KPMG PRESENTATION- WHAT ARE THE THREE OPINIONS AUDITORS ARE REQUIRED TO ISSUE?

1. FINANCIAL STATEMENTS
2. INTERNAL CONTROL
3. MANAGEMENT ASSESSMENT OF INTERNAL CONTROL.

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16-87

Listed below are five causes of temporary differences. For each temporary difference indicate (by letter) whether it will create future deductible amounts (D) or future taxable amounts (T).

**Temporary Difference**

- **D** 1. Newspaper subscriptions; taxable when received, recognized for financial reporting when earned.
- **D** 2. Accrued bond interest; tax-deductible when paid.
- **D** 3. Unrealized loss from recording investments available for sale at fair value; tax deductible when the investment is sold.
- **D** 4. Advance rent receipts on an operating lease (as the lessor); taxable when received.
- **D** 5. Accrued expense for employee postretirement benefits; tax deductible when subsequent payments are made.

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14-90

Match the terms below (by letter) with the appropriate definition listed below.

**Term**

a. straight-line method  
b. effective interest method  
c. current liabilities  
d. long-term liabilities  
e. indenture  
f. discount  
g. premium  
h. debenture

- **e** 1. The difference between the face value and the issue price when bonds are sold at more than face
- **b** 2. Provides for recognition of an increasing amount of premium or discount each accounting period
- **e** 3. The contract between the issuing entity and the bond investors
- **G** 4. Obligations that are expected to be paid within one year or the normal operating cycle whichever is longer
Darkside Company leased a machine from Jedi Corporation on January 1, 2000. The machine has a fair value of $2,000,000. The lease agreement calls for four equal payments at the end of each year. The useful life of the machine was expected to be four years with no residual value. The appropriate interest rate for this lease is 10%.

Other information:
- PV of an ordinary annuity @10% for 4 periods: 3.16987
- PV of an annuity due @ 10% for 4 periods: 3.4869

Required:
1. Determine the amount of each lease payment.
2. Prepare the journal entry for Darkside Company at the inception of the lease.
3. Prepare the journal entry for the first lease payment.
4. Prepare the journal entry for the second lease payment.

Difficulty: Hard

Answer:
1. $2,000,000 / 3.16987 = $630,941
2. Leased asset 2,000,000
   Lease payable 2,000,000
3. Interest expense 200,000
   Lease payable 430,941
   Cash 630,941
4. Interest expense 156,906
   Lease payable 474,035
   Cash 630,941

Listed below are several terms and phrases associated with long-term debt. Pair each item from list A (by letter) with the item from list B that is most appropriately associated with it.

<table>
<thead>
<tr>
<th>List A</th>
<th>List B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Issuer may pay off bonds prior to maturity.</td>
<td>a. serial bonds</td>
</tr>
<tr>
<td>2. Bonds mature in a lump-sum.</td>
<td>b. junk bonds</td>
</tr>
<tr>
<td>3. Bonds with no specific collateral pledged.</td>
<td>c. convertible bonds</td>
</tr>
<tr>
<td>4. Bonds that can be exchanged for stock</td>
<td>d. term bonds</td>
</tr>
<tr>
<td>5. Bonds sold at significant discounts.</td>
<td>e. callable bonds</td>
</tr>
<tr>
<td>6. High risk bonds issued by weak companies.</td>
<td>f. zero-interest bonds</td>
</tr>
<tr>
<td>7. Bonds for which assets are pledged.</td>
<td>g. coupon bonds</td>
</tr>
<tr>
<td>8. Bonds that mature in installments.</td>
<td>h. registered bonds</td>
</tr>
<tr>
<td></td>
<td>i. mortgage bond</td>
</tr>
<tr>
<td></td>
<td>j. debenture bonds</td>
</tr>
<tr>
<td></td>
<td>k. secured bonds</td>
</tr>
</tbody>
</table>

Whitejet, Incorporated reports pretax accounting income of $400,000, but due to a single temporary difference, taxable income is $500,000. At the beginning of the year, no temporary differences existed.

Required:
Assuming a tax rate of 40%, prepare the appropriate journal entry to record Whitejet's income taxes.
Clinton Company, organized on January 2, 2000, had pretax accounting income of $7,000,000 and taxable income of $10,000,000 for the year ended December 31, 2000. The 2000 tax rate was 40%. The only difference between book and taxable income is estimated warranty costs. Expected payments and scheduled enacted tax rates are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Before Warranty</th>
<th>Tax Rate</th>
<th>Enacted Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$1,000,000</td>
<td>35%</td>
<td>3,500,000</td>
</tr>
<tr>
<td>2002</td>
<td>500,000</td>
<td>35%</td>
<td>175,000</td>
</tr>
<tr>
<td>2003</td>
<td>500,000</td>
<td>35%</td>
<td>175,000</td>
</tr>
<tr>
<td>2004</td>
<td>1,000,000</td>
<td>30%</td>
<td>300,000</td>
</tr>
</tbody>
</table>

Answer:

Income tax expense (to balance) 3,500,000 175,000 175,000 3,000,000
Deferred tax asset
(change in deferred tax balance) 1,000,000
Income tax payable (tax currently payable) 4,000,000

