Learning Module 3: Analyzing Balance Sheet

Q.348 A company's ability to meet short-term obligations is *most likely* termed as

A. solvency.

B. liquidity.

C. profitability.

The correct answer is **B.**

A company's ability to meet short-term obligations is most accurately described by its liquidity. Liquidity refers to the ease with which a company can convert its assets into cash to pay off its short-term liabilities without significant loss in value. This is a critical measure of financial health, as it indicates a company's capability to handle its immediate financial responsibilities, such as paying suppliers, employees, and other operational expenses. High liquidity levels suggest that a company can easily meet its short-term obligations, thereby reducing the risk of financial distress. Liquidity is often assessed using ratios such as the current ratio and the quick ratio, which compare a company's current assets to its current liabilities.

A is incorrect. Solvency refers to a company's ability to meet its long-term financial commitments and obligations. It is a measure of financial stability and endurance, indicating whether a company can sustain its operations and growth over the long term. Solvency is assessed through ratios such as the debt-to-equity ratio and the interest coverage ratio, which evaluate a company's long-term debt levels and its ability to service this debt.

C is incorrect. Profitability refers to a company's ability to generate earnings relative to its revenue, assets, or equity over time. It is an indicator of a company's efficiency in using its resources to produce a return. Common measures of profitability include the net profit margin, return on assets (ROA), and return on equity (ROE). While profitability is essential for assessing a company's financial performance and its potential to generate wealth for shareholders, it does not directly measure the company's capacity to meet short-term financial obligations.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

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Q.1974 Which of the following is the *most appropriate* statement regarding deferred tax assets?

A. Deferred tax assets are created when the amount of tax expense exceeds the amount of taxes payable.

B. Deferred tax assets are created when the amount of taxes payable exceeds the amount of tax expense in the income statement.

C. Deferred tax assets are created when the amount of taxes payable is equal to the amount of taxes expense in the income statement.

The correct answer is **B.**

Deferred tax assets are recognized in situations where the amount of taxes payable exceeds the tax expense reported in the income statement. This discrepancy usually arises due to differences in accounting methods used for financial reporting purposes and those used for tax calculations (known as temporary differences). Deferred tax assets indicate that a company has either prepaid taxes or has certain tax carryforwards, which can be used to offset future tax liabilities. Essentially, it represents an amount that the company is expected to recover in future periods through lower tax payments.

A is incorrect. It inaccurately describes the creation of deferred tax assets. Deferred tax assets are not generated when tax expense on the income statement exceeds taxes payable. Instead, this scenario typically leads to the recognition of a deferred tax liability, not an asset. A deferred tax liability indicates that the company will owe more taxes in the future than what is currently reported on the income statement, due to temporary differences between the accounting and tax treatments of certain items.

C is incorrect. It suggests that deferred tax assets are created when the amount of taxes payable is equal to the tax expense in the income statement. This statement is fundamentally flawed as deferred tax assets (or liabilities) arise due to differences between the tax base of assets or liabilities and their carrying amount in the financial statements. When the taxes payable are equal to the tax expense, it indicates that there are no temporary differences, and thus, no deferred tax assets or liabilities would typically be recognized under this scenario.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3d: explain the financial reporting and disclosures related to non-current liabilities

Q.1978 Everest Bank is analysing D-Corp to measure its ability to pay off a long-term debt that D-Corp has recently applied for. Which of the following analyses will serve this purpose?

A. Solvency analysis.

B. Liquidity analysis.

C. Profitability analysis.

The correct answer is **A.**

The solvency analysis is used to measure the ability of a company to meet its long-term obligations.

B is incorrect. Liquidity analysis is used to measure the ability of a company to meet short-term obligations.

C is incorrect. Profitability analysis is used to measure the ability of a company to generate profit on capital invested.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

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Q.1981 Trance Inc. purchased outstanding stocks of Deep House Corp for \$450 million. The following table is an excerpt of Deep House's balance sheet., calculate the amount of goodwill or the amount of gain on the purchase of Deep House's stocks if the fair value of the assets of Deep House is equal to its book value.

