Schweser Printable Answers - Session Financial Statement Analysis: Pensions and Intercorporate Investments

Test ID#: 1362405

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Question 1 - #8828

Rocky Mountain Air Cargo is a privately held commercial aviation company serving the western United States. It publishes financial statements in accordance with U.S. GAAP and uses a fiscal year that matches the calendar year.

Rocky Mountain was in good financial shape heading into 2003, with assets of $50 million at the beginning of the fiscal year. That year, it earned $3 million in net income and was easily able to maintain its traditional 50 percent dividend payout ratio. However, Rocky Mountain had a very difficult year in 2004, reporting a loss of $800,000. It managed to pay $1 million in dividends, but the decision to pay dividends in such a weak financial year further undermined the company's fiscal stability.

Flitenight Air Lines, a publicly-traded aviation firm serving the central and Midwestern United States, wanted to expand its range of service by coordinating its flight schedule with airlines serving different geographic regions of North America. One of these airlines was Rocky Mountain Air Cargo.

To cement the relationship, Flitenight's CEO, John "Bulldog" Basten, decided to make a significant investment in Rocky Mountain Air Cargo. He was easily able to convince both boards of the wisdom of the deal, and, in his usual brash style, personally negotiated the terms with his counterpart at Rocky Mountain, Buck Matthews. Flitenight Air Lines acquired a 20 percent stake in Rocky Mountain Air Cargo (with an option to purchase 40 percent more) for $10 million cash. The deal closed on January 1, 2003 and Flitenight accounted for the investment using the equity method.

Basten was not happy to find that he had invested right at the peak of Rocky Mountain's profitability and wound up with a money-losing airline. He had a difficult conversation with Matthews in early 2005, complaining about the impact of the Rocky Mountain investment on Flitenight's financials. Basten pointed out that he had a loss on his books: the original $10 million investment in Rocky Mountain was carried at only $9,940,000 on Flitenight's December 31, 2004 balance sheet. Matthews countered that this was just an accounting entry: on a cash basis, Flitenight had a gain of 5 percent on its investment over the two years.

Matthews' insistence that the investment had earned money for Flitenight did not sit well with Basten. Basten decided that Rocky Mountain was clearly being mismanaged and concluded it was time to gain control of the company.

Basten assured Neil Glenn, the Chairman of Flitenight's board, that he could turn Rocky Mountain around. He promised Glenn that, in 2005, Rocky Mountain would once again achieve $3 million in earnings and a 50 percent payout ratio. "With those results," Basten promised Glenn, "our asset accounts will value the Rocky Mountain investment at $10,240,000 on our December 31, 2005 balance sheet – so we'll show a gain on our original investment." Glenn was skeptical of anyone's ability to turn the airline around so quickly. Even so, Glenn assured Basten, "If it takes you longer to turn it around, at least we'll have the dividend income on our 2005 cash flow statements."

Basten notified Matthews and Rocky Mountain's board that Flitenight intended to exercise its option. At the direction of Basten and Glenn, Flitenight purchased the additional shares for cash and gained control of Rocky Mountain on December 31, 2004.

Part 1)
In 2003, Flitenight would reflect its investment in Rocky Mountain on its income statement by recording:

A) $300,000.
B) $900,000.
C) -$200,000.
D) $600,000.

Your answer: A was incorrect. The correct answer was D) $600,000.

Under the equity method, Flitenight would record $600,000 = ($3 million × 0.2) on its 2003 income statement as its share of Rocky Mountain's earnings. The dividends received by Flitenight are already included as part of its share of Rocky Mountain's net income in the equity method.

Part 2)
Since the coordination of flight schedules implies a stronger economic link between Rocky Mountain and Flitenight Air Lines than that implied merely by the ownership percentage, a proportionate consolidation is being considered. Which of the following statements regarding the consolidation method and the proportionate consolidation method is **CORRECT**?

A) Both are provisions of U.S. GAAP.

B) The proportionate consolidation method differs from the consolidation method in its treatment of minority interest.

C) Both report all of the affiliate’s liabilities on the parent’s balance sheet.

D) Both report the same level of assets on the parent’s balance sheet.

