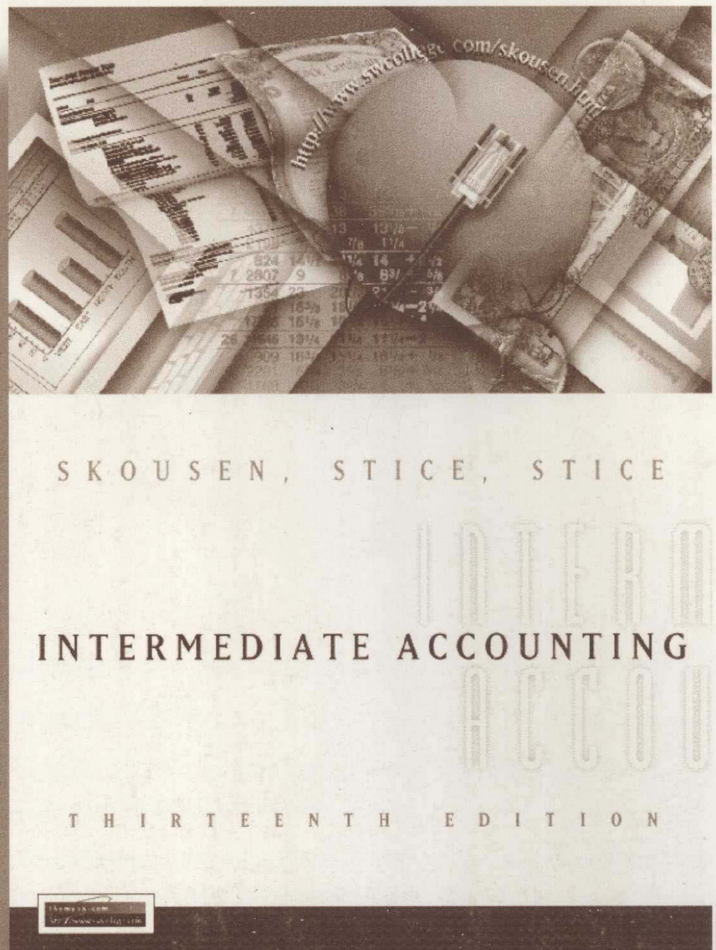
TEST BANK

VOLUME 2, CHAPTERS 15-21

INTERMEDIATE ACCOUNTING



SKOUSEN, STICE, STICE

Prepared by
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VOLUME 2, CHAPTERS 15-21

INTERMEDIATE ACCOUNTING

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SOUTH-WESTERN College Publishing
An International Thomson Publishing Company

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MULTIPLE CHOICE QUESTIONS

a 1. Generally accepted accounting principles require that certain lease agreements be accounted for as purchases. The theoretical basis for this treatment is that a lease of this type
- a. effectively conveys all of the benefits and risks incident to the ownership of property.
- b. is an example of form over substance.
- c. provides the use of the leased asset to the lessee for a limited period of time.
- d. must be recorded in accordance with the concept of cause and effect.

d 2. Which of the following statements characterizes an operating lease?
- a. The lessee records depreciation and interest.
- b. The lessee records the lease obligation related to the leased asset.
- c. The lessor transfers title of the leased property to the lessee for the duration of the lease term.
- d. The lessor records depreciation and lease revenue.

b 3. One of the four general criteria for a capital lease is that the present value at the beginning of the lease term of the minimum lease payments equals or exceeds
- a. the property's fair market value.
- b. 90 percent of the property's fair market value.
- c. 75 percent of the property's fair market value.
- d. 50 percent of the property's fair market value.

b 4. Which of the following statements characterizes a leveraged lease?
- a. The lessee does not capitalize the leased asset.
- b. The lessor borrows a portion of the purchase price of the leased asset from a third party.
- c. The lessor treats the lease as an operating lease.
- d. The lessee makes lease payments to the lessor's equity participant rather than to the lessor.

a 5. The present value of the minimum lease payments should be used by the lessee in the determination of a(n)

	Capital Lease Liability	Operating Lease Liability
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

c 6. One of the four general criteria for a capital lease specifies that the lease term be equal to or greater than
- a. the estimated economic life of the property.
- b. 90 percent of the estimated economic life of the property.
- c. 75 percent of the estimated economic life of the property.
- d. 50 percent of the estimated economic life of the property.