Account	Amount (in million \$)
Cash	200
Inventory	50
Property, Plant and Equipment	480
Short-term Liabilities	80
Long-term Liabilities	150
Common Equity	500

If Deep House's fair value is equal to its book value, the amount of goodwill or the amount of gain on the purchase of Deep House's stocks is *closest to*:

A. Goodwill of \$50 million is recognized on the balance sheet.

B. A loss of \$50 million is recognized in the income statement.

C. A gain of \$50 million is recognized in the income statement.

The correct answer is **C.**

$$\begin{aligned}&\text{Net Assets Value} = \$200 \text{ million (Cash)} + \$50 \text{ million (Inventory)} + \$480 \text{ million (Plant)}\\&- \$80 \text{ million (Short-term liabilities)} - \$150 \text{ million (Long-term liabilities)} = \$500 \text{ million}\end{aligned}$$

The price paid for the purchase of Deep House stocks is \$450 million, which is less than the fair value of the net assets of \$500 million. Therefore, a \$50 million gain on the purchase of the assets is to be recognized.

A is incorrect. Goodwill is the excess of the purchase price of an acquired company over the fair value of the identifiable net assets acquired. If the purchase price is less than the fair value of net assets, then again is recognized in the acquirer's income statement.

B is incorrect. Contradicts option C.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 2 – Analyzing Income Statements, LOS 3a: a: describe general principles of revenue recognition, specific revenue recognition applications, and implications of revenue recognition choices for financial analysis

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Q.1992 Simon Belfast, an equity analyst, analyzes two market leaders (Sun Corp. & Moon Inc.) in the automotive industry. As such, he collected the following data.

	Sun Corp.	Moon Inc.
Cash	250,000	410,000
Marketable securities	380,000	240,000
Inventory	220,000	550,000
PP&E	650,000	1,300,000
Short-term liabilities	300,000	300,000
Long-term liabilities	700,000	400,000
Common equity	500,000	1,800,000

The Sun Corp's cash ratio is *closest to*:

A. 0.63

B. 2.10

C. 2.83

The correct answer is **B.**

$$\text{Cash ratio} = \frac{\text{Cash} + \text{Marketable securities}}{\text{Current liabilities}}$$
$$= \frac{250,000 + 380,000}{300,000} = 2.1$$

Note: The cash ratio looks at the company’s most liquid short-term assets, which are those that can be used most easily to pay off current obligations. **A is incorrect.** Uses long-term liabilities to calculate cash ratio:

$$\text{Cash ratio} = \frac{(250,000 + 380,000)}{(300,000 + 700,000)} = 0.63$$

. **C is incorrect.** Included inventory in the numerator of the cash ratio:

$$\text{Cash ratio} = \frac{(250,000 + 380,000 + 220,000)}{300,000} = 2.83$$

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

Q.1993 Simon Belfast, an equity analyst, is analyzing two market leaders (Sun Corp. & Moon Inc.) in the automotive industry. Using the data given in the following table, Moon Inc's debt-to-asset ratio is *closest to*:

	Sun Corp.	Moon Inc.
Cash	250,000	410,000
Marketable securities	380,000	240,000
Inventory	220,000	550,000
PP&E	650,000	1,300,000
Short-term liabilities	300,000	300,000
Long-term liabilities	700,000	400,000
Common equity	500,000	1,800,000

A. 0.16

B. 0.28

C. 0.48

The correct answer is **B.**

$$\begin{aligned}\text{Debt-to-asset ratio} &= \frac{\text{Total debt}}{\text{Total assets}}\\ \text{Total debt} &= \text{short-term liabilities} + \text{long-term liabilities}\\ &= 400,000 + 300,000 = 700,000\\ \text{Total Assets} &= \text{Cash} + \text{Marketable securities} + \text{Inventory} + \text{PPE}\\ &= 410,000 + 240,000 + 550,000 + 1,300,000 = 2,500,000\\ \text{Debt ratio} &= \frac{700,000}{2,500,000} = 0.28\end{aligned}$$

Note: The debt-to-asset ratio is a financial ratio that indicates the percentage of a company's assets that are provided through debt.