Your answer: A was incorrect. The correct answer was B) The proportionate consolidation method differs from the consolidation method in its treatment of minority interest.

A proportionate consolidation is not a provision of U.S. GAAP, although it has been adopted in IAS 31. An analyst would perform a proportionate consolidation on a firm that is currently accounted for using the equity method if a stronger link exists between the two firms than is implied by the ownership percentage. A joint venture is a typical example in which a proportionate consolidation would be used.

A proportionate consolidation will lead to the same results as a normal consolidation except that the consolidation method reports minority interest in the financial statements and the proportionate consolidation method does not. In a proportionate consolidation, the parent's proportionate share of asset and liability accounts (net of intercorporate transfers) is simply added to the parent’s financials. Note that the equity accounts are not added together.

Part 3)
If Flitenight were to account for its Rocky Mountain investment using the cost method instead of the equity method, Flitenight’s 2004 income statement would reflect its investment in Rocky Mountain by including which of the following?

A) Only a loss of $160,000.

B) Both dividends received by Flitenight from Rocky Mountain and Flitenight’s share of Rocky Mountain’s earnings.

C) Only income of $200,000.

D) Nothing, since the cost of the acquisition is not adjusted until the asset is sold.

Your answer: A was incorrect. The correct answer was C) Only income of $200,000.

If Flitenight accounted for its Rocky Mountain investment using the cost method, in 2004 it would record on its income statement ($1 million × 0.2) = $200,000 in dividends. That method would not be a permissible choice for Flitenight, however, since it controls more than 20 percent of Rocky Mountain.

Part 4)
Which of the following statements about the consolidation method and the equity method is **FALSE**?

A) Both result in the same net income.

B) Only capital flows between parent and investee (such as dividends) appear in the cash flows of the parent.

C) Both result in the same net worth.

D) Both result in the same ROE.

Your answer: A was incorrect. The correct answer was B) Only capital flows between parent and investee (such as dividends) appear in the cash flows of the parent.

Under the consolidation method and the equity method, net income, net worth and ROE are all the same. The equity method includes only capital flows between parent and investee in the cash flows of the parent, but the consolidation method includes all cash flows of the subsidiary in the cash flow of the parent (with minority interest subtracted out).

Part 5)
Regarding Basten’s and Matthews’ statements about the gain/loss that Flitenight had at the end of 2004 on its investment in Rocky Mountain, which is **CORRECT**?

A) Basten's statement is correct and Matthews' statement is incorrect.

B) Basten's statement is incorrect and Matthews' statement is incorrect.

C) Basten's statement is correct and Matthews' statement is correct.

D) Basten's statement is incorrect and Matthews' statement is correct.

Your answer: A was incorrect. The correct answer was C) Basten's statement is correct and Matthews' statement is correct.

If Flitenight accounted for its Rocky Mountain investment using the equity method, the value of the investment as of December 31, 2004, would be:

Flitenight's original $10 million investment + (Flitenight's share of Rocky Mountain's 2003 earnings less dividends Flitenight received in 2003) + (Flitenight's share of Rocky Mountain's 2004 earnings less dividends Flitenight received in 2004).

Since we know that Flitenight owns 20 percent of Rocky Mountain and consequently receives 20 percent of the dividends that Rocky Mountain pays, we can calculate:

Value of Rocky Mountain on Flitenight's books at the end of 2004 =

$10 million + (0.20 x $3 million in 2003 earnings - 0.20 x $1.5 million in 2003 dividends) + (0.20 x -$800,000 in 2004 earnings - 0.20 x $1 million in 2004 dividends) =

$10 million + ($600,000 - $300,000) + (-$160,000 - $200,000) =

$10,000,000 + $300,000 - $360,000 = $9,940,000

Basten's statement is correct.

On a cash basis, Flitenight spent $10 million to acquire its stake in Rocky Mountain, and received ($300,000 in 2003 dividends + $200,000 in 2004 dividends) = $500,000 in dividends over the two years. $500,000 in cash return on a $10,000,000 cash investment equals 5 percent over the two years. Matthews' statement is also correct.

Part 6)
Regarding Basten's and Glenn's statements about the impact of Rocky Mountain on Flitenight's 2005 balance sheet and cash flow statement, which is **CORRECT**?

