Jon Horton, CFA, is the Chief Financial Officer (CFO) for Springtown Corporation, a manufacturer of windows for residential and commercial applications. As part of an ongoing diversification strategy, Springtown Corp. has recently entered into a preliminary agreement to purchase all of the assets of Prime Doors, a manufacturer and distributor of doors to the same residential and commercial market in which Springtown sells its windows. Horton is head of the due diligence team that will fully evaluate Prime Doors' financial statements prior to the proposed acquisition.

Prime Doors has been in operation for thirty years, and currently has approximately 800 employees at two operating facilities. Horton observes in the notes to the financial statements that Prime Doors has a defined benefit pension plan, for which all employees are eligible. Employees are vested at the rate of 20% per year of employment, and are fully vested upon completion of five years of employment. Springtown does not offer a pension plan to its employees, but encourages employees to contribute to Individual Retirement Accounts (IRAs) and offers a 401(k) program.

Horton wants to fully evaluate the financial implications of Springtown's assumption of Prime Doors' pension assets and the associated future liabilities and expenses. Like most companies, the pension plan for Prime Doors' employees is not fully funded, but Horton wants to review all assumptions used by Prime Doors' accountants in the valuation of the plan's current liabilities. The most current information regarding the pension plans is as follows:

Select Pension Plan Information for Prime Doors (as of 12/31/05)	
Projected benefit obligation (PBO)	$15,500,000
Accumulated benefit obligation (ABO)	$13,750,000
Market value of plan assets	$11,875,000

Horton notices a paragraph in the pension plan footnotes that the original pension plan was amended last year, effectively increasing the level of benefits to be paid to employees with more than ten years of service. However, he is not able to detect what effect, if any, this change in projected benefits has had on Prime Doors' financial statements or is expected to have in the future.

Horton is aware that a commonly used method can be used to adjust the income statement and provide a better measure of Prime Doors' economic pension cost than reported pension expense. He is not quite sure which components of the financial statements are utilized to derive an adjusted pension expense, but intends to investigate what analysis he can perform to gain more insight into the company's position with regards to its pension plan.

Question #1 - 6 of 53

Question ID: 1208882

When accounting for pension liabilities in the U.S., a company must make fundamental assumptions to estimate the future liability and expense for each employee. How are the following assumptions required to be treated in the pension footnotes?

	Required disclosure	Not required to be disclosed
A)	Discount rate	Rate of compensation growth
B)	Discount rate	Expected return on plan assets
C)	Rate of compensation growth	Expected length of employment

Explanation

A company must disclose the discount rate, the expected return on plan assets, and the rate of compensation growth. The expected length of employment is not a required disclosure.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #2 - 6 of 53

Question ID: 1208883

What effect will an increased discount rate and increased expected rate of return have on a company's projected benefit obligation (PBO) and accumulated benefit obligation (ABO) as reflected in the financial statements?

A) Both will decrease.

B) Both will increase.

C) Only one will increase.

Explanation

The use of a higher discount rate will decrease a company's PBO and ABO because it will result in a lower present value of future pension liability. The expected rate of return has no impact on pension obligations.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #3 - 6 of 53

Question ID: 1208884

According to U.S. GAAP, companies must account for pension assets and the associated pension obligation in their financial statements. These could be reported in two ways. Method 1 is to report the values of the pension fund assets and liability separately on the balance sheet. Method 2 is to report a net amount for the difference between the value of the fund assets and the fund liabilities. Which of the following statements *most* accurately describes the requirements of U.S. GAAP?

A) Companies are required to use Method 2. ✓

B) Companies are required to use Method 1. ✗

C) Companies may choose to use either method. ✗

Explanation

GAAP requires that companies use the "net" method, which decreases a firm's total assets and total liability. Netting also affects certain financial ratios, such as return on assets and leverage ratios.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #4 - 6 of 53

Question ID: 1208885

Prime Doors has recorded a net pension liability of $1.5 million on its balance sheet. According to current U.S. accounting standards, Prime Doors is required to:

A) immediately recognize $2,125,000 as additional pension expense in its income statement. ✗

B) record $2,125,000 as additional pension liability on its balance sheet. ✓

C) record $375,000 as additional pension expense on its balance sheet.

Explanation

According to current U.S. accounting standards, the funded status must be reported on the balance sheet. The plan is underfunded by $3,625,000 ($11,875,000 Plan assets − $15,500,000 PBO). Since Prime Doors is reporting a liability of $1,500,000, an additional liability of $2,125,000 ($3,625,000 required liability − $1,500,000 reported liability) must be reported.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #5 - 6 of 53

Question ID: 1208886

Which of the following statements regarding the treatment of pension plan amendments under U.S. GAAP standards is *most* accurate? A plan amendment results in:

A) the disclosure in the pension plan footnotes of the nature of the amendment and the projected future financial impact.

B) an unrecognized prior service cost that is amortized over the expected remaining service life of the affected employees.

C) an immediate increase in pension expense equal to the amount of the amendment.

Explanation

The amendment affects the funded status on the balance sheet immediately. In the income statement, the amendment is amortized as a component of pension expense over the remaining service life of the affected employees.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #6 - 6 of 53

Question ID: 1208887

Pension expense as reported by a firm is routinely adjusted by analysts to derive a more accurate measure of a firm's true economic pension cost. Economic pension expense is calculated as:

A) reported pension expense – service cost + interest cost.