c 7. For a capital lease, the amount recorded initially by the lessee as a liability should
   a. exceed the present value at the beginning of the lease term of minimum lease payments during the lease term.
   b. exceed the total of the minimum lease payments during the lease term.
   c. not exceed the fair value of the leased property at the inception of the lease.
   d. equal the total of the minimum lease payments during the lease term.

c 8. Johnson Institute leased a new machine having an expected useful life of 12 years. The noncancellable lease term is 10 years, and Johnson may exercise a purchase option at the end of the noncancellable term. The machine should be capitalized by Johnson and depreciated over
   a. 9 years.
   b. 12 years.
   c. 10 years.
   d. 10 or 12 years at Johnson's option.

d 9. The lessee's balance sheet liability for a capital lease would be periodically reduced by the
   a. minimum lease payment.
   b. minimum lease payment plus the amortization of the related asset.
   c. minimum lease payment less the amortization of the related asset.
   d. minimum lease payment less the portion of the minimum lease payment allocable to interest.

a 10. What are the three types of period costs that a lessee experiences with capital leases?
   a. Interest expense, amortization expense, executory costs
   b. Amortization expense, executory costs, lease expense
   c. Executory costs, interest expense, lease expense
   d. Lease expense, executory costs, initial costs

c 11. An eight-year capital lease specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fourth year applicable to the reduction of the net lease liability should be
   a. the same as in the third year.
   b. less than in the third year.
   c. less than in the fifth year.
   d. more than in the fifth year.

d 12. Which of the following statements concerning guaranteed residual values is appropriate for the lessee?
a. The asset and related liability should be increased by the amount of the residual value.
b. The asset and related liability should be decreased by the amount of the residual value.
c. The asset and related liability should be decreased by the present value of the residual value.
d. The asset and related liability should be increased by the present value of the residual value.

c 13. Johntech Inc. leased a new machine having an expected useful life of 30 years from Carbide Co. Terms of the noncancellable 25-year lease were that Johntech would gain title to the property upon payment of a sum equal to the fair market value of the machine at the termination of the lease. Johntech accounted for the lease as a capital lease and recorded an asset and a liability in the financial records. The asset recorded under this lease should properly be amortized over
a. 5 years (the period of actual ownership).
b. 22.5 years (75 percent of the 30-year asset life).
c. 25 years (the term of the lease).
d. 30 years (the total asset life).

c 14. Which one of the following items is not part of the minimum lease payments from the standpoint of the lessee?
a. The minimum rental payments called for by the lease.
b. Any guarantee the lessee is required to make at the end of the lease term regarding any deficiency from a specified minimum.
c. Any estimated residual value at the end of the lease term.
d. Any payment the lessee must make at the end of the lease term to purchase the leased property under a bargain purchase option.

c 15. A lease contains a bargain purchase option. In determining the lessee's capitalizable cost at the beginning of the lease term, the payment called for by the bargain purchase option would be
a. subtracted at its present value.
b. added at its exercise value.
c. added at its present value.
d. subtracted at its exercise price.

c 16. Which of the following statements characterizes a sales-type lease?
a. The lessor recognizes only interest revenue over the life of the asset.
b. The lessor recognizes only interest revenue over the lease term.
c. The lessor recognizes a dealer's profit at lease inception and interest revenue over the lease term.
d. The lessor recognizes a dealer's profit at lease inception and interest revenue over the asset life.

b 17. Initial direct costs incurred by a lessor in consummating a sales-type lease are
a. charged to unearned income in the first period of the lease term.
b. charged to cost of sales in the first period of the lease term.
c. deferred and allocated over the lease term in proportion to the recognition of rent revenue.
d. deferred and allocated over the lease term on a straight-line basis.

d 18. Equal monthly rental payments for a particular lease should be charged to Rental Expense by the lessee for which of the following?

