Question #1 of 57

Question ID: 1457883

When a lessee recognizes a balance sheet asset and liability for a new lease:

A) the liability is typically greater than the asset. ✗

B) the asset is typically greater than the liability. ✗

C) the asset and liability are equal. ✓

Explanation

At the initiation of a lease, the lessee records an asset and a liability that are both equal to the present value of the promised lease payments.

(Module 25.4, LOS 25.g)

Question #2 of 57

Question ID: 1457850

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

A) 1023. ✗

B) 923. ✓

C) 855. ✗

Explanation

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

(Module 25.1, LOS 25.a)

Question #3 of 57

Question ID: 1457848

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

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

Initial Liability	Liability in 6 months

A)	$3,653,451	$3,799,589	✓
B)	$5,000,000	$5,000,000	✗
C)	$3,675,149	$3,675,149	✗

Explanation

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

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

(Module 25.1, LOS 25.a)

Question #4 of 57

Question ID: 1457881

Compared to purchasing an asset with borrowing, leasing the asset *most likely*:

A) reduces the risk of obsolescence. ✓

B) is a more expensive method of financing. ✗

C) requires a larger initial cash outflow. ✗

Explanation

A reduced risk of obsolescence is an advantage of leasing compared to purchasing an asset because the lessee can return the asset to the lessor at the end of the lease. A lease typically requires little or no cash outflow at initiation. Because a lease is effectively secured by the leased asset, the interest rate implicit in a lease is likely to be less than the interest rate to borrow the purchase price of the asset.

(Module 25.4, LOS 25.f)

Question #5 of 57

Question ID: 1457862

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

A) The associated interest expense will be lower than that implied by the coupon rate. ✗

B) The bond will be shown on the balance sheet at the premium value. ✗

C) The value of the bond will be amortized toward zero over the life of the bond. ✓

Explanation

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

(Module 25.2, LOS 25.b)

Question #6 of 57

Question ID: 1457880

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

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

B) may be made obsolete by rapid technological advances. ✓

C) is costly to move from place to place. ✗

Explanation

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

(Module 25.4, LOS 25.f)

Question #7 of 57

Question ID: 1457899

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

A) increase its leverage ratios and increase its coverage ratios. ✗

B) decrease its leverage ratios and increase its coverage ratios. ✗

C) increase its leverage ratios and decrease its coverage ratios. ✓

Explanation

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

(Module 25.4, LOS 25.j)

Question #8 of 57

Question ID: 1457884

For a long-term lease, the amount recorded initially by the lessee as a liability is:

A) the total of the lease payments.

B) the fair value of the leased asset.

C) the present value of the lease payments.

Explanation

With a finance lease, both an asset and liability are reported on the lessee's balance sheet, equal to the present value of the promised lease payments.

(Module 25.4, LOS 25.g)

Question #9 of 57

Question ID: 1457845

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

A) investing.

B) operations.

C) financing.

Explanation

Issuing securities is a financing activity. Cash from financing (CFF) is increased by the amount of the proceeds.

(Module 25.1, LOS 25.a)

Question #10 of 57

Question ID: 1457854

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

A) the market rate.

B) the coupon payment.

C) the unamortized bond discount.

Explanation

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

(Module 25.2, LOS 25.b)

Question #11 of 57

Question ID: 1457849

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

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

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

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

Explanation

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

(Module 25.1, LOS 25.a)

Question #12 of 57

Question ID: 1457886

For a lessee, the portion of a lease payment that represents repayment of principal is a cash flow from:

A) investing. ✗

B) operations. ✗

C) financing. ✓

Explanation

The principal portion of a lease payment is a financing outflow on the lessee's cash flow statement. The interest portion is an operating cash outflow under U.S. GAAP and may be treated as an operating or financing outflow under IFRS.

(Module 25.4, LOS 25.g)

Question #13 of 57

Question ID: 1457870

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

A) at maturity, but not before maturity.

B) before maturity, but not at maturity.

C) either before maturity or at maturity.

Explanation

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

(Module 25.3, LOS 25.c)

Question #14 of 57

Question ID: 1457859

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

A) cash flows from financing will be increased by the par value of the bond issue.

B) the interest expense will be equal to the coupon payment plus the amortization of the discount.

C) the interest expense will increase over time.