B) reported pension cost – actual return on plan assets.

C) Contribution – (Ending funded status – beginning funded status)

Explanation

Economic pension expense is calculated without reflecting the amortized items normally included in pension expense and using "actual" instead of "expected" return on assets. It can be also computed as Change in funded status excluding contributions.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #7 of 53

Question ID: 1208906

Which of the following measures is *least* sensitive to changes in pension plan actuarial assumptions?

A) Projected benefit obligation (PBO).

B) Total periodic pension cost.

C) Balance sheet asset or liability.

Explanation

Total periodic pension cost is a net (smaller) amount and therefore, is generally quite sensitive to relatively minor changes in actuarial assumptions.

Changing an assumption may have a small effect on the projected benefit obligation (PBO) but may have a much larger effect on the funded status (which is a *net* pension amount) which is the balance sheet asset or liability.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #8 of 53

Question ID: 1208902

Tim Gresham, CFO of Alpha Logistics is concerned about changes in the business environment which could lead to Alpha violating some of the covenants of their outstanding debentures. Specifically Gresham is concerned about leverage and profitability ratios. Gresham reviews Alpha's most recent financial statements and decides that changing the assumptions for the company's defined benefit pension plan may provide some relief in the short-run. Alpha reports under U.S. GAAP.

Which of the following changes in the pension plan's assumptions would *most likely* lead to lower reported leverage and higher reported profitability?

A) Increasing the discount rate.

B) Increasing expected return on plan assets.

C) Increasing the growth rate in compensation expense.

Explanation

Increasing discount rate leads to lower present values and reduces reported pension liability in the balance sheet and also reduces pension expense by reducing the service cost component. Increasing expected return on plan assets does reduce pension expense but does not affect reported assets or liabilities. Increasing the growth rate in compensation expense increases service cost as well as reported pension liability.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #9 of 53

Question ID: 1208919

The following information relates to Nazarali Inc. (Nazarali) and its defined-benefit pension plan for the year:

Contributions	$3.0 million
Reported pension expense	$2.8 million
Total periodic pension cost	$3.1 million

Based on the information above, which of the following statements is *most* accurate?

A) There is a source of borrowing of $100,000.

B) There is a reduction in the overall pension obligation of $100,000.

C) There is a reduction in the overall pension obligation of $200,000.

Explanation

The total periodic pension cost represents the true cost of the pension. The reported pension expense is irrelevant in this case.

Since the true pension expense ($3.1 million) exceeds the contributions ($3.0 million), the $100,000 difference can be viewed as a source of borrowing. Alternatively, if the firm's contributions exceed the true pension expense, the difference can be viewed as a reduction in the overall pension obligation, similar to an excess principal payment on a loan.

(Study Session 5, Module 14.6, LOS 14.f)

Related Material

SchweserNotes - Book 2

Question #10 of 53

Question ID: 1208923

Which of the following statements about the methods of valuing employee stock options is *least* accurate?

A) Once the options are in-the-money, compensation expense is recognized on the income statement.

B) With either method, the offset to compensation expense recognized is an increase in paid-in capital.

C) With the fair value method, compensation expense is allocated in the income statement for the period between the grant date and the vesting date.

Explanation

Compensation expense is based on the fair value of the option on the grant date based on the number of options that are expected to vest. The vesting date is the first date the employee can actually exercise the option. The compensation is allocated in the income statement over the service period (which is the time between the grant date and the vesting date).

For any compensation expense recognized, the offset is an expense in paid-in capital, which is a stockholders' equity account.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #11 of 53

Question ID: 1208903

In order to *decrease* the projected benefit obligation (PBO) of a pension plan, which of the following changes in pension assumptions can be made to yield the desired result?

A) Decrease the rate of compensation growth.

B) Decrease the discount rate.

C) Increase the expected rate of return.

Explanation

A decrease in the rate of compensation growth will lower future pension payments and in turn, lower the PBO.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #12 of 53

Question ID: 1208920

Which of the following is NOT an advantage of share based compensation over cash compensation?

A) Share based compensation serves to align employee interest with the interests of stockholders.

B) Share based compensation does not require a cash outlay.

C) In a share based compensation plan, expense is not recognized, unless the exercise price is set below the market price.

Explanation

Share based compensation needs to be recognized at fair value under both U.S. GAAP and IFRS. Intrinsic value does not matter. However, the expense does not require a cash outlay and serves to align the interests of employees and stockholders.

(Study Session 5, Module 14.7, LOS 14.g)

Related Material

SchweserNotes - Book 2

Question #13 of 53

Question ID: 1208895

Financial analysts can use select data from a company's financial statements to derive total periodic pension cost in order to better reflect the company's true economic pension cost. Which of the following formulas will *most* accurately calculate a company's true pension expense?

A) Service cost + interest cost – actual return on plan assets – benefits paid.

B) Beginning fair value of plan assets + service cost + interest cost – ending fair value of plan assets.

C) Service cost + interest cost + plan amendments – actual return on plan assets.

