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**CPA**

**Certified Public Accountant (Business Environment and Concepts)**



**Version 1.0**

**Sections**

1. Volume A
2. Volume B
3. Volume C
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**Exam A**

**QUESTION 1**

Fanny and John each own and manage their own companies. Fanny's business is manufacturing freight boxes of all types, and John's business is selling freight boxes to different industries. They decide to combine their expertise and knowledge to produce and sell freight boxes specifically designed for the new airline company that just formed in their city. Which of the following best describes the business formed by the parties?

- A. A general partnership.
- B. A limited liability partnership.
- C. A sole proprietorship.
- D. A joint venture.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. A joint venture is formed for a single business undertaking such as building and designing freight containers to be sold specifically to one company. Each company coming together in this joint venture has its own business outside of this one endeavor.

Choice "a" is incorrect. A general partnership is more broad in its business purpose than a joint venture is.

Choice "b" is incorrect. A limited liability partnership is primarily designed for professionals who want to work as partners but with limited personal liability. Choice

"c" is incorrect. Sole proprietorships have only one person in the business.

**QUESTION 2** A sole proprietorship would be an ideal form of business to select if:

- A. The individual desired no liability beyond his capital investment.
- B. The individual wanted to be able sell the business at will.
- C. The individual wanted the business to be a separate entity from the sole proprietor.
- D. The individual wanted the business to continue indefinitely.



**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A sole proprietor is free to transfer or sell the business at will.

Choice "a" is incorrect because a sole proprietor is personally liable for all obligations of the business.

Choice "c" is incorrect. A sole proprietorship is not considered an entity separate from the sole proprietor. Choice

"d" is incorrect because a sole proprietorship ends with the death of the sole proprietor.

**QUESTION 3**

Formation of which of the following types of business does not require the filing of documents with the state?

<u>Corporation</u>	<u>Limited Partnership</u>	<u>Sole Proprietorship</u>
A. Need not file	Need not file	Need not file
B. Need not file	Must file	Need not file
C. Must file	Must file	Need not file
D. Must file	Need not file	Must file

A. Option A

- B. Option B
- C. Option C
- D. Option D

**Correct Answer:** C  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. A sole proprietorship can be formed without filing with the state. Formation of either a corporation or a limited partnership requires a filing. Choices "a", "b", and "d" are incorrect per the Explanation above.

**QUESTION 4**

Which of the following forms of business can be formed with only one individual owning the business?

	<u>Sole Proprietorship</u>	<u>Limited Liability Company</u>	<u>Partnership</u>
A.	Yes	Yes	Yes
B.	Yes	Yes	No
C.	Yes	No	Yes
D.	No	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D



**Correct Answer:** B  
**Section:** Volume A  
**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "b" is correct. A sole proprietorship and (in most states) a limited liability company can be formed with only one owner. A partnership requires two or more partners. Choices "a", "c", and "d" are incorrect per the Explanation above.

**QUESTION 5**

Noll Corp. and Orr Corp. are contemplating entering into an unincorporated joint venture. Such a joint venture:

- A. Will be treated as a partnership in most important legal respects.
- B. Must be dissolved upon the completion of a single undertaking.
- C. Will be treated as an association for federal income tax purposes and taxed at the prevailing corporate rates.
- D. Must file a certificate of limited partnership with the appropriate state agency.

**Correct Answer:** A  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "a" is correct. The legal requirements, the consequences, the advantages, and disadvantages of forming a joint venture generally are identical to those of a general partnership. Joint ventures are treated as a partnership in most important legal aspects.

Choice "b" is incorrect. A joint venture need not be dissolved upon the completion of a single undertaking. Joint ventures may be formed for a single transaction or for a related series of transactions.

Choice "c" is incorrect because a joint venture would be taxed like a partnership, not a corporation.

Choice "d" is incorrect because a joint venture, like a partnership, may be formed without filing with the state.

**QUESTION 6** What term is used to describe a partnership without a specified duration?

- A. A perpetual partnership.
- B. A partnership by estoppel.
- C. An indefinite partnership.
- D. A partnership at will.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. A partnership at will is a partnership with no definite term (i.e., without specified duration). Such a partnership can be terminated at any time.

Choice "a" is incorrect. A partnership without a specified duration is called a partnership at will, not a perpetual partnership. There is no such thing as a perpetual partnership because a partnership is not perpetual. A partnership may be dissolved after a partner dies or otherwise dissociates from the partnership.

Choice "b" is incorrect. A partnership by estoppel is the appearance of a partnership when there is no formal partnership. If parties who are not partners give the appearance to third parties that they are partners, the law may deem the parties to be a partnership by estoppel. The parties will be treated as partners, even though they are not.

Choice "c" is incorrect. The legal term for a partnership of indefinite duration is a partnership at will, not an indefinite partnership.

**QUESTION 7** A general partnership must:

- A. Pay federal income tax.
- B. Have two or more partners.
- C. Have written articles of partnership.
- D. Provide for apportionment of liability for partnership debts.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A partnership is an organization of two or more persons who carry on a business for a profit.

Choice "a" is incorrect. Partnerships do not pay federal income taxes; the partners report their shares of the partnership's income on their individual returns.

Choice "c" is incorrect. A partnership agreement need not be in writing.

Choice "d" is incorrect. If the partnership agreement is silent on the apportionment of liability for partnership debts, state law or the Uniform Partnership Act will cover the omission.