Explanation

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

(Module 25.2, LOS 25.b)

Question #15 of 57

Question ID: 1457898

A firm is more solvent if it has:

A) low leverage and coverage ratios.

B) high leverage and coverage ratios. ✗

C) low leverage ratios and high coverage ratios. ✓

Explanation

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

(Module 25.4, LOS 25.j)

Question #16 of 57

Question ID: 1457891

Which of the following is *most accurate* regarding financial reporting of an operating lease from a lessor's perspective?

A) The lessor recognizes the lease payments as income. ✓

B) At lease inception, the lessor removes the asset from the balance sheet. ✗

C) The lessor does not record the depreciation expense. ✗

Explanation

For an operating lease, the lessor reports the lease payments as income. The lessor does not remove the leased asset from the balance sheet and continues to record the depreciation expense over the life of the asset.

(Module 25.4, LOS 25.g)

Question #17 of 57

Question ID: 1457882

An airline leases a new airplane from its manufacturer for 10 years. For financial reporting, the airline must record an asset and a liability on its balance sheet:

A) regardless of whether the lease is a finance or operating lease. ✓

B) only if the lease is a finance lease. ✗

C) only if the lease is an operating lease. ✗

Explanation

For both finance and operating leases, both IFRS and U.S. GAAP require an asset and a liability to be recorded on the lessee's balance sheet, unless the lease is short-term or (under IFRS) for a low-value asset.

(Module 25.4, LOS 25.g)

Question #18 of 57

Question ID: 1457846

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

A) increase. ✓

B) decrease. ✗

C) remain constant. ✗

Explanation

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

(Module 25.1, LOS 25.a)

Question #19 of 57

Question ID: 1457873

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

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

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

With respect to these statements:

A) both are incorrect. ✗

B) both are correct. ✗

C) only one is correct. ✓

Explanation

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

(Module 25.3, LOS 25.d)

Question #20 of 57

Question ID: 1457875

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

A) decreasing its common dividends. ✗

B) issuing new common shares. ✗

C) repurchasing common shares. ✓

Explanation

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

(Module 25.3, LOS 25.d)

Question #21 of 57

Question ID: 1457896

An employer offers a defined benefit pension plan and a defined contribution pension plan.

The employer's balance sheet is *most likely* to present an asset or liability related to:

A) the defined contribution plan. ✗

B) both of these pension plans. ✗

C) the defined benefit plan. ✓

Explanation

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

(Module 25.4, LOS 25.i)

Question #22 of 57

Question ID: 1457887

The *least likely* reason for a corporation to lease rather than buy a fixed asset is to:

A) benefit from appreciation in the asset's value.

B) conserve cash at lease inception.

C) decrease its financing costs.

Explanation

A lessee would not be concerned with the value of the asset at the end of the lease unless the lease included an option to buy the asset. Typically, leases require a small, if any, payment at lease inception. Because a lease is secured by an asset, financing costs may be lower than the rate on a loan to purchase the asset.

(Module 25.4, LOS 25.g)

Question #23 of 57

Question ID: 1457844

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

A) a discount.

B) a premium.

C) par.

Explanation

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

(Module 25.1, LOS 25.a)

Question #24 of 57

Question ID: 1482637

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

A) $538.

B) $1,209.

C) $3,495.

Explanation

Face value of bonds = $135,662.

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

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

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

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

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

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

Alternatively, we can calculate the bond's value with N = 3 and find the difference from the face value:

I/Y = 8.00%; N = 3; PMT = $135,662 × 0.07 = $9,496.34; FV = $135,662; CPT PV = $132,166

$135,662 – $132,166 = $3,496.

(Module 25.1, LOS 25.a)

Question #25 of 57

Question ID: 1457893

For an operating lease, the leased physical asset appears on the balance sheet of:

A) the lessor.

B) the lessee.

C) neither the lessor nor the lessee.

Explanation

With an operating lease, the actual leased asset remains on the lessor's balance sheet and the lessor recognizes depreciation expense on the asset. The lessee is required to recognize an asset and a liability equal to the present value of the promised lease payments.