A is incorrect. Includes common equity as debt.

C is incorrect. Includes common equity as an asset.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

Q.1994 Simon Belfast, an equity analyst, is analyzing two market leaders (Sun Corp. & Moon Inc.) in the automotive industry. Using the data given in the following table, determine which firm is more liquid based on current ratios.

	Sun Corp.	Moon Inc.
Cash	250,000	410,000
Marketable securities	380,000	240,000
Inventory	220,000	550,000
PP&E	650,000	1,300,000
Short-term liabilities	300,000	300,000
Long-term liabilities	700,000	400,000
Common equity	500,000	1,800,000

A. Sun Corp is more liquid because its current ratio is 2.83.

B. Moon Inc. is more liquid because its current Ratio is 4.

C. Moon Inc. is more liquid because its current ratio is 2.83.

The correct answer is **B.**

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Sun Corp's current ratio} = \frac{250,000 + 380,000 + 220,000}{300,000} = 2.83$$

$$\text{Moon Inc's current ratio} = \frac{410,000 + 240,000 + 550,000}{300,000} = 4$$

Therefore, Moon Inc. is more liquid than Sun Corp.

B is incorrect. Sun Corp cannot be more liquid than Moon Inc. since it has a lower current ratio.

C is incorrect. The current ratio of Moon Inc. is 4.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

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Q.1995 Which of the following is *most likely* a conservative liquidity ratio?

A. Cash Ratio.

B. Quick Ratio.

C. Current Ratio.

The correct answer is **A.**

The cash ratio is the most stringent and conservative of the three short-term liquidity ratios (current, quick, and cash). It only looks at the most liquid short-term assets of the company, which are those that can be used most easily to pay off current obligations. Formally, cash ration is defined as:

$$\text{Cash ratio} = \frac{\text{Cash} + \text{Marketable securities}}{\text{Current liabilities}}$$

B is incorrect. The quick ratio is more conservative than the current ratio because it includes only the more liquid current assets in relation to current liabilities. Quick ratio is defined as:

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Short term marketable investments} + \text{Receivables}}{\text{Current liabilities}}$$

C is incorrect. Current ratio is defined as:

$$\text{Current Ratio} = \frac{(\text{Current assets})}{(\text{Current liabilities})}$$

Intuitively, the current ratio is less conservative compared with the cash ratio.

More Information

The cash ratio is a liquidity ratio that measures a company's ability to pay its short-term obligations with its most liquid assets, which are cash and cash equivalents. This ratio is considered to be the most stringent and conservative measure of a company's liquidity because it only takes into account the most liquid assets, which are easily convertible into cash. The quick ratio, also known as the acid-test ratio, is similar to the cash ratio, but it also includes short-term investments that can be easily sold for cash within 90 days.

The current ratio is a more comprehensive measure of a company's liquidity that takes into account both its current assets and current liabilities. This ratio provides a more comprehensive view of a company's financial position, but it is not as stringent as the cash ratio. In conclusion, the cash ratio is considered to be the most conservative liquidity ratio because it only takes into account the most liquid assets, which provides a more stringent measure of a company's ability to meet its short-term obligations.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

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Q.3811 In 2018, the cash, quick and current ratios of a company were 2.09, 3.10, and 2.29 respectively. Below is select information from the balance sheet of the Company in 2019. Determine the ratio that *most likely* decreased.