Explanation

The total periodic pension cost, (absent any information on changes in actuarial assumptions) is calculated without reflecting the amortization of unrecognized items and other smoothing mechanisms included in reported pension expense, and in addition uses the plan's actual return on assets, rather than the plan's expected return.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

Question #14 of 53

Question ID: 1208922

In determining the fair value of employee stock options, which of the following statements is *most* appropriate?

A) A lower risk-free rate will usually increase the estimated fair value.

B) Absent a market-based instrument, U.S. GAAP and IFRS prefer firms to use the Black-Scholes option-pricing model.

C) A higher than expected dividend yield will decrease the estimated fair value.

Explanation

Dividends paid out reduce the value of the underlying shares and therefore, reduce the value of the option.

There is no preference of a specific option-pricing model in either IFRS or U.S. GAAP. Acceptable models include the Black-Scholes model or the binomial model.

A lower risk-free rate will usually *decrease* the estimated fair value of the option (refer to the Study Session on derivatives). The sensitivity factor is "Rho" and for call options, there is a positive relationship between the risk-free rate and the estimated fair value of the option.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #15 of 53

Question ID: 1208924

Which of the following statements about stock appreciation rights, performance stock, and phantom stock is *most* accurate?

A) Performance stock cannot be sold by the employee until vesting has occurred.

B) Stock appreciation rights never have any dilution effect on the existing shareholders.

C) Phantom stock payoffs are based on the performance of the firm's actual shares.

Explanation

Stock appreciation rights do not cause dilution to the existing shareholders since no shares are actually issued.

Performance stock is a type of stock grant. It is contingent on meeting performance goals such as accounting earnings or other financial reporting metrics like return on assets or return on equity. Unfortunately, tying performance to accounting earnings and other metrics may result in manipulation by the employee. With restricted stock, the transferred stock cannot be sold by the employee until vesting has occurred.

Phantom stock is similar to stock appreciation rights except the payoff is based on the performance of hypothetical stock instead of the firm's actual shares.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #16 of 53

Question ID: 1208898

Wes Livingston is the founder and CEO of Bigwell Corporation. Livingston is interested in Bigwell being acquired by a larger competitor and wants to have his company's financial statements appear as attractive as possible to a potential suitor. In order to decrease the projected benefit obligation (PBO) of the company's pension plan, which of the following changes in actuarial assumptions could be made?

A) Increase the discount rate.

B) Increase the rate of compensation growth.

C) Decrease the discount rate.

Explanation

Increasing the assumed discount rate of a pension plan will result in lower projected benefit obligation (PBO). Increasing rate of compensation growth and decreasing discount rate would increase the PBO.

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2

Question #17 of 53

Question ID: 1208921

Which of the following statements about stock-based compensation are correct or incorrect?

Statement #1:	The grant date of a service-based award is the date when the employees' benefits are fully vested.
Statement #2:	When two or more performance conditions must be satisfied, the requisite service period ends when the first condition is met.

A) Both are incorrect.

B) Only one is correct.

C) Both are correct.

Explanation

The grant date is the date an award is approved by the board of directors or compensation committee. When two or more performance conditions must be satisfied, the requisite service period does not end until *all* conditions are met.

(Study Session 5, Module 14.7, LOS 14.g)

Related Material

SchweserNotes - Book 2

Question #18 of 53

Question ID: 1208901

An analyst views the assumptions made by a company reporting under U.S. GAAP regarding its pension liabilities as unrealistic, and thinks the discount rate and expected rate of return should both be increased. The *most likely* effect of increasing the discount rate and expected rate of return on the pension benefit obligation (PBO) is:

	Discount rate	Expected rate of return
A)	Increase	Decrease
B)	Decrease	No effect
C)	No effect	Decrease

Explanation

The PBO will decrease because a higher discount rate will cause the present value of the future obligations to decline. There will be no effect from changing the expected rate of return because expected return relates to the pension expense, not to the size of the obligation.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #19 of 53

Question ID: 1208909

Which of the following statements regarding pension accounting under U.S. GAAP standards and/or under International Financial Reporting Standards (IFRS) is *most* accurate?

A) Under IFRS and U.S. GAAP, the calculation of pension expense is the same.

B) Under IFRS, the funded status (difference in the PBO and the plan assets) is reported on the balance sheet.

C) Under U.S. GAAP, firms are required to provide a reconciliation of the funded status and the reported net pension asset or liability.

Explanation

The calculation of reported pension expense differs between U.S. GAAP and IFRS. Under U.S. GAAP and under IFRS, the net pension asset or liability reported on the balance sheet is equal to the funded status, without adjustment for unrecognized items.

Since balance sheet asset/liability under U.S. GAAP and IFRS reflects funded status, no reconciliation is necessary in the footnotes.

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #20 of 53

Question ID: 1208904

The Board of Directors of Prime Bank has asked management to make changes in the accounting of its pension plan obligations in order to decrease the reported service cost. Management determines that there are two changes in actuarial assumptions that will result in a lower service cost. Which of the following pairs of changes in actuarial assumptions will *best* achieve the desired effect? Prime Bank can either:

A) increase the discount rate or decrease the rate of compensation growth.

B) decrease the discount rate or increase the expected rate of return.

C) decrease the rate of compensation growth or increase the expected rate of return.

Explanation

An increase in the discount rate will result in lower service cost. Using a lower rate of compensation growth will yield lower future pension benefits owed, and thus a lower service cost. The expected return has no impact on service cost.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #21 of 53

Question ID: 1208897

Which of the following statements regarding total periodic pension cost is *least* accurate?