(Module 25.4, LOS 25.h)

Question #26 of 57

Question ID: 1457878

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

A) Collateral pledged as security in the event of default. ✗

B) The amount of debt that matures in each of the next five years. ✗

C) The market rate of interest on the balance sheet date. ✓

Explanation

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

(Module 25.3, LOS 25.e)

Question #27 of 57

Question ID: 1457890

ABC Company leases manufacturing equipment for five years with annual payments of $20,000. The company will return the equipment to the lessor at the end of the lease. The term of the lease is equal to the equipment's useful life. Under U.S. GAAP, the company will:

A) report the lease as an operating lease. ✗

B) recognize an amortization expense equal to the principal repayment each period. ✗

C) record a right-of-use asset on the balance sheet. ✓

Explanation

The company will report a finance lease because the lease is in effect for the asset's useful life. With a finance lease, the company will recognize the present value of the lease payments on the balance sheet as a right-of-use asset, and amortize this asset straight-line over the lease term.

(Module 25.4, LOS 25.g)

Question #28 of 57

Question ID: 1457894

A lessor will remove the leased asset from its balance sheet and record interest income from the lease only if the lease is classified as:

A) an operating lease.

B) a finance lease.

C) a sales-type lease.

Explanation

Under IFRS and U.S. GAAP, a lessor will classify a lease as either an operating lease or a finance lease. If it is classified as a finance lease, the leased asset is removed from the lessor's balance sheet and interest income is recognized over the life of the lease. A sales-type lease is a classification under U.S. GAAP that does not affect the accounting treatment.

(Module 25.4, LOS 25.h)

Question #29 of 57

Question ID: 1457860

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

A) $1,200,000.

B) $1,600,000.

C) $1,346,549.

Explanation

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

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

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

(Module 25.2, LOS 25.b)

Question #30 of 57

Question ID: 1457871

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

A) $10,000,000 CFF outflow and $100,000 CFO outflow. ✗

B) 10,100,000 CFF outflow. ✓

C) $10,100,000 CFO outflow. ✗

Explanation

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

(Module 25.3, LOS 25.c)

Question #31 of 57

Question ID: 1457858

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

A) $923. ✗

B) $935. ✓

C) $967. ✗

Explanation

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

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

(Module 25.2, LOS 25.b)

Question #32 of 57

Question ID: 1457865

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

A) $9,661,279.

B) $9,737,568.

C) $10,346,511.

Explanation

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

(Module 25.2, LOS 25.b)

Question #33 of 57

Question ID: 1457857

A bond is issued with the following data:

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

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

	Value in 1-Year	Total Interest Expense
A)	10,181,495	2,962,107
B)	11,099,495	2,437,893
C)	10,181,495	2,437,893

Explanation

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

To determine the total interest expense:

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

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

(Module 25.2, LOS 25.b)

Question #34 of 57

Question ID: 1457895

A lessor who enters into a finance lease is *least likely* to:

A) add an asset to her balance sheet.

B) amortize a receivable.

C) record a profit.

Explanation

A lessor will recognize a profit or loss on entering a finance lease only if the lease value is greater than its net book value asset on the lessor's balance sheet. At inception, a lessor adds a lease receivable to her balance sheet and amortizes it over the term of the lease.

(Module 25.4, LOS 25.h)

Question #35 of 57

Question ID: 1457856

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

A) $200,000.

B) $210,336.

C) $210,833.

Explanation

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

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

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

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

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

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

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

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

(Module 25.2, LOS 25.b)

Question #36 of 57

Question ID: 1457897

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

A) as an actuarial adjustment in other comprehensive income.

B) on the balance sheet as a net pension asset or liability.

C) on the income statement as pension expense.

Explanation

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

(Module 25.4, LOS 25.i)

Question #37 of 57

Question ID: 1457877

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

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

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

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

Explanation

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

(Module 25.3, LOS 25.e)

Question #38 of 57

Question ID: 1462854

A firm issues a 4-year semiannual-pay bond with a face value of $10 million and a coupon rate of 10%. The market interest rate is 11% when the bond is issued. The balance sheet liability at the end of the first semiannual period is *closest* to:

A) $9,715,850. ✓

B) $9,683,250. ✗

C) $9,650,700. ✗

Explanation

The initial liability is the amount received from the creditor, not the par value of the bond.

N = 8; I/Y = 11/2 = 5.5; PMT = 500,000; FV = 10,000,000; CPT → PV = $9,683,272.

The interest expense is the effective interest rate (the market rate at the time of issue) times the balance sheet liability. $9,683,272 × 0.055 = $532,580.