A) Basten's statement is correct and Matthews' statement is incorrect.

B) Basten's statement is correct and Matthews' statement is correct.

C) Basten's statement is incorrect and Matthews' statement is correct.

D) Basten's statement is incorrect and Matthews' statement is incorrect.

Your answer: A was incorrect. The correct answer was D) Basten's statement is incorrect and Matthews' statement is incorrect.

The equity method of accounting is used when the parent has significant influence over the investee but does not exercise control. Consolidation is required when the parent controls, directly or indirectly, more than 50 percent of the voting stock.

Once Flitenight exercised its option to purchase the additional 40 percent of Rocky Mountain's stock (for total ownership of 60 percent) on December 31, 2004, it could no longer use the equity method and had to switch to the consolidation method. In the consolidation method, Flitenight's investment in Rocky Mountain is no longer listed as a separate asset on the balance sheet (all of Rocky Mountain's assets and liabilities are combined with Flitenight's, with the minority interest shown as a liability), so Basten's statement is incorrect. In the consolidation method, parent company cash flows exclude those between parent and investee, so Glenn's statement is also incorrect.

Question 2 - #8868

Jean Baptiste Prudhomme and Sons, Inc. is a publicly-traded housing and construction company that has been operated by five generations of the Prudhomme family. Xavier Prudhomme, the current CEO, believes that the firm's future success depends on finding a way to mitigate the inherent cyclicality of the construction industry. He and the COO, his cousin, Michel Sanscartier, have decided to invest in a firm that operates in a counter-cyclical industry.

Prudhomme is in a strong financial position to make an investment in another firm. The company has 1 million shares outstanding. When the books closed for the year on December 31, 2003, the stock closed at $72 per share.

The firm Prudhomme Inc. chose to invest in was outplacement counselors Quality Connections, Inc. The firms completed the transaction on December 31, when both companies closed their 2003 books.

Quality is a much smaller firm than Prudhomme, with total assets of $2 million when the transaction closed, compared to Prudhomme's $30 million. However, Quality is more liquid than Prudhomme: half of Quality's assets were current assets, compared to only one-third of Prudhomme's. In addition, current liabilities at Quality accounted for only 10 percent of total liabilities plus owners' equity as of the transaction date, with common stock equal to another 40 percent. (The remainder was retained earnings.)

Prudhomme does have some financial advantages over Quality, however. Prudhomme's long history means that it has much higher retained earnings than Quality: Retained earnings at Prudhomme accounted for two-thirds of total liabilities plus owners' equity when the transaction closed. (The remainder was equally divided between current liabilities and common stock.)

Prudhomme also does a much better job than Quality of turning assets: 2004 revenue at Prudhomme was twice the level of assets the firm had on its December 31, 2003 balance sheet, while Quality's revenue was only 1.5 times assets. Despite the lower turnover, however, Quality is far more profitable. Net income at Quality in 2004 reached 20 percent of revenue, while net income at Prudhomme came in at only 10 percent of revenue. The remainder at both companies is Cost of Goods Sold (COGS).

The greater and more stable profitability at Quality is reflected in dividend payments: Quality paid out half its 2004 net income in dividends, while Prudhomme paid out only one-third. This high and stable dividend payment is a key reason that Xavier Prudhomme and Sanscartier were interested in investing in Quality.

Sanscartier also considered Quality undervalued. He believed that Quality's low investor profile – it trades on a small, regional exchange – prevented the firm's dividend sustainability from being fully reflected in the company's share price. Quality's market capitalization at the close of 2003 trading was twice 2004 revenues (with 1 million shares outstanding), a figure Sanscartier believes is too low given the profitability of the firm and its excellent growth prospects.

Although Xavier Prudhomme and Sanscartier were both generally very happy with their investment in Quality Connections, they shared one significant concern about the timing. At the time the transaction closed, the economy appeared to be slowing, and both men expected a cyclical decline in stock values. They were right: Prudhomme, Inc. stock dropped by $12 per share by year-end 2004. Quality Connections, Inc. stock dropped from $6 to $5 per share by December 31, 2004.