<table>
<thead>
<tr>
<th>Future deductible amount</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting income</td>
<td>$7,000,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Temp. diff - estimated warranty expense</td>
<td>3,000,000</td>
<td>$1M</td>
<td>$.5M</td>
<td>$.5M</td>
<td>$1M</td>
</tr>
<tr>
<td>Taxable income</td>
<td>10,000,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enacted tax rate</td>
<td>40%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>30%</td>
</tr>
<tr>
<td>Tax payable currently</td>
<td>$4,000,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td></td>
<td>$350K</td>
<td>$175K</td>
<td>$175K</td>
<td>$300K</td>
</tr>
<tr>
<td>Less: Beginning balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$1M</td>
</tr>
</tbody>
</table>

At January 1, 2003, Brainard Industries, Inc., owed Second BancCorp $12 million under a 10% note due December 31, 2004. Interest was paid last on December 31, 2001. Brainard was experiencing severe financial difficulties and asked Second BancCorp to modify the terms of the debt agreement. After negotiation Second BancCorp agreed to:

a. Forgive the interest accrued for the year just ended.

b. Reduce the remaining two years’ interest payments to $1 million each and delay the first payment until December 31, 2004.

c. Reduce the unpaid principal amount to $11 million.

Required:

Exercise 14-24

Analysis:  Carrying amount:  $12 million + $1.2 million = $13,200,000  
           Future payments:  ($1 million x 2) + $11 million = 13,000,000  
           Gain to debtor  $ 200,000  

1. January 1, 2003

Accrued interest payable (10% x $12,000,000) .......... 1,200,000  
Note payable ($13 million – $12 million)* .......... 1,000,000  
Gain on troubled debt restructuring ................. 200,000  

* Establishes a balance in the note account equal to the total cash payments under the new agreement.

2. December 31, 2004

Note payable............................................. 1,000,000  
Cash (revised “interest” amount).......................... 1,000,000  

Note:  No interest should be recorded after the restructuring. All subsequent cash payments result in reductions of principal.

3. December 31, 2005

Note payable............................................. 1,000,000  
Cash (revised “interest” amount).......................... 1,000,000  
Note payable............................................. 11,000,000  
Cash (revised principal amount).......................... 11,000,000  

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14-30  
Intermediate Accounting, 3/e
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   Cash: 630,941
4. Interest expense: [10% x (2,000,000 - 430,941)]
   Lease payable: 474,035
   Cash: 630,941

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16-92 Whitejet, Incorporated reports pretax accounting income of $400,000, but due to a single temporary difference, taxable income is $500,000. At the beginning of the year, no temporary differences existed.

Required:
Assuming a tax rate of 40%, prepare the appropriate journal entry to record Whitejet's income taxes.

\[ \text{INCOME TAX EXPENSE} \quad 160,000 \]
\[ \text{DEFERRED TAX ASSET} \quad (500,000 - 400,000) \times 0.40 \]
\[ \text{INCOME TAX PAYABLE} \quad 200,000 \]
\[ 500,000 \times 40\% \]
The following selected transactions relate to contingencies of Bowe-Whitney, Inc. which began operations in 1997. Bowe-Whitney's fiscal year ends on December 31 and financial statements are published in March, 1998.

Required:
Prepare the appropriate journal entries to record any amounts that should be recorded as a result of each of these contingencies.

1. Bowe-Whitney is involved in a lawsuit resulting from a dispute with a customer over a 1997 transaction. At December 31 attorneys advised that it was probable that Bowe-Whitney would lose $3 million in an unfavorable outcome. On February 12, 1998, judgment was rendered against Bowe-Whitney in the amount of $14 million plus interest, a total of $15.2 million. Bowe-Whitney does not plan to appeal the judgment.

2. At April 1, 1998, the IRS is in the process of auditing Bowe-Whitney's tax returns for 1996-1997, but has not proposed a deficiency assessment. Management feels an assessment is reasonably possible, and if an assessment is made a settlement of up to $33 million is probable.

Ordinarily, the proceeds from the sale of a bond issue will be equal to
a. the face amount of the bond.
b. the total of the face amount plus all interest payments.
c. the present value of the face amount plus the present value of the stream of interest payments.
d. the face amount of the bond plus the present value of the stream of interest payments.

At the beginning of 1997, Gabriel Corporation began offering a 2-year warranty on its products. The warranty program was expected to cost Gabriel 4% of net sales. Net sales made under warranty in 1997 were $180 million. Fifteen percent of the units sold were returned in 1997 and repaired or replaced at a cost of $5.3 million. The amount of warranty expense on Gabriel’s 1997 income statement is:

a. $ 5.3 million
b. $ 7.2 million
c. $10.6 million
d. $27.0 million

21. On July 1, 1989, Lundy Company issued 500 of its 8%, $1,000 bonds for $438,000. The bonds were issued to yield 10%. The bonds are dated July 1, 1989 and mature on July 1, 1999. Interest is payable semiannually on January 1 and July 1. Using the interest method, how much of the bond discount should be amortized for the 6 months ended December 31, 1989?

A. $3,800
B. $3,100
C. $2,480
D. $1,900

3. A bond issued on June 1, 1988 has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 1988 would be for a period of

A. Three months.
B. Four months.
C. Six months.
D. Seven months.