52. Books Forever, Inc., uses short-term bank debt to buy inventory. Assuming an initial current ratio that is greater than 1, and an initial quick (or acid test) ratio that is less than 1, what is the effect of these transactions on the current ratio and the quick ratio?
   A. Both ratios will decrease.
   B. Neither ratio will decrease.
   C. Only one ratio will decrease.

53. Which of the following statements regarding the financial statement reporting of leases is *most accurate*?
   A. Under an operating lease, the lessee treats the entire lease payment as a cash outflow from operations.
   B. The lessee's current ratio is the same whether a lease is treated as an operating or finance lease.
   C. At the inception of a direct financing lease, the lessor recognizes gross profit.

54. A construction firm uses the percentage-of-completion method to recognize revenue from long-term contracts. In its next reporting period, the firm will adopt the converged accounting standards that were issued in May 2014. Compared to the prior accounting standards, in that period the firm is *most likely* to recognize:
   A. less revenue.
   B. more revenue.
   C. the same revenue.

55. Which of the following accounting practices is *most likely* to decrease reported earnings in the current period?
   A. Using the straight-line method of depreciation instead of an accelerated method.
   B. Capitalizing advertising expenses rather than expensing them in the current period.
   C. Using LIFO inventory cost methods during a period of rising prices.

56. Which of the following statements about dilutive securities is *most accurate*?
   A. A simple capital structure is one that contains only common stock and antidilutive securities.
   B. A dilutive security is one that will cause earnings per share to decrease if it is converted into common stock.
   C. Warrants are antidilutive if their exercise price is less than the stock price at the end of the period.

57. A company that receives a cash payment for a service it will provide in the next accounting period is *least likely* to recognize:
   A. accrued revenue.
   B. unearned revenue.
   C. an accrued liability.

58. In periods of rising prices and stable or increasing inventory quantities, compared with companies that use LIFO inventory accounting, companies that use the FIFO method will have:
    A. higher COGS and lower taxes.
    B. higher net income and higher taxes.
    C. lower inventory balances and lower working capital.

59. Rowlin Corporation, which reports under IFRS, wrote down its inventory of electronic parts last period from its original cost of €28,000 to net realizable value of €25,000. This period, inventory at net realizable value has increased to €30,000. Rowlin should revalue this inventory to:
    A. €28,000 and report a gain of €3,000 on the income statement.
    B. €30,000 and report a gain of €3,000 on the income statement.
    C. €30,000 and report a gain of €5,000 on the income statement.

60. Under IFRS, remeasurements related to defined benefit pension plans are initially recognized in:
    A. net income in the current period.
    B. other comprehensive income and are not amortized to income.
    C. other comprehensive income and amortized over time to income.

61. During a period when net income is unexpectedly weak, managers who attempt to smooth earnings are *most likely* to:
    A. capitalize an expense.
    B. capitalize a new lease.
    C. classify a nonrecurring gain as recurring income.

62. Which of the following definitions used in accounting for income taxes is *least accurate*?
    A. Income tax expense is current period taxes payable adjusted for any changes in deferred tax assets and liabilities.
    B. A valuation allowance is a reserve against deferred tax assets based on the likelihood that those assets will not be realized.
    C. A deferred tax liability is created when tax expense is less than taxes payable and the difference is expected to reverse in future years.

63. From the extended (5-part) DuPont equation, which of the following components describes the equation EBT / EBIT?
    A. Tax burden.
    B. Interest burden.
    C. Financial leverage.

50. **C** Interest income is considered an operating cash flow under U.S. GAAP. (Study Session 7, LOS 26.a)

51. **C** Dilution occurs since the exercise price for the warrants ($45) is less than the average market price for the shares ($50). The incremental number of shares outstanding is found from:

$$\left(\frac{\text{market price} - \text{exercise price}}{\text{market price}}\right) \times \#\,\text{warrants} = \left(\frac{50-45}{50}\right) \times 120{,}000 = 12{,}000$$

Number of shares to use in diluted EPS calculation = 500,000 + 12,000 = 512,000. (Study Session 7, LOS 24.h, LOS 24.i)

52. **A** As an example, start with CA = 2, CL = 1, and Inv = 1.2. We begin with a current ratio of 2 and a quick ratio of 0.8. If the firm increases short-term bank debt (a current liability) by 1 to buy inventory (a current asset) of 1, both the numerator and denominator increase by 1, resulting in $\frac{3}{2} = 1.5$ (new current ratio) and $\frac{3-2.2}{2} = 0.4$ (new quick ratio). (Study Session 7, LOS 27.b)