Xavier Prudhomme and Sanscartier shared a common worry about the potential damage to Prudhomme Inc.'s 2004 income statement from a decline in Quality Connections' stock price. Before the transaction settled, Xavier Prudhomme argued forcibly that Prudhomme should buy at least 20 percent of Quality so the market fluctuations in the stock wouldn't affect Prudhomme's reported income. He favored buying 25 percent of Quality's shares outstanding on December 31, 2003 for a 10 percent discount from market, in cash.

Sanscartier favored purchasing 100,000 of Quality's shares outstanding on December 31, 2003 at the closing market price, also for cash. He suggested that if they made that investment, Prudhomme could avoid having fluctuations in Quality's share price flow through Prudhomme's income statement if Quality were no longer traded publicly and its fair value was not readily determined.

Part 1)
Regarding Xavier Prudhomme and Sanscartier's remarks about the impact of the investment in Quality on Prudhomme Inc.'s income statement, which of the following is correct?

A) Prudhomme's statement is incorrect and Sanscartier's statement is correct.
B) Prudhomme's statement is correct and Sanscartier's statement is incorrect.
C) Prudhomme's statement is correct and Sanscartier's statement is correct.
D) Prudhomme's statement is incorrect and Sanscartier's statement is incorrect.

Your answer: A was incorrect. The correct answer was C) Prudhomme's statement is correct and Sanscartier's statement is correct.

If a firm has a non-controlling interest of between 20% but no more than 50%, it is usually deemed to wield significant influence, and the firm will use the equity method of consolidation. In the equity method, the parent's reported income is not affected by changes in the market value of the investee, unless the value decline is considered permanent or realized losses are incurred upon sale of the investment. The decline in value at Quality is cyclical and not permanent. Thus, with a 25% investment in the firm Prudhomme would use of the equity method and thus avoid any affects on its net income.

If the investment were more than 50%, SFAS 94 would require the use of the consolidated method. In the consolidated statements, the fluctuations in market value of Quality would not affect Prudhomme's income statement. Thus, Xavier Prudhomme's statement that buying at least 20% of Quality's stock would prevent having fluctuations in the stock price affect Prudhomme's income statement is correct.

Sanscartier's suggestion of purchasing 100,000 shares of Quality would represent a 10% interest in the firm. Ownership of less than 20% is typically viewed as a non-controlling interest and the two firms are treated as separate entities. If there were no public market for Quality's shares and no readily determined fair value, the cost method would have to be used. In that case, changes in market value would be recognized only on the sale of the securities. Thus Sanscartier's statement is also correct.

Part 2)
If Prudhomme Inc. follows Sanscartier's recommendation and classifies its shares of Quality as be trading securities, what would be the effect of its ownership of Quality on Prudhomme's income statement for fiscal year 2004?

A) -$100,000.
B) -$70,000.
C) No effect.
D) +$30,000.

Your answer: A was incorrect. The correct answer was B) -$70,000.

Sanscartier's suggestion is to acquire only 10% of Quality. The value of a share dropped from $6 to $5, or $1 per share. Unrealized changes in the market value of trading securities are included in income. The income of Prudhomme is also increased by the dividend paid by Quality. We are told that Quality's revenues are 1.5 times its assets of $2 million, so income is $3 million. Of this, 20% is profit, so profits are $600,000. Half of the profits are paid out as dividends. So:

[($5.00 - $6.00) * (100,000)] + [($300,000 / 1,000,000) * 100,000)] = -$70,000

Part 3)
If Prudhomme Inc. acts on Xavier Prudhomme's recommended investment and considers its shares of Quality to be available-for-sale, what is the value of Quality on the balance sheet of Prudhomme as of December 31, 2004?

A) $1,425,000.
B) $1,500,000.
C) $1,575,000.
D) $1,250,000.

Your answer: A was incorrect. The correct answer was A) $1,425,000.

Xavier Prudhomme recommended buying a 25% interest in Quality, which would be considered to give Prudhomme Inc. significant influence over Quality. The equity method is used when an investor has significant influence over an investee. Recall that he believed that this purchase could be made at a 10% discount from market value. Prudhomme's actual dollar investment in Quality plus Prudhomme's share of net income less Prudhomme's share of dividends determines the carrying value of the acquired stock.

