ACCT 202 – PROF. FARINA PRE-QUIZ #2 (Chapter 15) Name\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

True-false: mark T for true or F for false to the left of the question number.

1. At the beginning of a lease agreement, a lessee's debt to equity ratio and rate of return on assets are both affected regardless of whether the lease is classified as a finance lease or as an operating lease.
2. If the lease begins "at or near the end" of an asset's economic life, the criterion of the lease term being for the major part of the economic life does not apply when classifying the type of lease. This is consistent with the basic premise of this criterion that most of the risks and rewards of ownership occur prior to that time.
3. In accounting for operating leases, the lessee will recognize amortization on the leased asset.
4. A bargain purchase option is defined as the option of purchasing leased property at a price that is equal to the expected fair value of a leased asset.
5. If the lessee expects to take ownership of a leased asset at the end of the lease term, the lessor must use an estimated residual value when calculating the lease payments necessary to achieve a desired rate of return.
6. On a transaction that qualifies for sale-leaseback accounting, any gain on the "sale" portion of the transaction is recognized immediately.
7. The different accounting treatments for finance and operating leases is primarily due to the matching principle.
8. The lessee in a financing lease would record interest expense but not amortization expense.
9. Lessees may classify leases as finance, operating, or sales-type without selling profit leases.

MULTIPLE CHOICE. Circle the letter of the best answer.

Use the information below to answer questions #10 - #13.

Technoid Inc. sells computer systems. Technoid leases computers to Lone Star Company on January 1, 2018. The manufacturing cost of the computers was $12 million.

This noncancelable lease had the following terms:

• Lease payments: $2,466,754 semiannually; first payment at January 1, 2018;

remaining payments at June 30 and December 31 each year through June 30, 2022.

• Lease term: five years (10 semiannual payments).

• No residual value; no purchase option.

• Economic life of equipment: five years.

• Implicit interest rate and lessee's incremental borrowing rate: 5% semiannually.

• Fair value of the computers at January 1, 2018: $20 million.

10. Technoid would account for this as:

A) A finance lease.

B) A sales-type lease without selling profit.

C) A sales-type lease with selling profit.

D) An operating lease.

11. Lone Star Company would account for this as:

A) A finance lease.

B) A sales type lease without selling profit.

C) A sales type lease with selling profit.

D) An operating lease.

12. What is the outstanding balance of the lease liability in Lone Star's June 30, 2018, balance sheet? **(Round your answer to the nearest dollar.)**

A) $15,943,154.

B) $17,533,246.

C) $21,000,000.

D) None of these answer choices is correct.

13. What is the interest revenue that Technoid would report for this lease in its 2018 income statement?

A) $0.

B) $1,673,820.

C) $876,662.

D) None of these answer choices is correct.

Use the information below to answer questions #14-#18.

On December 31, 2017, Reagan Inc. signed a lease with Silver Leasing Co. for some equipment having a seven-year useful life. The lease payments are made by Reagan annually, beginning at signing date. Title does not transfer to the lessee, so the equipment will be returned to the lessor on December 31, 2023. There is no purchase option, and Reagan guarantees a residual value to the lessor on termination of the lease.

Reagan's lease amortization schedule appears below:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Dec. 31** | **Payments** | | | **Interest** | | | **Decrease in**  **Balance** | | | **Outstanding**  **Balance** | | | |
| 2017 |  |  |  |  |  |  |  |  |  | | $ | 519,115 |  | |
| 2017 | $ | 90,000 |  |  |  |  | $ | 90,000 |  | |  | 429,115 |  | |
| 2018 | $ | 90,000 |  | $ | 17,165 |  |  | 72,835 |  | |  | 356,280 |  | |
| 2019 | $ | 90,000 |  |  | 14,251 |  |  | 75,749 |  | |  | 280,531 |  | |
| 2020 | $ | 90,000 |  |  | 11,221 |  |  | 78,779 |  | |  | 201,752 |  | |
| 2021 | $ | 90,000 |  |  | 8,070 |  |  | 81,930 |  | |  | 119,822 |  | |
| 2022 | $ | 90,000 |  |  | 4,793 |  |  | 85,207 |  | |  | 34,615 |  | |
| 2023 | $ | 36,000 |  |  | 1,385 |  |  | 34,615 |  | |  | 0 |  | |

14. In this situation, Reagan:

A) is the lessee in a sales-type lease.

B) is the lessee in a finance lease.

C) is the lessor in a finance lease.

D) is the lessor in a sales-type lease.

15. What is the balance of the lease liability on Reagan's December 31, 2019, balance sheet (after the third lease payment is made)?

A) $280,531.

B) $190,530.

C) $266,280.

D) $356,280.

16. At what amount would Reagan record the right-of-use asset at the beginning of the agreement?

A) $519,115.

B) $429,115.

C) $540,000.

D) $576,000.

17. What is the effective annual interest rate charged to Reagan on this lease?

A) 4%.

B) 6%.

C) 8%.

D) 17%.

18. What is the amount of residual value guaranteed by Reagan to the lessor?

A) $1,385.

B) $34,615.

C) $36,000.

D) Cannot be determined from the given information.

19. On January 1, 2018, Green Co. recorded a right-of-use asset of $270,360 in an operating lease. The lease calls for ten annual payments of $40,000 at the beginning of each year. The interest rate charged by the lessor was 10%. The balance in the right-of-use asset at December 31, 2018, will be:

A) $270,360.

B) $253,396.

C) $243,324.

D) $230,360.

