results in higher net income, this may be considered aggressive. The other changes result in both a higher obligation and expense (lower net income), a more conservative outcome.

Rationale
A change in the year from 20X9 to 20X8 that the ultimate health care trend rate is assumed to be reached.
If the year that the ultimate health care trend rate is assumed to be reached is moved up by one year (earlier), then the obligation and pension expense will most likely decrease. As this change results in higher net income, this may be considered aggressive. The other changes result in both a higher obligation and expense (lower net income), a more conservative outcome.

Question 49

L2FR-PQ1823-1410
LOS: LOS-6980
LOS: LOS-7000
Lesson Reference: Lesson 4: Disclosures of Pension and Other Post-Employment Benefits, and Cash Flow Related Information
Difficulty: medium

Which of the following is an adjustment that an analyst would *least likely* make to financial statements prepared using U.S. GAAP to make them comparable to financial statements prepared using IFRS?

- Include past service costs on the P&L as pension expense.
- Include the effects of amortization of unrecognized actuarial gains and losses arising in previous periods.
- Incorporate the effects of the expected return on plan assets based on the discount rate instead of the expected rate.

Rationale

This Answer is Correct

The effects of amortization of unrecognized actuarial gains and losses arising in previous periods must be **excluded** from U.S. GAAP financial statements to make them comparable to IFRS.