($6.00 * 250,000 * 0.9) + ($600,000 * 0.25) – ($300,000 * 0.25) = $1,425,000.

Part 4)
If Prudhomme Inc. acts on Xavier Prudhomme's recommended investment and considers its shares of Quality to be trading securities, what is the effect of its ownership of Quality on Prudhomme's income statement for FY2004?

A) +$75,000.
B) -$100,000.
C) -$175,000.
D) +$150,000.

Your answer: A was incorrect. The correct answer was D) +$150,000.

The equity method is used when an investor has significant influence over an investee, even if the company considers the investment trading securities. Prudhomme's income will include 25 percent of Quality's net income, or (.25 * $600,000) = $150,000. In applying the equity method, dividends and changes in market value do not affect income.

Part 5)
If Prudhomme Inc. had purchased 750,000 shares of Quality for cash at a 10 percent discount from market value on December 31, 2003 and considered its shares of Quality to be available for sale, what would be the minority interest on the December 31, 2004 balance sheet?

A) $450,000.
B) $600,000.
C) $525,000.
D) $250,000.

Your answer: A was incorrect. The correct answer was C) $525,000.

Since Prudhomme has a controlling interest in Quality, the consolidation method is used. The balance sheet minority interest at the time of acquisition is the minority interest of (1 - 0.75)= 25% times owners' equity of (1,000,000 + 800,000)= $1.8 million for a total of $450,000. The balance sheet minority interest on December 31, 2003 is computed by taking the previous minority interest of $450,000, adding the 2004 income statement minority interest in income of ($600,000 * 0.25)= $150,000, and subtracting the minority interest dividend share of ($300,000 * 0.25)= $75,000. Thus the 2004 minority interest becomes:($450,000 + $150,000 - $75,000)= $525,000.

Part 6)
Assume Prudhomme's only investment in Quality was the purchase of 500,000 shares of Quality for cash at market value on December 31, 2003 and Prudhomme considers its shares of Quality to be available for sale. On December 31, 2004, Quality declares bankruptcy and Quality's stock price tumbles to $0.10 per share. What is the value of Quality on the balance sheet of Prudhomme as of December 31, 2004?

A) $50,000.
B) $0.
C) $500,000.
D) $600,000.

Your answer: A was incorrect. The correct answer was A) $50,000.

Consolidation is not appropriate when control is temporary or the parent does not control the subsidiary, even if it owns more than 50% of the subsidiary's stock. Bankruptcy is an instance when control is relinquished. Prudhomme's investment is therefore carried at fair value on the balance sheet.

(500,000 shares x $0.10) = $50,000.

Question 3 - #8812

On December 15, 2004, the Zeisler Company faces a financial crisis. Zeisler's industry has gone into recession and net income has declined to nearly zero. Jeremiah Welch, the company's CFO, is extremely concerned that, when the final figures for 2004 come in, the poor operating results will throw the firm into violation of its debt covenants, which specify that it must meet a certain return on assets (ROA) and not exceed a certain debt-to-asset ratio. A violation of either covenant would trigger a provision in the lending agreement allowing lenders to put Zeisler's debt back to the firm and likely force Zeisler into bankruptcy.

With only two weeks before the close of the firm's fiscal year on December 31, there is no way to avoid bankruptcy through improved operations. Welch calls an emergency meeting with Olivia Dupree, the firm's controller, to come up with a plan of action to keep Zeisler out of bankruptcy. He explains to Dupree that they need to increase Zeigler's reported ROA and reduce its reported debt-to-assets ratio relative to the numbers that would otherwise be reported for 2004.

Dupree suggests that Zeisler's equity investments might be useful in staving off bankruptcy. Zeisler acquired 100,000 shares of the Market Square Corporation on January 1, 2004, at $25 per share. Market Square paid dividends during 2004 of $1.50 per share and was expected to have earnings for 2004 of $2.50 per share. Zeisler also holds 250,000 shares of General Nuclear, purchased for $72 per share. General Nuclear has no dividends and is expected to report a loss for 2004. Both securities are classified on the financial statements as available-for-sale.