	Capital Lease	Operating Lease
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

b 19. Lease Y does not contain a bargain purchase option, but the lease term is equal to 90 percent of the estimated economic life of the leased property. Lease Z does not transfer ownership of the property to the lessee by the end of the lease term, but the lease term is equal to 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

	Lease Y	Lease Z
a.	Capital lease	Operating lease
b.	Capital lease	Capital lease
c.	Operating lease	Capital lease
d.	Operating lease	Operating lease

c 20. M & J Construction built an office building at a cost of $500,000. M & J sold this building to Matson at a material gain and then leased it back from Matson for a stipulated annual rental. This gain should be
a. recognized in full as ordinary item in the year of the transaction.
b. recognized in full as an extraordinary item in the year of the transaction.
c. deferred and amortized proportionately over the life of the lease.
d. treated as a reduction in the obligation under the capital lease.

c 21. If a lease involves both land and buildings and a bargain purchase option is reasonably assured, then
a. both will be capitalized and amortized.
b. buildings are capitalized and amortized; land is an operating lease.
c. buildings are capitalized and amortized; land is capitalized and left at cost.
d. both are operating leases since criteria 3 and 4 are not met.

d 22. Which of the following statements characterizes lessor accounting for residual values?
a. Guaranteed residual values are included in the gross investment amount, but unguaranteed residual values are excluded from the gross investment.
b. Unguaranteed residual values are included in the gross investment amount, but guaranteed residual values are excluded from the gross investment.
c. Guaranteed residual values and unguaranteed residual values are excluded from the gross investment.
d. Guaranteed residual values and unguaranteed residual values are included in the gross investment.

a 23. Draper Corp. leased a new building and land from Baylor Leasing Inc. for 25 years. At the inception of the lease the building and land have fair market values of $200,000 and $25,000, respectively. The building has an expected economic life of 30 years. Which of the following statements is correct regarding Draper's treatment of the lease?
a. Draper should treat the lease as a capital lease even though there is no bargain purchase option and no automatic transfer of ownership at the termination of the lease.
b. Draper should treat the lease as a capital lease only if there is either a bargain purchase option or an automatic transfer of ownership at the termination of the lease.
c. Draper should treat the lease as a capital lease provided that the land and building are recorded in separate asset accounts and accounted for separately.
d. Draper should treat the lease as a capital lease only if Baylor treats the transaction as a leveraged lease.

* a 24. State Repairs acquires equipment under a noncancellable lease at an annual rental of $45,000, payable in advance for five years. After five years, there is a bargain purchase option of $75,000. The appropriate interest rate is 12 percent. What is the total present value of the lease and the first year's interest expense?

a. $224,234 and $21,508
b. $224,234 and $26,908
c. $204,771 and $21,508
d. $204,771 and $19,173

a 25. Stockton, Inc. leased machinery with a fair value of $250,000 from Layton Machine Co. on December 31, 1999. The contract is a six-year noncancellable lease with an implicit interest rate of 10 percent. The lease requires annual payments of $50,000 beginning December 31, 1999. Stockton appropriately accounted for the lease as a capital lease. Stockton's incremental borrowing rate is 12 percent. Assuming the present value of an annuity due of 1 for 6 years at 10 percent is 4.7908 and the present value of an annuity due of 1 for 6 years at 12 percent is 4.6048, what is the lease liability that Stockton should report on the balance sheet at December 31, 1999?

a. $189,540
b. $200,000
c. $230,240
d. $239,540

d 26. Baxter Company leased equipment to Fritz Inc. on January 1, 1999. The lease is for an eight-year period expiring December 31, 2006. The first of eight equal annual payments of $900,000 was made on January 1, 1999. Baxter had purchased the equipment on December 29, 1998, for $4,800,000. The lease is appropriately accounted for as a sales-type lease by Baxter. Assume that the present value at January 1, 1999, of all rent payments over the lease term discounted at a 10 percent interest rate was $5,280,000. What amount of interest revenue should Baxter record in 2000 (the second year of the lease period) as a result of the lease?