**QUESTION 8**

When a partner in a general partnership lacks actual or apparent authority to contract on behalf of the partnership, and the party contracted with is aware of this fact, the partnership will be bound by the contract if the other partners:

	<u>Ratify the contract</u>	<u>Amend the partnership agreement</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer: B**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. "Yes - No."

Rule: The authority of partners is governed by agency law. Under agency law, a principal is not bound to the third party unless the agent had actual authority or apparent authority. When the agent has no actual authority and no apparent authority, the principal (in this case the partnership) will only be liable if it chooses to adopt the agreement (i.e., ratify).

Rule: Amending the partnership agreement (presumably to grant authority) will not cause the partnership to be bound because authority must exist at the time the contract is made or the partnership must ratify the contract. Choices "a", "c", and "d" are incorrect, per the above rules.

**QUESTION 9**

On February 1, Addison, Bradley, and Carter, physicians, formed ABC Medical Partnership. Dr. Bradley was placed in charge of the partnership's financial books and records. On April 1, Dr. Addison joined the City Hospital Medical Partnership, retaining the partnership interest in ABC. On May 1, ABC received a writ of attachment from the court attaching Dr. Carter's interest in ABC. The writ resulted from Dr. Carter's failure to pay a credit card bill. On June 1, Dr. Addison was adjudicated bankrupt. On July 1, Dr. Bradley was sued by the other partners of ABC for an accounting of ABC's revenues and expenses.

Under the Revised Uniform Partnership Act, which of the preceding events resulted in the dissociation of a partner?

- A. Dr. Addison joining the City Hospital Medical Partnership.
- B. Dr. Carter's interest in the partnership being attached by the court.
- C. Dr. Addison being adjudicated bankrupt.
- D. Dr. Bradley being sued for an accounting by the other partners of ABC.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The bankruptcy of a partner will result in the dissociation of a partner.

Choice "a" is incorrect, because although joining the city hospital medical partnership could be construed as a breach of fiduciary duty owed to the other partners in ABC medical partnership, standing alone, it would not result in a dissociation.

Choice "b" is incorrect. All that was attached was the partner's right to distributions, which does not cause dissociation.

Choice "d" is incorrect, because although being sued might cause Dr. Bradley to resign, which would cause dissociation, standing alone, being sued by the other partners does not cause dissociation.

**QUESTION 10**

When parties intend to create a partnership that will be recognized under the Revised Uniform Partnership Act, they must agree to:

	<u>Conduct a business for profit</u>	<u>Share gross receipts from a business</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A B.  
Option B  
C. Option C D.  
Option D

**Correct Answer: B**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. "Yes - No."

Rule: A partnership is an agreement between two or more persons to carry on, as co-owners, a business for profit; partners share management and profits and losses, not gross receipts.

Choices "a", "c", and "d" are incorrect, per the above rule.

#### QUESTION 11

Park and Graham entered into a written partnership agreement to operate a retail store. Their agreement was silent as to the duration of the partnership. Park wishes to dissociate from the partnership. Which of the following statements is correct?

- A. Park may dissociate from the partnership at any time.  
B. Unless Graham consents to the dissociation, Park must apply to a court and obtain a decree ordering the dissociation.  
C. Park may not dissociate from the partnership unless Graham consents.  
D. Park may dissociate from the partnership only after notice of the proposed dissolution is given to all partnership creditors.

**Correct Answer: A**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. Because the agreement is silent as to duration, it is a partnership at will. A partner may dissociate from a partnership at will at any time.

Choice "b" is incorrect. Because the agreement is silent as to duration, it is a partnership at will. A partner may dissociate from a partnership at will at any time. No court order is required.

Choice "c" is incorrect. Partnerships are consensual relationships, so any partner has the power to dissociate at any time; he or she need not obtain the consent of the other partners (though absent consent, the partner will be liable for damages if the dissociation is wrongful).

Choice "d" is incorrect. There is no requirement of giving partnership creditors a formal notice of intent to dissociate, but it is a good idea to do so to avoid liability on future partnership obligations.

#### QUESTION 12

The partners of College Assoc., a general partnership, decided to dissolve the partnership and agreed that none of the partners would continue to use the partnership name. Under the Revised Uniform Partnership Act, which of the following events will occur on dissolution of the partnership?

	<i>Each partner's existing liability <u>would be discharged</u></i>	<i>Each partner's apparent authority <u>would continue</u></i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer: C**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. "No - Yes."

Rule: Upon the dissolution of the partnership, each of the partners continues to have liability for partnership debts. Upon dissolution of the partnership each of the partners will continue to have apparent authority. The apparent authority of a partner can only be negated upon proper notice to third parties. Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 13** Which of the following requirements must be met to have a valid partnership exist?

- I. Co-ownership of all property used in a business.
- II. Co-ownership of a business for profit.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

**Correct Answer: B**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "b" is correct.

Rule: A partnership is defined as an association of two or more persons who agree to carry on as coowners a business for profit. Thus, II is necessary. However, there is no requirement that all property used in the business be co-owned; it may be owned by individual partners. Thus I is not necessary. Choices "a", "c", and "d" are incorrect, per the above rule.

**QUESTION 14**

Locke and Vorst were general partners in a kitchen equipment business. On behalf of the partnership, Locke contracted to purchase 15 stoves from Gage. Unknown to Gage, Locke was not authorized by the partnership agreement to make such contracts. Vorst refused to allow the partnership to accept delivery of the stoves and Gage sought to enforce the contract. Gage will:

- A. Lose, because Locke's action was not authorized by the partnership agreement.
- B. Lose, because Locke was not an agent of the partnership.
- C. Win, because Locke had express authority to bind the partnership.
- D. Win, because Locke had apparent authority to bind the partnership.