Dupree added that Zeisler also holds several million dollars of Market Square's debt securities, classified as a held-to-maturity investment. The holding in Market Square represents a small fraction of Zeisler's total fixed-income investments, all of which are also classified as held-to-maturity. The investment in Market Square's debt differs significantly from Zeisler's other investments in fixed-income securities in that Market Square's debt is trading slightly above Zeisler's cost while Zeisler's other fixed-income investments are all trading significantly below Zeisler's cost because of a general increase in market interest rates. Welch points out, however, that even if the firm were to sell all its marketable securities, the proceeds would not be sufficient to pay off the debt and avert bankruptcy.

Dupree left the meeting with Welch for a moment to check the stock market. She found that Market Square was trading at $35 per share and General Nuclear was at $43. This new information gave Dupree an idea.

Dupree suggested to Welch, "We could reclassify our equity investment in Market Square as trading before year-end. That will help raise our ROA for this year." Welch pointed out that a reclassification of the equity investment from available-for-sale to trading would reduce Zeisler's reported net income because the firm would be required to stop including the dividends it receives from Market Square in net income.

Welch suggested that, instead of reclassifying Market Square's equity, they sell Market Square's debt. That would reduce Zeisler's debt-to-assets ratio because the unrealized gain in the market value of the Market Square debt would be realized when the security was sold. Dupree added that the firm could also liquidate the General Nuclear investment to raise cash without affecting the firm's reported ROA for 2004. Welch and Dupree decided to liquidate the two assets to help improve the firm's financial position.

Part 1)
What is the investment income that Zeisler Company will report for the year 2004 on its investment in Market Square Corporation shares if it continues to account for the shares as an available-for-sale investment?

A) $200,000.
B) $100,000.
C) $150,000.
D) $250,000.

Your answer: A was incorrect. The correct answer was C) $150,000.

The investment income for available-for-sale securities includes dividends, interest, and realized gains. In this case, the investment income from Market Square Corporation would be the dividends it paid to the number of shares Zeisler owns:

100,000 shares × $1.50 per share = $150,000.

Part 2)
If Zeisler were to account for the Market Square Corporation shares as trading securities, assuming that the securities do not change in value between the December 15th meeting and the end of the year, the carrying amount of these shares on Zeisler's December 31, 2004 balance sheet would be:

A) $3.50 million.
B) $2.75 million.
C) $2.60 million.
D) $2.50 million.

Your answer: A was incorrect. The correct answer was A) $3.50 million.

Trading securities are carried at fair market value:

100,000 shares × $35 per share = $3,500,000

Part 3)
If Zeisler reclassified the common stock of General Nuclear as a trading security, what effect would it have on Zeisler's 2004 income statement?

A) Net income would increase.
B) Reclassifying the security would have no effect on the income statement because gains and losses would be recognized in equity.
C) Net income would decline.

D) Reclassifying the security would have no effect on the income statement because gains and losses are not realized.

Your answer: A was incorrect. The correct answer was C) Net income would decline.

Reclassifying a security from available-for-sale to trading requires unrealized gains and losses to be recognized in income. Since Zeisler's investment in General Nuclear has an unrealized loss, net income would be reduced.

Part 4)
Regarding the statements made by Dupree and Welch about reclassifying Zeisler's equity investment in Market Square to trading:

A) Welch's statement is incorrect; Dupree's statement is correct.
B) Welch's statement is correct; Dupree's statement is correct.
C) Welch's statement is correct; Dupree's statement is incorrect.
D) Welch's statement is incorrect; Dupree's statement is incorrect.

Your answer: A was incorrect. The correct answer was A) Welch's statement is incorrect; Dupree's statement is correct.

Welch's statement is incorrect because dividends and interest are recognized as income both when the securities are classified as trading and when they are classified as available-for-sale.

Dupree's statement is correct. Reclassifying the securities from available-for-sale to trading will significantly raise Zeisler's near-zero net income by allowing Zeisler to recognize the unrealized gain in income when the security is reclassified. It will have no material effect on asset value because the shares will be carried at fair market value as trading securities and were already carried at fair market value (with the net unrealized gain in equity) as available-for-sale securities. Even though it may appear that equity would decline by the amount of the unrealized gain if the securities were reclassified, the unrealized gain will flow through income in 2004 and thus return to equity. Consequently, reclassifying the equity securities of Market Square would help increase Zeisler's ROA by raising net income and having little effect on assets.