	Amount in Millions
Cash and Cash Equivalents	102.0
Marketable Securities	369.5
Accounts Receivables	13.5
Other Current Assets	123
Total Current Assets	608
Accrued Interests and Expenses	92.0
Other Current Liabilities	103.0
Total Current Liabilities	195.0

A. Cash Ratio.

B. Quick Ratio,

C. Current Ratio.

The correct answer is **B.**

$$\text{Cash Ratio} = \frac{\text{Cash+Marketable Securities}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Cash+Marketable Securities+Accounts Receivables}}{\text{Current Liabilities}}$$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

	Current Year	Previous Year	Change
Cash Ratio	2.42	2.09	+0.33
Quick Ratio	2.49	3.10	−0.61
Current Ratio	3.12	2.29	+0.83

A is incorrect. The current ratio has increased by 0.83.

C is incorrect. The cash ratio has increased by 0.33.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

Q.3812 Calculate the financial leverage of a company based on the data below.

Working Capital	$70 Million
Non-Current Assets	$245 Million
Equity	$180 Million
Current Ratio	2.0

A. 0.78

B. 1.36

C. 2.14

The correct answer is **C.**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$
$$\text{Working Capital} = \text{Current Assets-Current Liabilities}$$
$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.00$$
$$\text{Current Liabilities} = \frac{\text{Current Assets}}{2.00}$$
$$\text{Working Capital} = \text{Current Assets-Current Liabilities}$$
$$70 = \text{Current Assets} - \frac{\text{Current Assets}}{2}$$
$$\text{Current Assets} = 140$$
$$\text{Current Liabilities} = 140 - 70 = 70 \text{ or Current Liabilities} = \frac{140}{2,00} = 70$$
$$\text{Financial Leverage} = \frac{\text{Total Assets}}{\text{Total Equity}}$$
$$\text{Financial Leverage} = \frac{140 + 245}{180} = 2.14$$

A is incorrect. Current assets have been used in place of total assets to calculate the financial leverage of the Company.

C is incorrect. It has used non-current assets instead of total assets to calculate financial leverage.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

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Q.3814 Select information from a company's 2018 balance sheet is as follows:

Cash and cash equivalents	$500 Million
Marketable Securities	$200 Million
Accounts Receivables	$100 Million
Inventories	$400 Million
Goodwill	$800 Million
Long Term Debt	$700 Million
Total Current Liabilities	$900 Million

If the current ratio of the company in 2017 was 1.50, its ability to meet its short-term obligations has *most likely*?

A. Increased.

B. Decreased.

C. Remained the same.

The correct answer is **B.**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$
$$\text{Current ratio} = \frac{1200}{900} = 1.33$$

The current ratio of the Company has dropped from 1.50 in 2018 to 1.33 in 2019. A decrease in the current ratio indicates a lower level of liquidity and, therefore, a reduced ability to meet short-term obligations.

A and C is incorrect. They contradict option B.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

Q.3817 Consider the following information of a hypothetical company:

- Long-Term Debt – $30 Million
- Current Liabilities - $20 Million
- Total Equity – $50 Million
- Current Assets –$35 Million
- Non-Current Assets – $65 Million

The financial leverage is *closest to* :

A. 0.6

B. 1.0

C. 2.0

The correct answer is **C.**

Recall that,

$$\text{Financial Leverage} = \frac{\text{Total Assets}}{\text{Total Equity}} = \frac{100}{50} = 2.0$$

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3e: calculate and interpret common-size balance sheets and related financial ratios

Q.4653 Under IFRS, the revaluation model for intangible assets can be used if:

A. the asset is internally generated.

B. the asset has a finite useful life.

C. there is a readily determinable market value for the asset.

The correct answer is **C.**

The revaluation model allows an intangible asset to be carried at a revalued amount, which is its fair value at the date of revaluation, less any subsequent accumulated amortization and any subsequent accumulated impairment losses. This model can only be applied if there is an active market for the asset, providing a readily determinable market value.

A is incorrect. The revaluation model is typically not applicable to internally generated intangible assets, as it is often challenging to determine a fair value for these assets due to the lack of an active market.

B is incorrect The choice of the revaluation model is not dependent on whether the intangible asset has a finite or indefinite useful life. Both types of assets can be revalued if there is an active market.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3a: explain the financial reporting and disclosures related to intangible assets

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Q.4654 Under US GAAP, which of the following costs associated with internally generated intangible assets is capitalized?