**Correct Answer:** D  
**Section:** Volume A  
**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. Every partner is an agent of the partnership and has apparent authority to bind the partnership to contracts that appear to carry on in the usual way the business of the partnership. It would be usual for a partner in a kitchen equipment business to have authority to purchase stoves. Thus, Gage will win because of Locke's apparent authority.  
Choice "a" is incorrect. Every partner is an agent for his partnership and has apparent authority to bind the partnership to contracts that appear to carry on in the usual way the business of the partnership.  
Choice "b" is incorrect. Every partner is an agent of the partnership.  
Choice "c" is incorrect. Locke did not have express authority to purchase the stoves. The facts state that Locke was not authorized to purchase the stoves and thus lacked express authority.

#### QUESTION 15

In a general partnership, the authorization of all partners is required for an individual partner to bind the partnership in a business transaction to:

- A. Purchase inventory.
- B. Hire employees.
- C. Sell goodwill.
- D. Sign advertising contracts.

**Correct Answer:** C  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. No such authority exists, however, for transactions outside the regular scope of business. The sale of a business's goodwill is extraordinary and is outside the ordinary scope of business. Thus, a partner must get authorization from all other partners to make the sale.  
Choice "a" is incorrect. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. Purchasing inventory is within the regular scope of business, so a partner need not get permission from the other partners to bind the partnership.  
Choice "b" is incorrect. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. Hiring employees is within the regular scope of a business, so a partner need not get permission from the other partners to bind the partnership.  
Choice "d" is incorrect. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. Entering into advertising contracts is within the regular course of business, and so a partner need not get permission from the other partners to bind the partnership.

**QUESTION 16** On dissolution of a general partnership, distributions will be made on account of:

- I. Partners' capital accounts.
- II. Amounts owed partners with respect to profits.
- III. Amounts owed partners for loans to the partnership.

In the following order:

- A. III, I, and II. B.
- I, II, and III. C. II,
- III, and I.
- D. III, II, and I.

**Correct Answer:** A  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**  
Explanation:



Choice "a" is correct.

Rule: On dissolution of a general partnership the "order of distribution" would be as follows:

III. General partner loans.

I. Partners' capital accounts.

II. General partners' profits.

Choices "b", "c", and "d" are incorrect, per the above rule.

**QUESTION 17** Which of the following is not necessary to create an express partnership?

- A. Execution of a written partnership agreement.
- B. Agreement to share ownership of the partnership.
- C. Intention to conduct a business for profit.
- D. Intention to create a relationship recognized as a partnership.

**Correct Answer:** A

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. A written partnership agreement, while certainly desirable, is not usually necessary to form a valid partnership; partnership agreements are not normally subject to the statute of frauds.

Choice "b" is incorrect. A partnership is an association of two or more persons who agree to carry on as co-owners of a business for profit. Thus, an agreement to share ownership of the partnership is a requirement for creating an express partnership.

Choice "c" is incorrect. A partnership is an association of two or more persons who agree to carry on as co-owners of a business for profit. Thus, an intent to carry on a business for a profit is a requirement for creating an express partnership.

Choice "d" is incorrect. A partnership is an association of two or more persons who agree to carry on as co-owners of a business for profit. The intent to create a business relationship recognized as a partnership is a requirement for creating an express partnership.

**QUESTION 18**

Eller, Fort, and Owens do business as Venture Associates, a general partnership. Trent Corp. brought a breach of contract suit against Venture and Eller individually. Trent won the suit and filed a judgment against both Venture and Eller. Trent will generally be able to collect the judgment from:

- A. Partnership assets only.
- B. The personal assets of Eller, Fort, and Owens only.
- C. Eller's personal assets only after partnership assets are exhausted.
- D. Eller's personal assets only.

**Correct Answer:** C

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. When a judgment is obtained against both a partnership and an individual general partner, the plaintiff must proceed against the partnership assets first and then the assets of any individual general partner. The partnership assets must be exhausted before any general partner's individual assets can be attached. Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 19**

Heather, Erika, and Shelby are members in HES LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed \$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has originated the other 10%.

If HES were a general partnership, who controls management?

- A. Heather, because she works the most.
- B. Erika and Shelby equally because they contributed the most.
- C. Heather, Erika, and Shelby equally because of state law.
- D. Erika and Shelby, because they originate most of the work.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

Rule: Absent an agreement to the contrary, partners have equal management authority. Choices

"a", "b", and "d" are incorrect, per the above rule.

**QUESTION 20**

Rivers and Lee want to form a partnership. For the partnership agreement to be enforceable, it must be in writing if:

- A. Rivers and Lee reside in different states.
- B. The agreement cannot be completed within one year from the date on which it will be entered into.
- C. Either Rivers or Lee is to contribute more than \$500 in capital.
- D. The partnership intends to buy and sell real estate.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A transaction which cannot be completed within a year must be in writing to be enforceable.

Choice "a" is incorrect. Residence of the prospective partners is not relevant.

Choice "c" is incorrect. The statute of frauds \$500 threshold applies to the sale of goods only.

Choice "d" is incorrect. Transactions in land are within the statute of frauds, but the possibility that a partnership may engage in a real estate transaction is not a transaction in land.

**QUESTION 21** Which of the following statements is correct regarding the division of profits in a general partnership when the written partnership agreement only provides that losses be divided equally among the partners?

Profits are to be divided:

- A. Based on the partners' ratio of contribution to the partnership.
- B. Based on the partners' participation in day-to-day management.
- C. Equally among the partners.
- D. Proportionately among the partners.