Part 5)
If Zeisler were to account for the Market Square Corporation shares using the equity method, assuming that the securities do not change in value between the December 15th meeting and the end of the year, the carrying amount of these shares on Zeisler's December 31, 2004 balance sheet would be:

A) $2.75 million.
B) $2.50 million.
C) $2.60 million.
D) $3.50 million.

Your answer: A was incorrect. The correct answer was C) $2.60 million.

Under the equity method the market value of the stock is ignored but the proportionate share of the earnings are added to the original investment and the proportionate share of the dividends are subtracted from the earnings. Hence, we have the original investment + (earnings - dividends) = total value of the investment.

[(100,000 shares)($25)] + [(100,000 shares)($2.50 earnings - 1.50 dividend)] = $2,600,000.

Part 6)
Regarding the statements made by Dupree and Welch about reclassifying Zeisler's debt investment in Market Square to trading:

A) Welch's statement is correct; Dupree's statement is incorrect.
B) Welch's statement is incorrect; Dupree's statement is incorrect.
C) Welch's statement is correct; Dupree's statement is correct.
D) Welch's statement is incorrect; Dupree's statement is correct.

Your answer: A was incorrect. The correct answer was B) Welch's statement is incorrect; Dupree's statement is incorrect.

Welch's statement is incorrect because SFAS 115 requires a firm that sells a held-to-maturity security before maturity to carry its remaining held-to-maturity securities at market value instead of cost. Since the Market Square debt is the only fixed-income investment trading above Zeisler's cost, and it represents only a small part of

Zeisler's total fixed-income portfolio, the net effect of selling the Market Square debt would be to reduce assets – not raise them – because it would require Zeisler to mark down all its other fixed-income investments. A decline in assets would effectively increase the debt to assets ratio.

Dupree's statement is also incorrect. The investment in General Nuclear would be carried on the books at fair market value, with the unrealized loss in equity. Selling the asset and converting it to cash would not materially affect total assets. However, selling the General Nuclear shares would reduce net income because the realized loss would have to be recognized in income. Thus, the sale would reduce reported ROA.

Question 4 - #46506

Molly Boone, CPA, is an auditor with the public accounting firm Wickes and Brown. The firm has been hired for a special project, which involves performing a comprehensive audit of the pension plan of the Red Corporation. The Red Corporation has come under media scrutiny recently for an embezzlement scandal involving the Chief Financial Officer (CFO) of the company. Among other various violations of the law, there is suspicion that the CFO inappropriately accounted for funds that were part of the pension plan's assets, however, all of the facts of the case are still being gathered. The CEO of the company has hired Wickes and Brown in an effort to demonstrate the company's full cooperation with the ongoing investigation, and to assuage any investor fears regarding the ongoing viability of the company. The CEO also wants to reassure employees of the company, both currently employed and retired, that the pension plan still has a sufficient asset base to be able to deliver all promised future benefits.

Select pension plan information for the Red Corporation (as of 12/31/05)

Projected benefit obligation	$31,500,000
Accumulated benefit obligation	$27,750,000
Estimated 2006 service cost	$1,625,000
Estimated 2006 interest cost	$475,000

According to their financial statements, pension plan assets at year-end 2005 had an approximate market value of $22,000,000. In this year's budget (year ending December 31, 2006), the company has projected that it will make total cash contributions of $2,500,000 to the pension plan by the end of 2006.

Boone suspects that key assumptions of the pension plan may have been adjusted for the sole purpose of falsely reporting an improved status of the plan. He observes in the notes of the pension plan, that adjustments have been made during the past year to the plan discount rate, rate of compensation increase and the expected rate of return. Boone acknowledges that adjustments to these assumptions are warranted from time to time, but speculates that the changes were made to mislead both the investors in the Red Corporation as well as the pension plan beneficiaries.

Part 1)
The primary difference between the projected benefit obligation (PBO) and the accumulated benefit obligation (ABO) of a company's pension plan is that the:

A) PBO is the actuarial present value of future benefits based upon expected future salary increases, while ABO is the portion of the PBO to which employees are entitled based on the vesting schedule.