A) It is a more volatile measure of pension expense than reported pension expense.

B) It is equal to the sum of all the changes in projected benefit obligation (PBO) for the period (except for benefits paid) minus the actual return on assets.

C) It is equal to the change in the funded status for the period.

Explanation

Total periodic pension cost (the true or economic pension expense) is equal to the change in the funded status for the period *excluding* the firm's contributions.

Total periodic pension cost is calculated by eliminating the smoothed amounts from reported pension expense and including the actual return on assets. The result is a more volatile measure of pension expense.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

Jason Moore, CFA, is a credit analyst for Everest Bank in New York in the firm's investment banking division. An existing customer of Everest, Longhorn Partners, which is based in Texas, has approached the bank for a $45 million loan to be used to acquire a smaller competitor. Moore has been appointed head of the credit team that will review Longhorn's current business with Everest as well as Longhorn's current operations, in order to assess Longhorn's request.

Overall, Longhorn has achieved consistent profitability over the last decade. The company is appropriately leveraged and appears to be well-run by its senior management team. However, there are a couple of items in the company's financial statements that Moore believes may warrant further analysis. He specifically wants to adjust Longhorn's reported operating profit for comparative analysis with other companies who may not report their entire pension expense as an operating expense.

For many years, Longhorn has offered to its fulltime employees a traditional defined-benefit pension plan: eligible employees are promised an annual pension payment of 3% per year of service times their annual salary at retirement. Selected information regarding the pension plan from Longhorn's most recent financial statement is as follows:

Pension Benefit Obligation (PBO) (ending)	$85,475,000
Accumulated Benefit Obligation (ABO) (ending)	65,250,000
Fair value of plan assets (ending)	71,365,000
Fair value of plan assets (beginning)	66,360,000
Operating income	17,185,000

Interest expense	1,285,000
Pension Expense	5,456,000
Contributions	7,200,000
Service cost	4,114,000
Interest cost	5,342,000
Discount rate	6.25%

Additionally, Longhorn has a share-based compensation plan for its senior executives.

Question #22 - 27 of 53

Question ID: 1208889

The balance sheet asset/liability related to Longhorn's pension plan is *closest* to:

A) an asset of $6,115,000.

B) a liability of $6,115,000.

C) a liability of $14,110,000.

Explanation

Pension plans are underfunded when the PBO exceeds the fair market value of the plan assets. In this case, the PBO exceeds the plan assets by $14,110,000 (= $85,475,000 − 71,365,000) and hence a liability will be reported.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #23 - 27 of 53

Question ID: 1208890

Moore reads in the footnotes to Longhorn's financial statements that the pension plan's PBO increased by $5,000,000 last year. Of this amount, approximately 50% was attributed to benefits earned by its employees that year. The remaining 50% was attributed to a change in the pension plan's actuarial assumptions. Which of the following changes to actuarial assumptions is *most likely* to cause an increase in PBO? A decrease in the:

A) discount rate.

B) rate of compensation growth.

C) expected rate of return.

Explanation

Decreasing the assumed discount rate used to calculate the present value of the pension obligations will increase the PBO.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #24 - 27 of 53

Question ID: 1208891

Compared to the reported net income, if Longhorn had used a higher stock price volatility assumption in valuing stock option grants to its senior executives, Longhorn's net income would have *most likely* have been:

A) lower.

B) higher.

C) unchanged.

Explanation

An increase in the assumed stock price volatility would increase the value of the option grants, increase the compensation expense and lower the reported net income.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #25 - 27 of 53

Question ID: 1208892

Compared to the reported compensation expense, if Longhorn had used a lower estimated life assumption in valuing stock option grants to its senior executives, Longhorn's compensation expense would have *most likely* been:

A) lower.

B) higher.

C) unchanged.

Explanation

Lower estimated life of the options lead to lower values of the option and lower compensation expense.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #26 - 27 of 53

Question ID: 1208893

Longhorn's adjusted operating profit is *closest* to:

A) $15,843,000

B) $14,110,000

C) $18,527,000

Explanation

Adjusted operating profit is computed as reported operating profit + reported pension expense − service cost.

=17,185,000 + 5,456,000 − 4,114,000 = $18,527,000

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #27 - 27 of 53

Question ID: 1208894

Assume for this question only that the actual return on plan assets was $981,200 higher than the expected return of $5,308,800. The amount of benefits paid to plan participants was *closest* to:

A) $8,485,000.

B) $1,285,000.

C) $5,192,000.

Explanation

Actual return on plan assets = 5,308,800 + 981,200 = $6,290,000

Beginning Plan assets (given)	66,360,000
(+) Contributions (given)	7,200,000
(+) Actual return on plan assets (computed)	6,290,000
(−) Benefits paid (plug)	8,485,000
(=) End Plan Assets (given)	71,365,000

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #28 of 53

Question ID: 1208896

Federal Companies reported the following information in the footnotes to its most recent financial statements:

Beginning Projected Benefit Obligation (PBO)	$65,000,000
Ending PBO	90,000,000
Service Cost	27,000,000
Interest Cost	3,000,000
Benefits Paid	5,000,000
Actual Return on Plan Assets	7,500,000
Expected Return on Plan Assets	8,500,000

Given the information above, calculate Federal's total periodic pension cost for the year.