**Correct Answer: C**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

Rule: When the partnership agreement is silent as to how profits are to be divided, they are divided equally. Note also that when the agreement is silent, losses are treated similar to profits, there is no reverse rule that profits are treated like losses.

Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 22**

Downs, Frey, and Vick formed the DFV general partnership to act as manufacturers' representatives. The partners agreed Downs would receive 40% of any partnership profits and Frey and Vick would each receive 30% of such profits. It was also agreed that the partnership would not terminate for five years.

After the fourth year, the partners agreed to terminate the partnership. At that time, the partners' capital accounts were as follows: Downs, \$20,000; Frey, \$15,000; and Vick, \$10,000. There also were undistributed losses of \$30,000.

Which of the following statements about the form of the DFV partnership agreement is correct?

- A. It must be in writing because the partnership was to last for longer than one year.
- B. It must be in writing because partnership profits would not be equally divided.
- C. It could be oral because the partners had explicitly agreed to do business together.
- D. It could be oral because the partnership did not deal in real estate.

**Correct Answer: A**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Under the statute of frauds, an agreement, which by its terms cannot be performed within a year, must be evidenced by a writing containing the material terms and signed by the parties to be charged. Absent a writing, the partnership will be treated as a partnership at will.

Choice "b" is incorrect. There is no requirement that partnership agreements be in writing merely because profits will be divided unequally.

Choice "c" is incorrect. The statute of frauds requires contracts that cannot by their terms be performed within one year to be evidenced by a writing containing the material terms and signed by the parties to be charged. Choice "d" is incorrect. Whether or not a partnership is to deal in real estate is irrelevant to whether the partnership agreement must be in writing.

**QUESTION 23**

Downs, Frey, and Vick formed the DFV general partnership to act as manufacturers' representatives.

The partners agreed Downs would receive 40% of any partnership profits and Frey and Vick would each receive 30% of such profits. It was also agreed that the partnership would not terminate for five years.

After the fourth year, the partners agreed to terminate the partnership. At that time, the partners' capital accounts were as follows: Downs, \$20,000; Frey, \$15,000; and Vick, \$10,000. There also were undistributed losses of \$30,000. Vick's share of the undistributed losses will be:

- A. \$0
- B. \$1,000
- C. \$9,000
- D. \$10,000

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Rule: Where the partnership agreement is silent, losses are shared in the same proportion as profits.

Choice "c" is correct. Vick was entitled to 30% of the profits and so will be responsible for 30% of the undistributed \$30,000 loss, or \$9,000. Choices

"a", "b", and "d" are incorrect, per the above rule.

**QUESTION 24**

Lewis, Clark, and Beal entered into a written agreement to form a partnership. The agreement required that the partners make the following capital contributions: Lewis, \$40,000, Clark, \$30,000, and Beal, \$10,000. It was also agreed that in the event the partnership experienced losses in excess of available capital, Beal would contribute additional capital to the extent of the losses. The partnership agreement was otherwise silent about division of profits and losses. Which of the following statements is correct?

- A. Profits are to be divided among the partners in proportion to their relative capital contributions.
- B. Profits are to be divided equally among the partners.
- C. Losses will be allocated in a manner different from the allocation of profits because the partners contributed different amounts of capital.
- D. Beal's obligation to contribute additional capital would have an effect on the allocation of profit or loss to Beal.

**Correct Answer: B**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: Regardless of the contributions and obligations of the partners, unless the partnership agreement specifically states otherwise, all partners are entitled to an equal share of the profits. Choices "a", "c", and "d" are incorrect, per the above rule.

#### QUESTION 25

Gillie, Taft, and Dall are partners in an architectural firm. The partnership agreement is silent about the payment of salaries and the division of profits and losses. Gillie works full-time in the firm, and Taft and Dall each work half time. Taft invested \$120,000 in the firm, and Gillie and Dall invested \$60,000 each. Dall is responsible for bringing in 50% of the business, and Gillie and Taft 25% each. How should profits of \$120,000 for the year be divided?

- A. Gillie \$60,000, Taft \$30,000, Dall \$30,000. B. Gillie \$40,000, Taft \$40,000, Dall \$40,000. C. Gillie \$30,000, Taft \$60,000, Dall \$30,000. D. Gillie \$30,000, Taft \$30,000, Dall \$60,000.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. \$40,000 – \$40,000 – \$40,000 (equally).

Rule: In the absence of an agreement to the contrary, the profits will be shared equally regardless of investment of money or time.

Choices "a", "c", and "d" are incorrect, per the above rule.

#### QUESTION 26

With respect to the following matters, which is correct if a general partnership agreement is silent?

- A. A partnership will continue indefinitely unless a majority of the partners votes to dissolve the partnership.  
B. Partnership losses are allocated in the same proportion as partnership profits.  
C. A partner may assign his interest in the partnership but only with the consent of the other partners.  
D. A partner may sell the goodwill of the partnership without the consent of the other partners when the sale is in the best interest of the partnership.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. As a general principle of partnership law, as well as under the Revised Uniform Partnership Act, in the absence of an agreement otherwise partnership losses are allocated among partners in the same proportion as partnership profits.

Choice "a" is incorrect. A partnership will dissolve on the death, bankruptcy, incapacity, or other withdrawal of a partner, unless the partners vote to continue.

Choice "c" is incorrect. A partner may assign his interest in the partnership at any time without consent of the partners since such an assignment does not make the assignee a partner; instead it merely gives the assignee the assignor's rights to distributions from the partnership.