a. $490,000
b. $480,000
c. $438,000
d. $391,800

a 27. Jordan Co. leased a machine on December 31, 1999. Annual payments under the lease are $110,000 (which includes $10,000 annual executory costs) and are due on December 31 each year, for a ten-year period. The first payment was made on December 31, 1999, and the second payment was made on December 31, 2000. According to the agreement, the lease payments are discounted at 10 percent over the lease term. Assume the present value of minimum lease payments at the inception of the lease and before the first annual payment was $615,000 and Jordan appropriately classified the lease as a capital lease. What is the lease liability Jordan should report in its December 31, 2000, balance sheet?
a. $466,500
b. $515,000
c. $534,150
d. $576,500

b 28. Aerotech Inc., a dealer in machinery and equipment, leased equipment to Quality Products on July 1, 1999. The lease is appropriately accounted for as a sale by Aerotech and as a purchase by Quality. The lease is for a ten-year period (the useful life of the asset) expiring June 30, 2009. The first of ten equal annual payments of $250,000 was made on July 1, 1999. Aerotech had purchased the equipment for $1,337,500 on January 1, 1999, and established a list selling price of $1,687,500 on the equipment. Assume that the present value at July 1, 1999, of the rent payments over the lease term discounted at 12 percent (the appropriate interest rate) was $1,582,500. What is the amount of profit on the sale and the amount of interest income that Aerotech should record for the year ended December 31, 1999?
a. $245,000 and $94,950
b. $245,000 and $79,950
c. $350,000 and $79,950
d. $350,000 and $94,950

c 29. On January 1, 1999, Shak, Inc. signed a noncancellable lease for a sneaker shining machine. The machine has an estimated useful life of nine years. The term of the lease is a six-year term with title passing to Shak at the end of the lease. The agreement called for annual payments of $40,000 starting at the end of the first year. Assume aggregate lease payments were determined to have a present value of $200,000, based on implicit interest of 12 percent. What amount of interest expense should Shak report in its 1999 income statement from this lease transaction?
a. $0
b. $16,000
c. $24,000
d. $33,333

a 30. Epson Distributing leased a machine for a period of eight years, contracting to pay $200,000 at the beginning of the lease term on December 31, 1999, and $200,000 annually on December 31 for each of the next seven years. The present value of the eight rent payments over the lease term, appropriately discounted at 10 percent, is $1,174,000. On its December 31, 2000, balance sheet, Epson should report a liability under capital lease of
a. $871,400.
b. $876,600.
c. $974,000.
d. $1,091,400.

c 31. Slice Company manufactures equipment that they sell or lease. On December 31, 1999, Slice leased equipment to Hook Company for a five-year period after which ownership of the leased asset will be transferred to Hook. The lease calls for equal annual payments of $50,000, due on December 31 of each year. The first payment was made on December 31, 1999. The normal sales price of the equipment is $220,000, and cost is $176,000. For the year ended December 31, 1999, what amount of income should Slice report from the lease transaction?
a. $10,000
b. $30,000
c. $44,000
d. $74,000

c 32. On March 1, 2000, Sturdy Corp. became the lessee of new equipment under a noncancellable six-year lease. The total estimated economic life of this equipment is ten years. The fair value of this equipment on March 1, 2000, was $100,000. The lease does not meet the criteria for classification as a capital lease with respect to transfer of ownership of the leased asset, or bargain purchase option, or lease term. Nevertheless, Sturdy must classify this lease as a capital lease if, at inception of the lease, the present value of the minimum lease payments (excluding executory costs) is equal to at least
a. $67,500.
b. $75,000.
c. $90,000.
d. $100,000.

d 33. On December 31, 1999, Divot Company sold a machine to Drive Company and simultaneously leased it back for one year. The machine has an estimated remaining useful life of 10 years. The present value of the lease payments at the date of sale is $25,000. The Sales price was $275,000 and at the time of sale the book value of the machine on Divot's records was $245,000. What amount of deferred revenue from the sale of this machine should Divot show on its December 31, 1999 balance sheet?
a. $0
b. $5,000
c. $25,000
d. $30,000

b 34. On December 31, 2000, Gephardt Enterprises leased equipment from B & B Equipment Rental. Pertinent lease transaction data are as follows:
- The estimated seven-year useful equipment life coincides with the lease term.
- The first of the seven equal annual $200,000 lease payments was paid on December 31, 2000.
- B & B's implicit interest rate of 12 percent is known to Gephardt.
- Gephardt's incremental borrowing rate is 14 percent.
- Present values of an annuity of 1 in advance for seven periods are 5.11 at 12 percent and 4.89 at 14 percent.