A) $22,500,000.00

B) $41,000,000.00

C) $27,500,000.00

Explanation

Total periodic pension cost = service cost + interest cost – actual return on plan assets + plan ammendments

Therefore, $27,000,000 + 3,000,000 – 7,500,000 = $22,500,000

There are no other actuarial assumptions affecting PBO as evidenced by reconciliation of PBO:

Beginning PBO	65
(+) Service cost	27
(+) Interest cost	3
(-) Benefits paid	(5)
(=) Ending PBO	90

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

Question #29 of 53

Question ID: 1208910

Under current U.S. GAAP, the assets and liabilities of a defined benefit pension plan are:

A) off balance sheet items which are shown only in the footnotes.

B) reported in the appropriate section of the balance sheet, with pension obligations shown under liabilities and plan assets shown under assets.

C) netted against each other, and only the net asset or liability amount is reported on the company's balance sheet.

Explanation

Under current U.S. GAAP, companies are required to report only the net asset or liability amount. They cannot show assets and liabilities separately. Although some smoothing details are still disclosed in the footnotes, all major components of pension assets and liabilities are now required to be shown on the balance sheet.

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #30 of 53

Question ID: 1208876

When considering the major differences between a defined contribution and a defined benefit pension plan, which of the following statements is *most* accurate?

A) A company with a defined contribution plan will report on its balance sheet the net difference between the value of the pension fund assets and the value of the

B) Accounting for a defined contribution pension plan is the most complicated because of the many investment options available to the employees.

C) Among the different types of pension plans, accounting for a pay-related defined benefit plan is the most complicated because of the required actuarial

Explanation

Three actuarial assumptions (discount rate, expected increase in employee compensation and the expected return on plan assets) must be estimated to project the value of the corporation's pension liability today. Subtle changes to any of the three assumptions can drastically change the estimated liability.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

Question #31 of 53

Question ID: 1208918

Consider a situation at a firm where the differences in its cash flow and economic pension expense are considered material to the financial statements. The relevant tax rate is 30%. The expected return on plan assets is $120,000, interest cost is $85,000, employer's contribution is $215,000, service cost is $450,000, and the actual return on plan assets is $50,000. Based on the information provided and for analytical purposes only, which of the following statements is *most* appropriate?

A) There is a reclassification of $189,000 from operating cash flow to financing cash flow.

B) There is a reclassification of $270,000 from operating cash flow to financing cash flow.

C) There is a reclassification of $140,000 from operating cash flow to financing cash flow.

Explanation

The total periodic pension cost = service cost + interest cost − actual return on plan assets = $450,000 + $85,000 − $50,000 = $485,000.

Since the differences in cash flow and economic pension expense are considered material, for analysis purposes we should consider reclassifying the difference from operating activities to financing activities in the cash flow statement.

The employer's contribution was only $215,000. Since the total periodic pension cost exceeds the cash flow, the difference, net of tax, is treated as a borrowing in the cash flow statement for analytical purposes. Given a tax rate of 30%, $189,000 is reclassified from operating cash flow to financing cash flow [($485,000 total periodic pension cost − $215,000 employer contribution) ((1 − 30% tax rate)].

(Study Session 5, Module 14.6, LOS 14.f)

Related Material

SchweserNotes - Book 2

Question #32 of 53

Question ID: 1208875

The financial statements of Pace Industries issued over the past five years show a progressively increasing net difference between the value of its pension fund and the projected future pension liability on the balance sheet. Pace *most likely* offers which of the following types of pension plans to its employees?

A) A defined contribution plan. ✗

B) A 401(k) plan. ✗

C) A defined benefit plan. ✓

Explanation

A company with a defined benefit plan will fund a portfolio structured to fulfill future pension obligations. The difference between the current value of the assets and the projected future liability is shown as a net amount on the balance sheet.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

Question #33 of 53

Question ID: 1208908

Wonderful Manufacturing has implemented a change in its pension plan, that will increase the future benefits for all of its current employees. Which of the following is the *most likely* effect on the company's financial statements of this change in promised benefits under current U.S. GAAP standards?

A) The pension expense for the next reporting period will increase by the projected increase in pension benefits due to employees.

B) The firm's prior financial statements will be adjusted to reflect the increase in benefits.

C) The net pension liability will increase immediately by the projected increase in pension benefits due to employees.

Explanation

A plan amendment will result in an immediate increase in the PBO. Under current U.S. accounting standards, an increase in PBO will result in an increase in the net pension liability (decrease in funded status).

(Study Session 5, Module 14.6, LOS 14.c)

Related Material

SchweserNotes - Book 2

Question #34 of 53

Question ID: 1208899

A company reporting under U.S. GAAP reduced the discount rate for its pension obligation from 10% to 8%, reduced the expected long-term rate of return on the assets in its pension plan from 8% to 6%, and changed its compensation growth rate assumption from 4% to 5%. What is the *most likely* impact of these changes on the current year ending defined benefit obligation and pension expense?

A) The reduction in the discount rate will decrease the defined benefit obligation and will increase reported pension expense.

B) The decrease in the long-term rate of return on plan assets will decrease reported pension expense.