A. Advertising expenses.

B. Research phase expenses.

C. Both research phases and advertising expenses are not capitalized.

The correct answer is **C.**

Under US GAAP, costs incurred during the research phase and the development phase of an internally generated intangible asset are typically expensed as incurred. Capitalizing such costs is prohibited.

A is incorrect. Advertising expenses are also expensed under US GAAP and are not capitalized as part of internally generated intangible assets.

B is incorrect. Research phase expenses are expensed as incurred under US GAAP and are not capitalized.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3a: explain the financial reporting and disclosures related to intangible assets

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Q.4655 The impairment testing for intangible assets with an indefinite useful life is conducted:

A. at least annually.

B. only at the time of acquisition.

C. on a systematic basis over the asset's useful life.

The correct answer is **A.**

At least annually. Intangible assets with an indefinite useful life are not amortized but are required to be tested for impairment at least annually or more frequently if events or changes in circumstances indicate that the asset might be impaired.

B is incorrect. While an initial impairment test may be conducted at the time of acquisition, ongoing impairment testing for intangible assets with an indefinite useful life is required at least annually.

C is incorrect. Systematic amortization is not applicable to intangible assets with an indefinite useful life; therefore, impairment testing is not conducted on a systematic basis over the asset's useful life.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3a: explain the financial reporting and disclosures related to intangible assets

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Q.4656 Under IFRS, the initial recognition of an internally generated intangible asset in the development phase requires all of the following *except*:

A. demonstration of the technical feasibility of completing the asset.

B. evidence of market research confirming the demand for the asset.

C. ability to measure reliably the expenditure attributable to the asset during its development.

The correct answer is **B.**

While market research may be important for business decision-making, it is not one of the criteria listed in IAS 38 for capitalizing costs incurred in the development phase of an internally generated intangible asset.

A is incorrect. Demonstrating the technical feasibility of completing the intangible asset is one of the criteria required for capitalizing development costs under IFRS.

C is incorrect. The ability to measure reliably the expenditure attributable to the intangible asset during its development is also a required criterion for capitalizing development costs under IFRS.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3a: explain the financial reporting and disclosures related to intangible assets

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Q.4657 Which of the following factors is *least likely* to be considered in the valuation of economic goodwill?

A. Customer loyalty.

B. Management expertise.

C. Book value of tangible assets.

The correct answer is **C.**

Economic goodwill pertains to intangible aspects that enhance a business's value beyond its tangible assets and liabilities. While customer loyalty and management expertise are intangible factors contributing to economic goodwill, the book value of tangible assets is not directly related to the valuation of economic goodwill.

A is incorrect. Customer loyalty is an intangible factor that contributes to a business's ability to generate future profits, making it a key component of economic goodwill.

B is incorrect. Management expertise is another intangible factor that can enhance a business's value by improving operational efficiency and strategic decision-making, thus contributing to economic goodwill.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3b: explain the financial reporting and disclosures related to goodwill.

Q.4658 In the context of goodwill impairment testing, which of the following statements is *most accurate*?

A. Goodwill impairment losses are amortized over the remaining useful life of the asset.

B. Goodwill impairment is tested by comparing the carrying amount of the reporting unit to its recoverable amount.

C. Goodwill impairment testing is performed only when there is a significant decline in the market value of the company.

The correct answer is **B.**

Goodwill impairment is tested by comparing the carrying amount of the reporting unit to its recoverable amount. Under both IFRS and US GAAP, the impairment test involves comparing the carrying amount of the reporting unit, including goodwill, to its recoverable amount (the higher of its fair value, less costs to sell, and its value in use). If the carrying amount exceeds the recoverable amount, an impairment loss is recognized.

A is incorrect. Goodwill impairment losses are not amortized. Once recognized, an impairment loss reduces the carrying amount of goodwill and is not subsequently reversed.