The value of the liability will change over time and is a function of the initial liability, the interest expense and the actual cash payments. In this case, it increases by the difference between the interest expense and the actual cash payment: $532,580 – $500,000 = $32,580 + $9,683,272 = $9,715,852. *Tip*: Knowing that the liability will increase is enough to select choice C without performing this last calculation. Entering N = 7 and solving for PV also produces $9,715,852. (Module 25.2, LOS 25.b)

Question #39 of 57

Question ID: 1457892

A lessor retains the leased asset on its balance sheet for:

A) finance leases, but not operating leases.

B) neither finance leases not operating leases.

C) operating leases, but not finance leases.

Explanation

For an operating lease, the lessor retains the leased asset on its balance sheet and recognizes depreciation expense over its life. For a finance lease, the lessor removes the leased asset from its balance sheet and recognizes a lease receivable.

(Module 25.4, LOS 25.h)

Question #40 of 57

Question ID: 1457866

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

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

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

A) $499.

B) $1,209.

C) $1,750.

Explanation

Face value of bonds = $67,831

Proceeds from bond sale: I/Y = 8; N = 4; PMT = $67,831 × 0.07 = $4,748.17; FV = $67,831; CPT PV = $65,582

Unamortized discount at issuance = $67,831 – $65,582 = $2,249.

First year interest expense = $65,582 × 0.08 =$5,247

Coupon payment = $67,831 × 0.07 = $4,748

Change in discount = $5,247 – $4,748 = $499

Unamortized discount at end of first year = $2,249 – $499 = $1,750.

(Module 25.2, LOS 25.b)

Question #41 of 57

Question ID: 1457855

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

A) $316,448.

B) $350,000.

C) $300,000.

Explanation

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

(Module 25.2, LOS 25.b)

Question #42 of 57

Question ID: 1457864

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

A) -$755,735. ✗

B) -$700,000. ✗

C) -$900,000. ✓

Explanation

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

(Module 25.2, LOS 25.b)

Question #43 of 57

Question ID: 1457874

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

A) maintain insurance on the collateral that secures the bond. ✗

B) maintain a debt-to-equity ratio of no less than 2:1. ✓

C) not increase dividends to common shareholders while the bonds are outstanding. ✗

Explanation

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

(Module 25.3, LOS 25.d)

Question #44 of 57

Question ID: 1457861

When bonds are issued at a premium:

A) coupon interest paid decreases each period as bond premium is amortized. ✗

B) earnings of the firm decrease over the life of the bond as the bond premium is amortized. ✗

C) earnings of the firm increase over the life of the bond as the bond premium is amortized.

Explanation

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

(Module 25.2, LOS 25.b)

Question #45 of 57

Question ID: 1457879

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

A) current liabilities only.

B) both current and long-term liabilities.

C) long-term liabilities only.

Explanation

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

(Module 25.3, LOS 25.e)

Question #46 of 57

Question ID: 1457853

A firm is issuing a bond with the following characteristics:

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

Ignoring flotation costs, at issuance the bond will increase:

A) assets by $9.626 million.

B) cash flow from investing by $9.626 million.

C) liabilities by $10.0 million.

Explanation

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

(Module 25.1, LOS 25.a)

Question #47 of 57

Question ID: 1457872

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

A) neither a gain nor a loss on redemption.

B) a loss on redemption.

C) a gain on redemption.

Explanation

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

(Module 25.3, LOS 25.c)

Question #48 of 57

Question ID: 1457900

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

A) an increasing trend in the ratio over the life of the bond.

B) a decreasing trend in the ratio over the life of the bond.

C) no effect on the ratio over the life of the bond.

Explanation

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

(Module 25.4, LOS 25.j)

Question #49 of 57

Question ID: 1457867

A company issues $10,000,000 face value of 5% annual coupon, 3-year bonds on January 1, 20X1, raising $8,000,000 in cash proceeds. Using the effective interest method, and ignoring issuance costs, interest expense for the year ending December 31, 20X2 is *closest* to:

A) $1,163,000. ✓

B) $1,084,000. ✗

C) $500,000. ✗

Explanation

Cash interest paid each year is 5% × $10,000,000 = $500,000. To calculate the effective interest rate: N = 3; PV = 8,000,000; FV = –10,000,000; PMT = –500,000; CPT I/Y = 13.55%

The initial bond liability equals the proceeds raised of $8,000,000. Interest expense for 20X1 = 13.55% × $8,000,000 = $1,084,000. The bond liability amortizes (toward face value at maturity) by the difference between interest expense and cash interest paid: $1,084,000 – $500,000 = $584,000.