C) The decrease in the long-term rate of return will have no impact on the defined benefit obligation and will increase reported pension expense.

Explanation

The decrease in the expected long-term rate of return on plan assets from 8% to 6% will have no effect on the defined benefit obligation (after all, it is an obligation and not an asset). The reduction will, however, increase reported pension expense for current and future periods because the expected return is subtracted while computing pension expense.

The reduction in the discount rate from 10% to 8% will increase (not decrease) the defined benefit obligation and will also increase reported pension expense because it will increase the current service cost. Additionally, the actuarial gains and losses resulting from this change (the difference between the defined benefit obligation after the increase and the defined benefit obligation before the increase) will be amortized into pension expense over time using the corridor approach. Amortization will start in the period after the change is made.

The decrease in the expected long-term rate of return on its plan assets from 8% to 6% will increase, not decrease, reported pension expense. Expected return reduces pension expense.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Jason Johnson, CFA, is a principal of a large private equity firm in New York. One of the associates in his firm has identified a potential investment opportunity for the firm: Gasline, Inc. is a major producer of carbon steel pipe used in the transportation of natural gas in the Southwestern United States.

Of particular concern to Johnson is Gasline's numerous, complicated transactions related to the company's various stock-based compensation plans and its defined benefit pension plan.

For example, the CEO of Gasline was awarded a stock option package at the beginning of 2013, which could ultimately have a significant impact on the company's future earnings. Details of the CEO's stock option grant are outlined below:

CEO Options (grant date January 1, 2013)

Strike price	$37.00
Current market price	$35.00
Number of options	100,000
Option period	4 years
Vesting period	25% per year

Question #35 - 40 of 53

Question ID: 1208926

For the valuation of the CEO's stock options granted on January 1, 2013, Gasline estimated a fair value of $100,000 by using Monte Carlo simulation.

In accordance with SFAS No. 123(R), which of the following statements is *most* accurate? Gasline's accounting treatment of the options is:

A) not in compliance because the fair value must be established by using the Black-Scholes option pricing model.

B) in compliance because the firm can elect to use either the intrinsic value model or the fair value model in the valuation of stock option plans.

C) in compliance because a Monte Carlo simulation is an acceptable method of valuing options in the absence of a market-based instrument.

Explanation

Under SFAS No. 123(R), firms are required to use the fair value method of valuing stock option plans. In the absence of a market-based instrument, firms may select and use an option-pricing model such as the Black-Scholes, the binomial model or Monte Carlo.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #36 - 40 of 53

Question ID: 1208927

Assume that the CEO of Gasline exercises $25,000 of his options on December 31, 2013, and the market price of the stock on that date is $39.50. Calculate the total compensation expense for the year ending 2013 that Gasline should recognize in association with the CEO option grant.

A) $100,000.

B) $62,500.

C) $25,000.

Explanation

Under the fair value method, as required by SFAS No. 123(R), Gasline will recognize compensation expense over the 4 year vesting period. For the year ending 2013, Gasline will recognize $25,000 (= $100,000 / 4 years) in compensation expense. Compensation expense is not affected when options are exercised.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #37 - 40 of 53

Question ID: 1208928

Which of the following actions by the management is *least likely* to reduce the reported option expense?

A) Assuming a low dividend yield on the stock

B) Assuming a lower risk-free rate.

C) Assuming a lower stock price volatility.

Explanation

Low dividend yield would increase option value (and option expense). Lower risk-free rate and lower volatility assumptions would reduce option value and option expense.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #38 - 40 of 53

Question ID: 1208929

If management increases the assumed discount rate, the *least likely* effect is that the:

A) plan assets will increase.

B) pension expense reported in P&L will decrease.

C) funded status will improve.

Explanation

Increasing the discount rate would reduce PBO and not change the plan assets, improving the funded status. Reported pension expense would also decrease in most cases.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #39 - 40 of 53

Question ID: 1208930

Regarding Gasline's defined benefit pension plan: if management increases the expected return on plan assets, the *most likely* effect is that the:

A) funded status would improve.

B) pension expense reported in P&L would decrease.

C) total periodic pension cost would decrease.

Explanation

Increasing the expected return on plan assets would not affect PBO or plan assets and hence would not affect the funded status. It would however reduce reported pension expense. Total periodic pension cost is based on actual return on plan assets and hence would not be affected.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #40 - 40 of 53

Question ID: 1208931

For this question only, assume that Gasline reports under IFRS. If changes in actuarial assumptions affecting the PBO lead to an actuarial gain, the *most likely* effect is that the:

A) plan assets would increase.

B) total periodic pension cost would decrease.

C) pension expense reported in P&L would decrease.

Explanation

Changes in actuarial assumptions do not affect plan assets. The funded status would change only due to changes in PBO due to change in actuarial assumptions. Total periodic pension cost would decrease due to actuarial gains. Actuarial gains would be considered remeasurement gains and would be reflected OCI (and not income statement). Under US GAAP if the gains meet the requirements of amortization under corridor approach, the future reported pension expense would be lower.

(Study Session 5, Module 14.7, LOS 14.h)

Related Material

SchweserNotes - Book 2

Question #41 of 53

Question ID: 1208877

The projected benefit obligation (PBO) is defined as the:

A) actuarial future value of all post-retirement healthcare benefits earned to date.