Choice "d" is incorrect. A sale of partnership good will is an extraordinary transaction that requires consent of the partners. A single partner has no authority to make such a sale on his own accord.

#### QUESTION 27

Which of the following statements is correct concerning liability when a partner in a general partnership commits a tort while engaged in partnership business?

- A. The partner committing the tort is the only party liable.  
B. The partnership is the only party liable.  
C. Each partner is jointly and severally liable.  
D. Each partner is liable to pay an equal share of any judgment.

**Correct Answer: C**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Each partner is jointly and severally liable for torts committed by any partner while in the course of partnership business.

Choice "a" is incorrect. All partners may be held liable for a tort committed by a partner in the course of partnership business.

Choice "b" is incorrect. Each partner is liable for torts committed by any partner while in the course of partnership business.

Choice "d" is incorrect. Each partner is liable for the full amount of damages incurred as a result of a partner's tort; the partners are not liable only for their pro rata share.

**QUESTION 28**

Lark, a partner in DSJ, a general partnership, wishes to withdraw from the partnership and sell Lark's interest to Ward. All of the other partners in DSJ have agreed to admit Ward as a partner and to hold Lark harmless for the past, present, and future liabilities of DSJ. As a result of Lark's withdrawal and Ward's admission to the partnership, Ward:

- A. Acquired only the right to receive Ward's share of DSJ profits.
- B. Has the right to participate in DSJ's management.
- C. Is personally liable for partnership liabilities arising before and after being admitted as a partner.
- D. Must contribute cash or property to DSJ to be admitted with the same rights as the other partners.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The general rule is that the mere assignment of a partner's interest does not make the assignee a partner. One may become a partner only with the consent of all other partners. Here, all other partner's consented to Ward's becoming a partner. Thus, Ward is a partner with full rights to participate in management.

Choice "a" is incorrect. The general rule is that the mere assignment of a partner's interest does not make the assignee a partner. One may become a partner only with the consent of all other partners.

Here, all other partner's consented to Ward's becoming a partner. Thus, Ward is a partner with full partner rights.

Choice "c" is incorrect. An incoming partner is not liable for debts that the partnership incurred before admission beyond the incoming partner's contribution, but is fully liable for debts incurred after becoming a partner. Choice

"d" is incorrect. A partnership is a consensual relationship; there is no requirement of a contribution to become a partner.

**QUESTION 29**

Unless the partnership agreement prohibits it, a partner in a general partnership may validly assign rights to:

	<i>Partnership property</i>	<i>Partnership distributions</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer: C**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

Rules: A partner has no right to assign an interest in partnership property because a partner's rights in partnership property are limited to using the property for partnership purposes. However, a partner does have a right to assign her interest in partnership distributions. The assignee does not become a partner, but merely has a right to receive whatever distributions the assignor would have received. Choices "a", "b", and "d" are incorrect, per the above rules.

### QUESTION 30

Cobb, Inc., a partner in TLC Partnership, assigns its partnership interest to Bean, who is not made a partner. After the assignment, Bean asserts the rights to:

- I. Participate in the management of TLC.
  - II. Cobb's share of TLC's partnership profits.
- Bean is correct as to which of these rights?

- A. I only.
- B. II only.
- C. I and II.
- D. Neither I nor II.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: The assignee of a partner's interest in the partnership does not thereby become a partner absent the unanimous consent of the other partners. Thus, the assignee has no right to participate in the management of the partnership and has only a right to receive the assignor's share of the partnership profits. Choices "a", "c", and "d" are incorrect, per the above rules.

### QUESTION 31

A partner's interest in specific partnership property is:

	<i>Assignable to the partner's individual creditors</i>	<i>Subject to attachment by the partner's individual creditors</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No



- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. No - No.

Rule: A partner's interest in specific partnership property is neither assignable to the partner's individual creditors nor is it subject to attachment by the partner's individual creditors. Choices "a", "b", and "c" are incorrect, per the above rule.

**QUESTION 32** If no provisions are made in an agreement, a general partnership allocates profits and losses based on the:

- A. Value of actual contributions made by each partner.
- B. Number of partners.
- C. Number of hours each partner worked in the partnership during the year.



D. Number of years each partner belonged to the partnership.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Absent an agreement to the contrary, all partners have equal rights to share in the profits of the partnership. Choices "a", "c", and "d" are incorrect, per the above Explanation.

### QUESTION 33

Under the Uniform Partnership Act, which of the following statements is(are) correct regarding the effect of the assignment of an interest in a general partnership?

- I. The assignee is personally responsible for the assigning partner's share of past and future partnership debts.
  - II. The assignee is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership.
- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A partner may assign his or her interest in the partnership. The effect of such an assignment is to transfer the partner's right to receive the partner's share of profits or surplus only. Such an assignment does not cause dissolution or make the assignee a new partner. The assignor is still regarded as a partner and is liable for past and future partnership debts. The assignee, since he is not a partner, is not liable for past and future partnership debts. Choice "a" is incorrect. The assignee of an interest in a general partnership is not personally responsible for the assigning partner's share of past and future partnership debts but is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership.

Choice "c" is incorrect. The assignee of an interest in a general partnership is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership but is not personally responsible for the assigning partner's share of past and future partnership debts.

Choice "d" is incorrect. The assignee of an interest in a general partnership is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership but is not personally responsible for the assigning partner's share of past and future partnership debts.