53. **A** With an operating lease, the entire lease payment is recorded as rent expense and classified as an operating cash outflow. A finance lease results in a lower current ratio than an operating lease because the current portion of the principal repayment component will be added to current liabilities. The lessor does not recognize any profit at the inception of a direct financing lease. (Study Session 8, LOS 29.p, LOS 31.h)

54. **C** Revenue recognition for long-term contracts under the converged accounting standards issued in May 2014 is based on progress toward satisfying the performance obligations in the contracts, which is comparable to the percentage-of-completion method under the prior accounting standards. (Study Session 7, LOS 24.d)

55. **C** LIFO will result in lower net income than FIFO in the current period, during a period of rising prices. The other choices will tend to increase current period earnings. (Study Session 8, LOS 28.c, LOS 29.c, LOS 29.e)

56. **B** Securities that can be converted to common stock are said to be dilutive to earnings if conversion would result in lower earnings per share. A simple capital structure has only common stock or only common stock and nonconvertible stock. It contains no securities that could ever become or create common stock, even antidilutive ones. Whether warrants are antidilutive depends on the average stock price over the reporting period, not the value at the reporting date. (Study Session 7, LOS 24.i)

57. **A** Accrued (unbilled) revenue is recorded at the end of an accounting period for revenue that the company has earned but has not yet recognized. Unearned revenue results from collecting cash in an earlier period than the goods or services will be delivered (which is when the revenue can be recognized). Unearned revenue is an accrued liability because the company owes goods or services to the buyers. (Study Session 6, LOS 22.e)

58. **B** FIFO companies have higher net income, lower COGS, higher inventory, and higher taxes. (Study Session 8, LOS 28.k, LOS 28.l)

59. **A** Under IFRS, inventory values are revalued upward only to the extent they were previously written down. In this case, that is from €25,000 back up to the original value of €28,000. The increase is reported as gain for the period. (Study Session 8, LOS 28.g)

60. **B** Remeasurements (actuarial gains and losses, difference between actual return and expected return on plan assets) are recognized as other comprehensive income under IFRS and are not amortized. (Study Session 8, LOS 31.j)

61. **A** Management may attempt to increase reported earnings in the current period by capitalizing an expense. Capitalizing a lease would decrease earnings in the current period compared to recording an operating lease. Classifying a nonrecurring gain as recurring income would not increase net income because it already includes nonrecurring gains. (Study Session 9, LOS 32.h)

62. **C** Deferred tax liability refers to balance sheet amounts that are created when tax expense is greater than taxes payable. (Study Session 8, LOS 30.a)

63. **B** EBT / EBIT is the interest burden, the second component in the extended DuPont equation. It shows that more leverage does not always lead to higher ROE. As leverage rises, so does the interest burden. The positive effects of leverage can be offset by the higher interest payments that accompany higher levels of debt. Net income / EBT is called the tax burden and is equal to (1 – tax rate). The higher the tax rate, the lower the ROE level. EBIT / revenue is called the EBIT margin or operating margin. (Study Session 7, LOS 27.d)

64. **C** Issuing debt results in a cash inflow from financing. Payment of debt at maturity has no effect on cash flow from operations but decreases cash flow from financing by the face value of the debt. (Study Session 8, LOS 31.a, LOS 31.b)

65. **A** The liability method (SFAS 109 of U.S. GAAP) takes a balance sheet approach and adjusts deferred tax assets and liabilities to future tax rates. An increase in the tax rate increases the value of both deferred tax assets and deferred tax liabilities. (Study Session 8, LOS 30.e)

66. **B** When a question does not specify which accounting standards apply, candidates are instructed to assume International Financial Reporting Standards (IFRS). According to IFRS, property held for the purpose of earning rental income is classified as investment property. However, when a property is transferred from owner-occupied to investment property, a firm using the fair value model must treat any increase in the property's value as a revaluation. That is, the firm may only recognize a gain on the income statement to the extent that it reverses a previously recognized loss. (Study Session 8, LOS 29.n)

67. **C** Under U.S. GAAP, an asset is considered impaired when its book value is greater than the sum of the estimated undiscounted future cash flows from its use and disposal. (Study Session 8, LOS 29.i)

68. **B** The four general categories are: (1) scale and diversification, (2) operational efficiency, (3) margin stability, and (4) leverage. Larger companies and those with more different product lines and greater geographic diversification are better credit risks. High operating efficiency is indicative of a better credit risk. Stable profit margins indicate a higher probability of repayment and thus, a better credit risk. Firms with greater earnings in relation to their debt level are better credit risks. While the availability of collateral certainly reduces lender risk, it is not one of the general categories used by credit rating agencies to determine *capacity* to repay. Specifically, they would consider (1) several specific accounting ratios and (2) business characteristics. The availability of collateral falls into neither category. (Study Session 9, LOS 33.c)