B) actuarial present value of all future pension benefits earned to date and based on current salary levels.

C) actuarial present value of all future pension benefits earned to date based on expected future salary increases.

Explanation

The projected benefit obligation (PBO) is defined as the actuarial present value of all future pension benefits earned to date based on expected future salary increases.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Paul Roberts, CPA, is a partner in Roberts & Smith, an accounting firm that is located in Chicago. The firm has recently been retained by Midwest Manufacturing, a major producer of heavy machinery and tractor parts in the U.S. Midwest has been in operation since 1965, and currently has approximately 700 full-time employees. The company had its initial public offering in 1986. The company has hired Roberts's firm to ensure that the accounting for Midwest's employee pension plan is fully in compliance U.S. GAAP standards.

Selected year-end pension plan information for Midwest Manufacturing

	2006	2007
PBO	$21 million	$23 million
Discount Rate	6.0%	7.5%
Rate of Compensation Increase	4.0%	4.0%
Benefits paid	$0.8m	$1m
Interest cost		$1.6m
Service cost		$3m

Roberts will educate Midwest's accounting department on pension plan accounting that would be relevant to their situation.

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Question ID: 1208912

In accordance with U.S. GAAP, distinguish which of the following events are classified as "actual" events and which ones are "smoothed" events.

	Actual	Smoothed
A)	service cost	expected return on plan assets
B)	interest cost	total periodic pension cost
C)	service cost	interest cost

Explanation

Service cost and interest cost are considered to be actual events. Expected return on plan assets, amortization of unrecognized prior service costs, and amortization and deferral of actuarial gains and losses are classified as smoothed events. Together, these five components are used to calculate a plan's reported pension expense or income on the income statement. Total periodic pension cost is actual cost (not smoothed) of the plan - but not reflected fully in the reported pension expense.

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #43 - 47 of 53

Question ID: 1208913

Based on the information provided, the impact of change in discount rate in 2007 (as compared to 2006) is *closest* to:

A) a decrease in PBO of $1.6 million.

B) a decrease in PBO of $2.6 million.

C) a decrease in PBO of $2 million.

Explanation

A higher discount rate will result in lower PBO. Reconciliation of opening and closing PBO shows:

Beginning PBO	$21 million	Given
(+) Interest cost	1.6	Given
(+) Service cost	3.0	Given
(-) Benefits paid	(1.0)	Given
(-) Actuarial Changes	(1.6)	PLUG
(=) Ending PBO	$23 million	Given

Changes due to actuarial assumptions = −$1.6m

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #44 - 47 of 53

Question ID: 1208914

As of January 1st, 2007, the fair value of plan assets was $19 million. Which three components are necessary to calculate the fair value of the plan assets at the end of the year?

A) actual return on assets, employer contributions, and benefits paid.

B) expected return on plan assets, employer and participant contributions, and benefits paid.

C) service cost, interest cost, and benefits paid.

Explanation

Companies are required to disclose a reconciliation of the beginning and ending balances of the fair value of plan assets, which can be calculated as follows:

Fair value of plan assets at the beginning of the year

+ Actual return on assets

+ Employer contributions

− Benefits paid

= Fair value of plan assets at the end of the year

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #45 - 47 of 53

Question ID: 1208915

Current U.S. GAAP pension accounting standards require public companies to report which of the following in the balance sheet?

A) The pension liability adjusted for unrecognized items.

B) The expected return on plan assets.

C) The funded status of the plan.

Explanation

The current standard requires companies to report the funded status of the plan, which is the difference between the PBO and the fair value of plan assets.

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #46 - 47 of 53

Question ID: 1208916

As of December 31st, 2007, the fair value of plan assets was $21 million. For this question only, assume that the sum of the unrecognized prior service cost and the unrecognized actuarial losses equals $1.5 million. Calculate the amount attributable to Midwest's pension plan as of December 31st, 2007 that must be reported on the balance sheet under U.S. GAAP.

A) −$500,000.

B) $2.0 million.

C) −$2.0 million.

Explanation

The funded status is the difference between the PBO and the fair value of plan assets as of the reporting date. For Midwest's plan, $21,000,000 − 23,000,000 = −$2,000,000. PBO figure is already given – and it includes all unrecognized items (and hence need not be adjusted).

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #47 - 47 of 53

Question ID: 1208917

Which of the following statements regarding the U.S. GAAP pension accounting standards is *most* accurate?

A) The balance sheet will now reflect the true economic position of the pension plan, but the income statement will not necessarily reflect a true measure of

B) For most companies, the pension liability will increase while financial leverage may increase or decrease as a result of applying the standard.

C) The changes in GAAP now cause U.S. standards to be consistent with the International Financial Reporting Standards (IFRS) for pension plans.

Explanation

Because deferred and unrecognized items are required to be reported on the balance sheet but not the income statement, the balance sheet will reflect the true economic position of the pension plan, but the income statement will not necessarily reflect a true measure of economic pension expense. U.S. GAAP and IFRS still differ with respect to reporting pension expense.

(Study Session 5, Module 14.6, LOS 14.e)

Related Material

SchweserNotes - Book 2

Question #48 of 53

Question ID: 1208907

Peak Productions is a publicly traded company that manufactures consumer electronics products in the U.S. The company has been in operation nearly fifty years, and has a considerable pension plan liability on its financial statements. Peak has a well-deserved reputation among analysts of utilizing aggressive accounting practices with regard to its pension plan. Which of the treatments of the following actuarial assumptions is the *best* example of aggressive accounting for a pension plan?