B) PBO is the actuarial present value of future benefits based upon an estimated discount rate, while ABO is based upon actual returns received by the plan to date.

C) PBO is actuarial present value of future benefits based upon an estimated discount rate, while ABO is the PBO plus any accumulated non-pension post retirement benefits.

D) PBO is the actuarial present value of future benefits based upon expected future salary increases, while ABO is based upon current salary levels.

Your answer: A was incorrect. The correct answer was D) PBO is the actuarial present value of future benefits based upon expected future salary increases, while ABO is based upon current salary levels.

PBO is the actuarial present value of future benefits based upon expected future salary increases, while ABO is the actuarial present value of future benefits ignoring future salary increases.

Part 2)
Assuming that for the year 2006, the pension plan earns an $850,000 return on assets, calculate the 2006 pension expense.

A) $1,625,000.

B) $1,250,000.
C) $2,100,000.
D) $775,000.

Your answer: A was incorrect. The correct answer was B) $1,250,000.

Pension expense for a given year equals the service cost plus interest cost minus return on assets. Therefore: $1,625,000 + $475,000 – $850,000 = $1,250,000

Part 3)

Boone wants to investigate whether the officer may have utilized aggressive assumptions in regards to the company's pension plan in order to improve reported results. Which of the following examples of the effect of changes in pension plan assumptions on PBO is *most* accurate?

	Decrease Discount Rate	Decrease Rate of Compensation
A)	Increase	Decrease
B)	Decrease	Decrease
C)	Increase	Increase
D)	Decrease	Increase

Your answer: A was incorrect. The correct answer was A)
Increase Decrease

An increase in the assumed discount rate will cause an increase in PBO, because it will result in a higher projected pension liability. A decrease in the assumed rate of compensation will decrease the PBO, because it results in lower project benefits earned by the employees.

Part 4)
Which of the following statements regarding the fundamental assumptions underlying a company's net pension liability and expense is *most* accurate?

A) The assumption of a higher return on plan assets will improve reported results because it will decrease the calculated PBO.
B) The assumption of a lower discount rate will result in a decreased service cost expense for the year.
C) The assumption of a higher discount rate will increase present values and lower pension liabilities.
D) The assumption of a lower rate of compensation increase will lower projected future pension payments and a lower PBO.

Your answer: A was incorrect. The correct answer was D) The assumption of a lower rate of compensation increase will lower projected future pension payments and a lower PBO.

A lower rate of compensation improves reported results because projected future pension payments are lower, as well as decreased service and interest costs.

Part 5)

Assume that the Red Corporation makes the budgeted contribution to the pension plan by year end. Calculate the PBO and the net pension liability of the plan for 2006 after the contribution.

	PBO	Net Pension Liability
A)	$31,500,000	$2,500,000
B)	$33,125,000	$4,600,000
C)	$31,975,000	$2,100,000
D)	$33,600000	$9,100,000

Your answer: A was incorrect. The correct answer was D)
$33,600000 $9,100,000

The 2006 PBO equals the 2005 PBO plus service cost and interest cost ($31,500,000 + $1,625,000 + $475,000 = $33,600,000). The value of plan assets after the 2006 contribution is $22,000,000 + $2,500,000 =

$24,500,000.The net pension liability of the plan for 2006 after the contribution is the difference between the value of the assets in the plan and the 2006 PBO ($33,600,000 – $24,500,000 = $9,100,000).

Part 6)
Under U.S. GAAP accounting standards, a company can choose to delay the recognition of certain events that affect the value of the plan and the company's pension obligation. Which of the following is an example of a type of event that can receive delayed recognition?

A) Decline in market value of plan assets.
B) A plan amendment that results in a prior service cost.
C) Lower than expected return on plan assets.
D) The discount rate assumption is increased.

Your answer: A was incorrect. The correct answer was B) A plan amendment that results in a prior service cost.

A plan amendment that increases future benefits owed to beneficiaries results in an immediate increase in PBO. However, the net pension liability and pension do not immediately increase, and the unrecognized loss is held off the financial statements as prior service cost and amortized over time.

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