20. Titanic Corporation leased executive limos under terms of a $20,000 first payment upon signing the lease and four equal annual payments of $30,000 on the anniversary date of the lease. The interest rate implicit in the lease is 11%. The first year's interest expense would be: (FV of $1, PV of $1, FVA of $1, PVA of $1, FVAD of $1 and PVAD of $1)

A) $13,200.

B) $10,238.

C) $33,200.

D) $15,543.

Use the information below to answer following questions #21-#22.

Refer to the following lease amortization schedule. The five payments are made annually starting with the beginning of the lease. A $2,000 purchase option is reasonably certain to be exercised at the end of the five-year lease. The asset has an expected economic life of eight years.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Lease**  **Payment** | **Cash**  **Payment** | **Effective**  **Interest** | | | **Decrease in**  **Balance** | | | | **Outstanding**  **Balance** | | |
|  |  |  |  |  |  |  |  |  | | 34,600 |  |
| 1 | 8,000 |  | ?? |  |  | ?? |  |  | | 26,600 |  |
| 2 | 8,000 |  | 2,660 |  |  | 5,340 |  |  | | 21,260 |  |
| 3 | 8,000 |  | 2,126 |  |  | 5,874 |  |  | | 15,386 |  |
| 4 | 8,000 |  | 1,539 |  |  | 6,461 |  |  | | 8,925 |  |
| 5 | 8,000 |  | ?? |  |  | ?? |  |  | | ?? |  |
| 6 | 2,000 |  | 182 |  |  | 1,818 |  |  | | 0 |  |

21. What is the effective annual interest rate?

A) 9%.

B) 10%.

C) 11%.

D) 20%.

22. What amount would the lessee record as annual amortization on the asset using the straight-line method, assuming no residual value?

A) $3,325.

B) $6,920.

C) $4,325.

D) $5,320.

23. Recording a sales-type lease with a selling profit is similar to recording:

A.) A sale of a fixed asset.

B.) A purchase of a fixed asset with a note payable.

C.) An exchange of fixed assets.

D.) None of the above.

24. L Corp. recorded a finance lease in February of Year 1 using an annuity due present value table. The company's statement of cash flows for the year ending December 31, Year 1 using the indirect method will report:

A) An addition to net income for amortization.

B) A cash inflow from financing activities.

C) A cash outflow from investing activities.

D) A cash inflow from operating activities.

25. Warren Co. recorded a right-of-use asset of $800,000 in a 10-year finance lease. The interest rate charged by the lessor was 8%. The balance in the right-of-use asset after two years will be:

A) $648,000.

B) $640,000.

C) $804,000.

D) $968,000.

26. On January 1, 2018, Green Co. recorded a right-of-use asset of $270,360 in an operating lease. The lease calls for ten annual payments of $40,000 at the beginning of each year. The interest rate charged by the lessor was 10%. The balance in the right-of-use asset at December 31, 2018, will be:

A) $270,360.

B) $253,396.

C) $243,324.

D) $230,360.

27. We classify a lease as a finance lease if:

A) the present value of lease payments is less than the asset's book value.

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

C) the lessee obtains control of the use of the asset.

D) the usual risks and rewards are retained by the lessor.

28. The costs that (a) are associated directly with consummating a lease, (b) are essential to acquire the lease, and (c) would not have been incurred had the lease agreement not occurred, are referred to as initial direct costs. Initial direct costs are expensed at the beginning of the lease in:

A) An operating lease.

B) A sales-type lease with selling profit.

C) A sales-type lease with no selling profit.

D) Both an operating lease and a sales-type lease with no selling profit.

29. If the lessee expects to obtain title to leased property due to a purchase option that is reasonably certain to be exercised or the passage of title at the end of the lease term:

A) The lessee ignores any residual value for the leased property.

B) The lessor ignores any residual value for the leased property.

C) The lessee adds the present value of the residual value to the amount recorded for the lease.

D) The lessor will always charge a higher annual lease rate.

Short Problem #1

On June 30, 2018, Blue, Inc. leased a machine from Big Leasing Corporation. The lease agreement qualifies as a capital lease and calls for Blue to make semiannual lease payments of $281,454 over a three-year lease term, payable each June 30 and December 31, with the first payment at June 30, 2018. Blue’s incremental borrowing rate is 10%, the same rate Big uses to calculate lease payment amounts.   
   
The lease agreement qualifies as a finance lease. Amortization is recorded on a straight-line basis at the end of each year.

**Required:**  
1**.** Determine the present value of the lease payments at June 30, 2018, (to the nearest $000) that Blue uses to record the right-of-use asset and lease liability.

2. Prepare the necessary journal entries on Blue’s books to record the transactions of June 30 and December 31, 2018.

3. What would be the amounts related to the lease that Blue would report in its balance sheet at December 31, 2018? (Ignore taxes.)

Short Problem #2

On June 30, 2018, Blue, Inc. leased a machine from Large Leasing Corporation. The lease agreement calls for Blue to make semiannual lease payments of $281,454 over a three-year lease term, payable each June 30 and December 31, with the first payment at June 30, 2018. Blue’s incremental borrowing rate is 10%, the same rate Big uses to calculate lease payment amounts. Depreciation is recorded on a straight-line basis at the end of each fiscal year. Large constructed the machine at a cost of $1,250,000.

1.Determine the price at which Large is “selling” the machine (present value of the lease payments) at June 30, 2018 (to the nearest $000).

2. Prepare the necessary journal entries on Large’s books to record the transactions of June 30 and December 31, 2018.

3. What would be the amounts related to the lease that Large would report in its balance sheet at December 31, 2018? (Ignore taxes.)