### QUESTION 34

Smith and James were partners in S and J Partnership. The partnership agreement stated that all profits and losses were allocated 60 percent to Smith and 40 percent to James. The partners decided to terminate and wind up the partnership. The following was the balance sheet for S and J on the day of the windup:

Cash	\$40,000
Accounts receivable	12,000
Property and equipment	<u>38,000</u>
Total assets	<u>\$90,000</u>
Accounts payable	\$24,000
Smith, capital	30,000
James, capital	<u>36,000</u>
Total liabilities and capital	<u>\$90,000</u>

Of the total accounts receivable, \$10,000 was collected and the remainder was written off as bad debt. All liabilities of S and J were paid by the partnership. The property and equipment are sold for \$32,000. Under the Uniform Partnership Act, what amount of cash was distributed to Smith?



- A. \$25,200
- B. \$26,000
- C. \$30,000
- D. \$34,800

**Correct Answer:** A  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Upon termination of the partnership creditors are paid first. After payment of creditors, each partner is deemed to have an account that is charged or credited an amount equal to the partner's contribution plus or minus the partner's share of any profits or losses.

The agreement between Smith and James was that profits and losses would be allocated 60% to Smith and 40% to James. The partnership had \$82,000 in assets (\$40,000 in cash, \$10,000 from accounts receivable, and \$32,000 from property and equipment). The partnership had \$90,000 in liabilities and capital. Of the \$82,000 in assets, \$24,000 is paid first to creditors. This leaves a balance of \$58,000.

Smith contributed \$30,000 in capital and James contributed \$36,000 in capital. With \$66,000 owed in capital and only \$58,000 available, there is a deficit of \$8,000. By agreement, Smith is responsible for 60% of the \$8,000 deficit or \$4,800.

Smith would be credited an amount equal to his capital (\$30,000) minus his share of the loss (\$4,800) or \$25,200. Only choice "a" reflects this amount. Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 35** Leslie, Kelly, and Blair wanted to form a business. Which of the following business entities does not require the filing of organization documents with the state?

- A. Limited partnership.
- B. Joint venture.
- C. Limited liability company.
- D. Subchapter S corporation.

**Correct Answer:** B  
**Section:** Volume A  
**Explanation**



**Explanation/Reference:**

Explanation:

Choice "b" is correct. A joint venture is like a partnership. A partnership or joint venture can be formed without filing any documents with the state.

Choice "a" is incorrect. Formation of a limited partnership requires the filing of a certificate of limited partnership with the state.

Choice "c" is incorrect. A limited liability company may be formed only by filing articles of organization with the state.

Choice "d" is incorrect. A corporation, including a Subchapter S corporation, may be formed only by filing articles of incorporation with the state.

**QUESTION 36**

Under the Revised Uniform Partnership Act, which of the following have the right to inspect partnership books and records?

- A. Employees.
- B. Former partners.
- C. Inactive partners.
- D. Transferees of partners' interests.

**Correct Answer:** C  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Every partner in a partnership - whether active or inactive - has the right to inspect the partnership's books and records.

Choice "a" is incorrect. Only a partner has a right to inspect the partnership's books and records; an employee of the partnership has no such right.

Choice "b" is incorrect. Only current partners have a right to inspect the partnership's books and records; former partners do not have such a right.

Choice "d" is incorrect. Only partners have a right to inspect a partnership's books and records. A transferee of a partner's interest has only the partner's right to distributions.

#### QUESTION 37

Berry, Drake, and Flanigan are partners in a general partnership. The partners made capital contributions as follows: Berry, \$150,000; Drake, \$100,000; and Flanigan, \$50,000. Drake made a loan of \$50,000 to the partnership. The partnership agreement specifies that Flanigan will receive a 50% share of profits, and Drake and Berry each will receive a 25% share of profits. Under the Revised Uniform Partnership Act and in the absence of any partnership agreement to the contrary, which of the following statements is correct regarding the sharing of losses?

- A. The partners will share equally in any partnership losses.
- B. The partners will share in losses on a pro rata basis according to the capital contributions.
- C. The partners will share in losses on a pro rata basis according to the capital contributions and loans made to the partnership.
- D. The partners will share in losses according to the allocation of profits specified in the partnership agreement.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits.

Choice "a" is incorrect. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits. Here, the partners agreed to share profits in a 2:1:1 ratio. Thus, losses will be shared in that manner rather than equally.

Choice "b" is incorrect. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits. They are not shared in accordance with the partners' capital contributions. Choice "c" is incorrect. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits. They are not shared in accordance with the partners' capital contributions or loans.

#### QUESTION 38

Fil and Breed are 50% partners in F&B Cars, a used-car dealership. F&B maintains an average used-car inventory worth \$150,000. On January 5, National Bank obtained a \$30,000 judgement against Fil and Fil's child on a loan that Fil had cosigned and on which Fil's child had defaulted. National sued F&B to be allowed to attach \$30,000 worth of cars as part of Fil's interest in F&B's inventory. Will National prevail in its suit?

- A. No, because the judgement was not against the partnership.
- B. No, because attachment of the cars would dissolve the partnership by operation of law.
- C. Yes, because National had a valid judgement against Fil.
- D. Yes, because Fil's interest in the partnership inventory is an asset owned by Fil.

**Correct Answer:** A

**Section:** Volume A

**Explanation**

#### Explanation/Reference:

Explanation:

Choice "a" is correct. A partner has no right to possess partnership property except for partnership purposes. Thus, a personal creditor of a partner has no right to attach items of partnership property to satisfy a partner's personal debt.

Choice "b" is incorrect. There is no such rule. If the partnership were liable for the individual partner's debt, the cars could be attached and the partnership would not be dissolved.