A) A high calculated projected benefit obligation (PBO).

B) A high discount rate.

C) A high compensation growth rate.

Explanation

The assumption of a high discount rate will result in a lower pension liability and almost always a lower pension expense. The more aggressive the actuarial assumptions for a pension plan are, the lower the quality of earnings for the firm.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #49 of 53

Question ID: 1208878

The actuarial present value of all future pension benefits earned to date, based on expected future salary increases, is called the:

A) total projected pension cost.

B) projected benefit obligation (PBO).

C) pension liability.

Explanation

The PBO is the actuarial present value (at an assumed discount rate) of all future pension benefits earned to date, *based on expected future salary increases*. It measures the value of the obligation, assuming the firm is a going concern and that the employees will continue to work for the firm until they retire. Pension cost is periodic and not total projected. Pension liability is the net amount of PBO and fair value of plan assets.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #50 of 53

Question ID: 1208905

Roberto Perez, CFA, is the Chief Financial Officer for Home Stores, Inc., a large home improvement retailer with stores located across the United States. Home Stores is preparing for a secondary stock offering to secure the necessary capital to pursue an aggressive expansion campaign. Perez has received a directive from his boss to make every legitimate effort to present Home Stores' upcoming financial statements in the best possible light. Perez determines that certain assumptions in the pension plan can be changed to fulfill this request. Which of the following pension plan assumptions can be changed by a firm to manipulate its reported results?

	Change	Result
A)	decreased discount rate	increased expected return
B)	decreased rate of compensation	decreased service cost
C)	increased expected rate of	decreased service cost

Explanation

The rate of compensation growth is the expected average annual increase in employee compensation. If the rate of growth is lowered, reported results will be improved due to a decrease in service cost. A decrease in service cost will result in lower pension expense.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

SchweserNotes - Book 2

Question #51 of 53

Question ID: 1208879

Which of the following statements regarding the projected benefit obligation (PBO) and the value of the pension plan assets is *most* accurate?

A) Plan amendments during the year generally result in a decrease of the PBO at the end of the year.

B) If the PBO and the plan assets are the same, then nothing needs to be reported on the balance sheet.

C) The fair value of plan assets is increased by the amount of the expected return on assets.

Explanation

Neither the PBO nor the plan assets are separately reported on the balance sheet. The funded status is the difference in the PBO and the plan assets. If the PBO exceeds the plan assets, the difference is reported as a liability. If the plan assets exceed the PBO, the difference is reported as an asset. If the amounts are the same, then neither a liability nor asset needs to be reported.

Plan amendments (i.e. additional benefits provided that increase the amount of the employer's obligation to plan participants) generally result in an *increase* of the PBO.

The fair value of plan assets at the beginning of the period is increased by the *actual* return on plan assets as well as any employer contributions. It is reduced by the amount of benefits paid.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #52 of 53

Question ID: 1208880

Which of the following statements regarding pension accounting is *most* accurate?

A) Changes in actuarial assumptions and past service costs fully and immediately affect the income statement.

B) Changes in the projected benefit obligation (PBO) and plan assets fully and immediately affect the balance sheet.

C) A reconciliation between the funded status and the net pension asset (liability) reported on the balance is required.

Explanation

Changes in the projected benefit obligation (PBO) and plan assets immediately affect the funded status (difference in PBO and plan assets) and the full amount of the changes is reflected on the balance sheet when the change occurs.

Changes in actuarial assumptions and past service costs are recognized in the income statement over time thereby smoothing pension expense.

Since the funded status is equal to the net pension asset (liability) reported on the balance sheet under no reconciliation is required.

(Study Session 5, Module 14.2, LOS 14.b)

Related Material

SchweserNotes - Book 2

Question #53 of 53

Question ID: 1208900

Fly-By-Night Airlines is a U.S. company planning to change its pension plan so that it can reduce its costs. It is considering reducing its defined benefit percentage from 10% to 5% of ending salary, retroactive for 10 years. In addition, since the firm is anticipating substantially reduced salary increases in the future, it is planning to reduce its compensation growth rate assumption. From a pension accounting perspective, the change in the:

A) Benefit percentage is a past service cost that will be amortized into and thus increase pension expense over the remaining service lives of its employees.

B) Compensation growth rate assumption is a change in actuarial assumption that will reduce the defined benefit obligation and future pension expense.

C) Benefit percentage is a change in actuarial assumption that will be recognized in full in current period pension expense.

Explanation

The change in the compensation growth rate assumption is a change in actuarial assumption that will reduce the defined benefit obligation and future pension expense, as the effect is amortized into pension expense over time. In this question, the change is a reduction in both the defined benefit obligation and pension expense.

The change in the contribution percentage is not a change in actuarial assumption but a plan amendment (which would be reflected as negative past service cost and either amortized under US GAAP or recognized in full under IFRS).

Amortization of negative past service cost (applicable only under US GAAP) would decrease, not increase, pension expense over the remaining service lives of its employees.

(Study Session 5, Module 14.5, LOS 14.d)

Related Material

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