Gephardt should record the equipment on the books at
a. $1,400,000.
b. $1,022,000.
c. $978,000.
d. $0.

b 35. On January 1, 1999, Collins Company leased a warehouse to Cuthbert under an operating lease for ten years at $80,000 per year, payable the first day of each lease year. Collins paid $36,000 to a real estate broker as a finder's fee. The warehouse is depreciated at $20,000 per year. During 1999, Collins incurred insurance and property tax expense totaling $15,000. Collins' net rental income for 1999 should be

a. $9,000.
b. $41,400.
c. $44,000.
d. $45,000.

c 36. On January 1, Twix Company as lessee signed a ten-year noncancellable lease for a machine with annual payments of $60,000. The first payment was also made on January 1. Twix appropriately treated this transaction as a capital lease. The ten lease payments have a present value of $405,000 at January 1, based on implicit interest of 10 percent. For the first year, Twix should record interest expense of

a. $0.
b. $6,000.
c. $34,500.
d. $40,500.

c 37. Hazard Inc. manufactures equipment that is sold or leased. On December 31, 1999, Hazard leased equipment to Robards for a five-year period expiring December 31, 2004, at which date ownership of the leased asset will be transferred to Robards. Equal $40,000 payments under the lease are due on December 31 of each year. The first payment was made on December 31, 1999. Collectibility of the remaining lease payments is reasonably assured, and Hazard has no material cost uncertainties. The normal sales price of the equipment is $154,000 and cost is $120,000. For the year ended December 31, 1999, how much income should Hazard recognize from the lease transaction?

a. $46,000
b. $40,000
c. $34,000
d. $28,000

c 38. On January 1, Gregory Company signed a ten-year noncancellable lease for a new machine, requiring $40,000 annual payments at the beginning of each year. The machine has a useful life of 15 years, with no salvage value. Title passes to Gregory at the lease expiration date. Gregory uses straight-line depreciation for all of its plant assets. Aggregate lease payments have a present value on January 1 of $252,000, based on an appropriate rate of interest. For the first year, Gregory should record depreciation (amortization) expense for the leased machine at

a. $40,000.
b. $25,200.
c. $16,800.
d. $14,133.

b 39. On December 1, 1999, Blake Inc. signed an operating lease for a warehouse for ten years at $24,000 per year. Upon execution of the lease, Blake paid $48,000 covering rent for the first two years. How much should be shown in Blake's income statement for the year ended December 31, 1999, as rent expense?

a. $0
b. $2,000
c. $24,000
d. $48,000

c 40. On December 31, 1999, Cooke Company leased a machine under a capital lease for a period of ten years, contracting to pay $100,000 on signing the lease and $100,000 annually on December 31 of the next nine years. The present value at December 31, 1999, of the ten lease payments over the lease term discounted at 10 percent was $676,000. At December 31, 2000, Cooke's total capital lease liability is

a. $486,000.
b. $518,000.
c. $533,600.
d. $607,960.

PROBLEMS

Problem 1

On July 1, 1999, Hawkeye Aviation leased two helicopters from Honnicutt Aircraft for an initial period of 12 months with a provision for a continuation on a month-to-month basis. The lease is properly classified as an operating lease. Lease payments are to be made as follows:

First two months	$15,000 per month
Second three months	12,000 per month
Third three months	10,000 per month
Last four months	8,000 per month

After the first year, the rent continues at $6,000 per month. Provide the entries required to record the lease payments for the first year on the books of

(1) Hawkeye Aviation.
(2) Honnicutt Aircraft.

Solution 1

(1) Hawkeye Aviation (Lessee)

<u>1999</u>			
July, Aug.	Prepaid Rent	4,333	
	Rent Expense ([2($15,000) + 3($12,000) + 3($10,000) + 4($8,000)] / 12)	10,667	
	Cash		15,000
Sept., Oct., Nov.	Prepaid Rent	1,333	
	Rent Expense	10,667	
	Cash		12,000
<u>1999</u>			
Dec.	Rent Expense	10,667	
<u>2000</u>	Cash		10,000
Jan., Feb.	Prepaid Rent		667
<u>2000</u>			
Mar., Apr.,	Rent Expense	10,667	
May, June	Cash		8,000
	Prepaid Rent		2,667