C is incorrect. While a decline in market value may trigger an impairment test, goodwill impairment testing is required annually, regardless of changes in market value. It may also be performed more frequently if there are indications of impairment.

CFA Level 1, Volume 3, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3b: explain the financial reporting and disclosures related to goodwill.

Q.4659 When assessing the fair value of net identifiable assets in a business combination, which of the following is *least likely* to be included?

A. Contingent liabilities.

B. Future revenue projections.

C. Recognized intangible assets.

The correct answer is **B.**

In a business combination, the fair value of net identifiable assets includes recognized tangible and intangible assets and liabilities, including contingent liabilities. However, future revenue projections are not considered identifiable assets and are not included in the fair value assessment.

A is incorrect. Contingent liabilities, such as potential legal settlements, are assessed at their fair value and included in the measurement of net identifiable assets in a business combination.

C is incorrect. Recognized intangible assets, such as patents and trademarks, are included in the fair value measurement of net identifiable assets in a business combination.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3b: explain the financial reporting and disclosures related to goodwill.

Q.4660 Which of the following is *least likely* a reason for analysts to exclude goodwill from balance sheet data when adjusting financial statements?

A. To simplify the calculation of financial ratios.

B. To eliminate the effects of non-cash expenses related to goodwill impairment.

C. To assess the company's financial position based on its tangible assets and equity.

The correct answer is **B.**

When analysts exclude goodwill from balance sheet data, it is typically to analyze the company's financial position and performance based on its tangible assets and equity, not to address non-cash expenses. Non-cash expenses related to goodwill impairment are more relevant to adjustments made to income data, not balance sheet data.

A is incorrect. Simplifying the calculation of financial ratios is not the primary reason for excluding goodwill from balance sheet data. The main purpose is to gain insights into the company's financial position based on tangible assets.

C is incorrect. Excluding goodwill from balance sheet data is often done to focus the analysis on the company's tangible assets and equity, providing a clearer picture of its financial position.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3b: explain the financial reporting and disclosures related to goodwill.

Q.4662 In the context of IFRS, which of the following *best* describes the measurement basis for a derivative instrument?

A. Fair value, with changes recognized in profit or loss.

B. Amortized cost, adjusted for changes in the entity's credit risk.

C. Fair value, with changes recognized in other comprehensive income.

The correct answer is **A.**

Derivative financial instruments are typically measured at fair value, with changes in fair value recognized in the income statement. This treatment reflects the volatile nature of derivatives and their potential impact on the entity's financial position and performance.

B is incorrect. Amortized cost is not a suitable measurement basis for derivatives, as it does not capture changes in their fair value. Additionally, adjustments for changes in the entity's credit risk are more relevant to the fair value measurement of non-derivative financial liabilities.

C is incorrect. While some financial instruments can be measured at fair value through other comprehensive income, derivative financial instruments are generally not eligible for this treatment under IFRS due to their speculative nature and the need for timely recognition of fair value changes.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3c: explain the financial reporting and disclosures related to financial instruments

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Q.4663 Which of the following scenarios would *most likely* result in a financial asset being reclassified from measured at fair value through profit or loss to measured at amortized cost under IFRS?

A. The financial asset is a derivative instrument used for hedging purposes.

B. The financial asset is an equity instrument, and the entity decides to hold it for long-term strategic purposes.

C. The financial asset is a debt instrument, and the business model changes to holding the asset to collect contractual cash flows until maturity.

The correct answer is **C.**

Under IFRS, a debt instrument can be reclassified from fair value through profit or loss to amortized cost if there is a change in the business model for managing the financial asset. This reclassification reflects the entity's revised intention and strategy for the asset.

A is incorrect. Derivative instruments used for hedging purposes are subject to specific hedge accounting rules under IFRS, which differ from the measurement categories of fair value through profit or loss and amortized cost.