Choice "c" is incorrect. A partner has no right to possess partnership property except for partnership purposes. Thus, a personal creditor of a partner has no right to attach items of partnership property to satisfy a partner's personal debt.

Choice "d" is incorrect. A partner has no right to possess partnership property except for partnership purposes. Thus, a personal creditor of a partner has no right to attach items of partnership property to satisfy a partner's personal debt.

#### QUESTION 39

Sam, CPA, is one of the partners in a limited liability partnership with other CPAs. Sam avoids personal liability for:

- A. The wrongful acts of employees acting under his supervision.
- B. His own negligent acts.
- C. The malpractice of his partners regarding errors and omissions.
- D. The negligent actions of his subordinates under his direct control.

**Correct Answer:** C

**Section:** Volume A

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct.

Rule: A partner in a LLP is personally liable for tort liabilities arising from his own negligence and the negligence of his direct subordinates and for breach of contract damages. He is NOT personally liable for the negligent actions committed by his partners.

Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 40** A limited liability partnership must:

- A. File registration documents with the state in which it is formed.
- B. Hold all partners personally liable for all debts and liabilities of the partnership and partners.
- C. Carry no less than one hundred thousand dollars of property insurance.
- D. Not have partners with professional licenses.

**Correct Answer:** A

**Section:** Volume A

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct.

Rule: To have limited liability, an LLP must file with the state a registration statement usually referred to as Articles of LLP. It is generally designed for professionals who desire to be partners with other like professionals and yet not have liability for the malpractice of their partners. Some states require that personal liability insurance (not property insurance) be carried to protect those harmed by the professionals' malpractice. Choices "b", "c", and "d" are incorrect, per the above rule.

**QUESTION 41**

Jones, Smith, and Bay wanted to form a company called JSB Co. but were unsure about which type of entity would be most beneficial based on their concerns. They all desired the opportunity to make taxfree contributions and distributions where appropriate. They wanted earnings to accumulate tax-free.

They did not want to be subject to personal holding tax and did not want double taxation of income. Bay was going to be the only individual giving management advice to the company and wanted to be a member of JSB through his current company, Channel, InC. Which of the following would be the most appropriate business structure to meet all of their concerns?

- A. Proprietorship.
- B. S corporation.
- C. C corporation.
- D. Limited liability partnership.

**Correct Answer:** D

**Section:** Volume A

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. An LLP does not pay taxes on its earnings. Instead, the profits and losses flow through to the partners as in a general partnership. The LLP files an informational tax return like that of a general partnership. The partners may agree to have the entity managed by one or more of the partners.

A partner may be another entity.

Choice "a" is incorrect. A proprietorship by definition has only one owner, not three owners.

Choice "b" is incorrect. While an S corporation allows for the same treatment of its earnings and distributions as in the facts, it is prohibited from having another company as an owner.

Choice "c" is incorrect. A C corporation pays its own taxes on its earnings, and any distributions to its shareholders are again taxed at the shareholder level (known as "double taxation").

**QUESTION 42**

Which of the following partners of a limited liability partnership (LLP) may avoid personal liability when a partner commits a negligent act?

- A. All the partners.

- B. The supervisor of the negligent partner.
- C. All the partners other than the negligent partner.
- D. All the partners other than the supervisor of, and, the negligent partner.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. LLP partners are liable only for their own negligence and the negligence of anyone who commits a wrongful act under the partner's direct control. Choices "a", "b", and "c" are incorrect, per the above.

**QUESTION 43** Green Trees, LP is a limited partnership. Dave is a limited partner. Seeds Today, Inc. is a creditor of the limited partnership. Upon dissolution of the partnership, the assets of Green Trees, LP will be distributed to pay:

- A. Seeds Today, Inc., first.
- B. Dave first.
- C. Seeds Today, Inc. and Dave.
- D. The general partners first.

**Correct Answer:** A

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct.

Rule: Upon dissolution, the assets of a limited partnership are first used to pay off the outside creditors. Limited partners such as Dave are next in line. Choices "b", "c", and "d" are incorrect, per the above rule.

**QUESTION 44** A limited partnership must have:

- A. One general partner and two limited partners.
- B. All must be general partners and one limited partner.
- C. One general partner and one limited partner.
- D. All limited partners.

**Correct Answer:** C

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

Rule: A limited partnership must have at least one general partner and one limited partner.

Choices "a", "b", and "d" are incorrect, per the above rule. Be careful of answers that include the word "all."

**QUESTION 45**

Juan is a limited partner in Pet Food and Fun, Limited Partnership. Juan visited Chow, Inc., a local supplier of dog food claiming to be a "partner" in the partnership and negotiated a distribution contract between the supplier and limited partnership on behalf of the partnership. As a result of these actions, Juan:

- A. Has limited liability as a limited partner in reference to all creditors.

- B. Has limited liability as a limited partner to all creditors except Chow, Inc.
- C. Has full personal liability to all creditors.
- D. None of the above.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: A limited partner will be considered a general partner with full personal liability only to those that the limited partner transacts with as if he were a general partner. Limited partners have no right to participate in management, such as negotiating contracts on behalf of the limited partnership. The limited partner will retain his status and limited liability to all others that the limited partner has not transacted with on behalf of the partnership. Choices "a", "c", and "d" are incorrect, per the above rule.