The bond liability at the beginning of 20X2 = $8,000,000 + $584,000 = $8,584,000. Interest expense for 20X2 = 13.55% × $8,584,000 = $1,163,132.

(Module 25.2, LOS 25.b)

Question #50 of 57

Question ID: 1457863

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

A) Cash flow from financing. ✗

B) Debt-to-equity ratio. ✓

C) Interest paid. ✗

Explanation

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

(Module 25.2, LOS 25.b)

Question #51 of 57

Question ID: 1457888

When the risks of ownership of an asset are not substantially transferred to the lessee, a lease is *most likely* to be reported as:

A) an investing lease.

B) a finance lease.

C) an operating lease.

Explanation

Both the lessee and lessor report a lease as an operating lease when the risks of ownership are not substantially transferred to the lessee.

(Module 25.4, LOS 25.g)

Question #52 of 57

Question ID: 1457847

A company issues $50 million face value of bonds with a 4.0% coupon rate, when the market interest rate on the bonds is 4.5%. Proceeds raised from these bonds will be:

A) greater than $50 million.

B) less than $50 million.

C) equal to $50 million.

Explanation

When the coupon rate on a bond is lower than the market rate (yield to maturity), the bond will sell for a discount. If bonds are issued at a discount, the proceeds raised will be less than their face value.

(Module 25.1, LOS 25.a)

Question #53 of 57

Question ID: 1457885

A lessee is *most likely* to be required to classify a lease as a finance lease if:

A) the lease is long term.

B) the sum of the lease payments is equal to the value of the leased asset.

C) the lessor has no other use for the asset.

Explanation

A lessee is required to classify a lease as a finance lease if the lessor has no other use for the asset. Long-term leases can be either operating or finance leases. A lease must be classified as a finance lease if the *present value* of the lease payments is equal to or greater than the value of the leased asset.

(Module 25.4, LOS 25.g)

Question #54 of 57

Question ID: 1462855

Robbins, Inc., reports under IFRS and uses the effective interest rate method for valuing its bond liabilities. Robbins sells a 10-year, $100 million, 5% annual coupon bond issue for $98 million and paid $500,000 in issuance costs. Two years later, the bond liability Robbins will report on its balance sheet for this debt is *closest* to:

A) $97.9 million.

B) $98.0 million.

C) $98.1 million.

Explanation

Under IFRS, bond liabilities are reported under the effective interest method and issuance costs are deducted from the proceeds to determine the initial liability. The yield at issuance is: PV = 97.5 million; FV = −100 million; PMT = −5 million; N = 10; CPT I/Y = 5.33. Change N to 8 and CPT PV after two years as 97.9 million. (Module 25.2, LOS 25.b)

Question #55 of 57

Question ID: 1457876

The primary purpose of bond covenants is to:

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

B) define bond characteristics.

C) protect bondholders from the actions of equity owners. ✓

Explanation

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

(Module 25.3, LOS 25.d)

Question #56 of 57

Question ID: 1457889

A lease is *most likely* to be reported as a finance lease when:

A) ownership of the leased asset transfers to the lessee. ✓

B) the present value of the lease payments is less than the asset's fair value. ✗

C) the lessor would otherwise operate the asset in its normal course of business. ✗

Explanation

A lease is reported as a finance lease when ownership of the leased asset transfers to the lessee. Among the other conditions for a finance lease are that the present value of the lease payments is greater than or equal to the asset's fair value, and that the lessor has no other use for the asset.

(Module 25.4, LOS 25.g)

Question #57 of 57

Question ID: 1457851

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

What is the unamortized discount when the bonds are issued?

A) $2,246.65. ✓

B) $1,748.07. ✗

C) $498.58. ✗

Explanation

Coupon payment = ($67,831)(0.07) = $4,748.17.

Present value of bond: FV = $67,831, N = 4, I = 8, PMT = $4,748.17, CPT PV = $65,584.35.

Discount = $67,831 - $65,584.35 = $2,246.65.

(Module 25.1, LOS 25.a)