B is incorrect. Equity instruments are generally not reclassified from fair value through profit or loss to amortized cost under IFRS, as the fair value measurement provides more relevant information for equity investments that are subject to market price fluctuations.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3c: explain the financial reporting and disclosures related to financial instruments

Q.4665 Under US GAAP, which of the following statements about the classification of financial assets is *most accurate*?

A. Debt securities intended to be held to maturity are classified as trading securities.

B. Equity investments that provide significant influence are measured at fair value through profit or loss.

C. Trading securities are acquired with the intention of selling them in the near term and are measured at fair value through profit or loss.

The correct answer is **C.**

Trading securities are acquired with the intention of selling them in the near term and are measured at fair value through profit or loss. This classification is for both debt and equity securities that are bought and held primarily for sale in the short term. Unrealized gains or losses on trading securities are recognized in the income statement.

A is incorrect. Debt securities intended to be held to maturity are classified as "held-to-maturity" securities under US GAAP, not as trading securities. They are measured at amortized cost.

B is incorrect. Equity investments that provide significant influence over the investee are generally not measured at fair value through profit or loss.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3c: explain the financial reporting and disclosures related to financial instruments

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Q.4666 How does the issuance of a bond at par value affect the company's financial statements over the life of the bond?

A. The carrying amount of the bond liability remains constant throughout its life.

B. The interest expense decreases over time due to the amortization of the discount.

C. The carrying amount of the bond liability fluctuates based on changes in market interest rates.

The correct answer is **A.**

The carrying amount of the bond liability remains constant throughout its life. When a bond is issued at par value, there is no discount or premium to amortize, so the carrying amount (amortized cost) of the bond remains equal to its face value from issuance to maturity.

B is incorrect. Since the bond is issued at par value, there is no discount to amortize, and the interest expense remains constant over the life of the bond, based on the stated interest rate and the face value.

C is incorrect. For bonds reported at amortized cost, the carrying amount does not fluctuate based on changes in market interest rates. This characteristic is more applicable to bonds reported at fair value.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3d: explain the financial reporting and disclosures related to non-current liabilities

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Q.4667 In the context of deferred tax liabilities, which of the following situations is *most likely* to result in a larger deferred tax liability over time?

A. A company consistently reports higher taxable income than accounting income.

B. A company recognizes revenue in the same period for both tax and financial reporting purposes.

C. A company applies straight-line depreciation for tax purposes and accelerated depreciation for financial reporting purposes.

The correct answer is **C.**

A company applies straight-line depreciation for tax purposes and accelerated depreciation for financial reporting purposes. This situation leads to lower taxable income compared to accounting income in the early years, resulting in deferred tax liabilities that grow over time until the depreciation methods converge.

A is incorrect. Consistently reporting higher taxable income than accounting income would generally lead to deferred tax assets, not liabilities.

B is incorrect. Recognizing revenue in the same period for both tax and financial reporting purposes would not create significant temporary differences and, thus, would not likely result in a large, deferred tax liability.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3d: explain the financial reporting and disclosures related to non-current liabilities

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Q.4668 Which of the following scenarios would *least likely* result in the creation of a deferred tax liability?

A. A company uses different methods for inventory valuation for tax and financial reporting purposes.

B. A company recognizes dividends from a subsidiary in its financial statements only when they are received.

C. A company incurs expenses that are deductible for tax purposes in a different period than they are recognized for financial reporting purposes.

The correct answer is **B.**

When a company recognizes dividends from a subsidiary in its financial statements only when they are received, it may result in a deferred tax asset if the dividends are taxable before they are recognized in the financial statements.

A is incorrect. Using different methods for inventory valuation for tax and financial reporting purposes can create temporary differences that lead to deferred tax liabilities.

C is incorrect. Incurring expenses that are deductible for tax purposes in a different period than they are recognized for financial reporting purposes can also create temporary differences that result in deferred tax liabilities.

CFA Level 1, Volume 2, Topic 3 – Financial Statement Analysis, Learning Module 3 – Analyzing Balance Sheets, LOS 3d: explain the financial reporting and disclosures related to non-current liabilities

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