#### **QUESTION 46**

Doug was the sole general partner in Heavy Foot, Limited Partnership. While driving to work one morning, Doug died in a car accident. The limited partnership:

- A. Continues to exist as it was before Doug's death.
- B. Dissolves by operation of law as a result of Doug's death.
- C. Dissolves only by attaining a judicial decree.
- D. Converts to a general partnership and all former limited partners become general partners.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: The death of a general partner will by operation of law, dissolve the limited partnership. Because the dissolution is by operation of law, there is no requirement to attain a judicial decree. Remaining limited partners do not automatically become general partners as a result of the death of the general partner. Choices "a", "c", and "d" are incorrect, per the above rule.

#### **QUESTION 47**

Which of the following statements is correct with respect to the differences and similarities between a corporation and a limited partnership?

- A. Stockholders may be entitled to vote on corporate matters but limited partners are prohibited from voting on any partnership matters.
- B. Stock of a corporation may be subject to the registration requirements of the federal securities laws but limited partnership interests are automatically exempt from those requirements.
- C. Directors owe fiduciary duties to the corporation and limited partners owe such duties to the partnership.
- D. A corporation and a limited partnership may be created only under a state statute and each must file a copy of its organizational document with the proper governmental body.

**Correct Answer: D**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Both a limited partnership and a corporation:

1. Can only be created by statute, and
2. Each must file a copy of its certificate with the proper state agency.

Choice "a" is incorrect. There are instances in which limited partners do vote on certain partnership matters (e.g., approve new general or limited partners).

Choice "b" is incorrect. Limited partnership interests are not automatically exempt from the federal securities laws. Choice "c" is incorrect. Limited partners do not owe a fiduciary duty to the limited partnership.

#### **QUESTION 48**

Aarons Group, Limited Partnership, was formed by three brothers, Aaron, Barry, and Sam. Aaron is the general partner and devotes more than 60 hours per week to the business. Barry and Sam are limited partners who work for different companies having no relationship to the limited partnership. The partners' capital contributions are as follows: Aaron invested 20%. Barry and Sam invested 40% each. During the formation of the limited partnership, the brothers signed an agreement that addresses how the brothers will split profits and losses. At year-end, the limited partnership enjoyed large profits due to high demand for the business' product line. The profits will be divided:

- A. In proportion to each partner's capital contribution.
- B. According to the agreement.
- C. Equally.
- D. By determining by the amount of time and labor each partner devoted to the operation of the partnership.

**Correct Answer: B**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: Partners in a limited partnership can agree as to how they will split profits and losses, with losses shared up to the amount of the limited partners' capital. Profits and losses are shared on the basis of percentages of capital contributions only in the absence of an agreement otherwise.

Choices "a", "c", and "d" are incorrect, per the above rule.

**QUESTION 49**

Lisa is a limited partner in a limited partnership. Jen, one of the other limited partners, is seeking to sell her interest in the partnership to Karen and allow Karen to become a new limited partner. Which of the following statements is true?

- A. Lisa may engage in the management of the limited partnership without losing her limited liability.
- B. Jen may transfer her interest and make Karen a new limited partner without the approval of the other partners.
- C. Jen may withdraw from the limited partnership without giving notice to the partnership.
- D. Lisa has a right to vote on the transferring of interest to and admission of Karen as a limited partner.

**Correct Answer: D**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Limited partners have the right to vote on the transfer of interest and admission of a new partner. Admission of a new partner requires unanimous consent.

Choice "a" is incorrect. A limited partner who acts as a general partner loses her limited liability status to those she acted as a general partner towards.

Choice "b" is incorrect. Partners can freely transfer their interests in profits and losses to third parties, but the third party cannot become a limited partner without the unanimous consent of the other partners. Choice "c" is incorrect. Limited partners must give 6 months notice of withdrawal in absence of an agreement to the contrary.

**QUESTION 50** Which of the following statements is correct with respect to a limited partnership?

- A. A limited partner may not be an unsecured creditor of the limited partnership.
- B. A general partner may not also be a limited partner at the same time.
- C. A general partner may be a secured creditor of the limited partnership.
- D. A limited partnership can be formed with limited liability for all partners.

**Correct Answer: C**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "c" is correct. In a limited partnership, a general partner may be a secured creditor of the limited partnership.

Choice "a" is incorrect. In a limited partnership, a limited partner may be an unsecured creditor of the limited partnership.

Choice "b" is incorrect. In a limited partnership, a general partner may also be a limited partner at the same time.

Choice "d" is incorrect. In a limited partnership, only the limited partners will have limited liability. A limited partnership must have at least one general partner and general partners have unlimited liability. (The word "all" makes this option wrong.)

**QUESTION 51** In general, which of the following statements is correct with respect to a limited partnership?

- A. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.
- B. A limited partnership can be formed with limited liability for all partners.
- C. A limited partner may not also be a general partner at the same time.
- D. A limited partner may hire employees on behalf of the partnership.

**Correct Answer:** A

**Section:** Volume A

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Choice "a" is correct. A limited partner has rights similar to those of a corporate shareholder; he must be allowed to review financial and tax information of the limited partnership. Choice "b" is incorrect. A limited partnership must have one or more general partners, whose liability is unlimited.

Choice "c" is incorrect. One may be both a general and a limited partner simultaneously. Such a person has all of the rights and liabilities of both a limited partner and a general partner. Choice "d" is incorrect. A limited partner has no management authority, rather he is a passive investor, like a corporate shareholder.

**QUESTION 52** In general, which of the following statements is correct with respect to a limited partnership?

- A. A limited partner will be personally liable for partnership debts incurred in the ordinary course of the partnership's business.
- B. A limited partner is unable to participate in the management of the partnership in the same manner as general partners and still retain limited liability.
- C. A limited partner's death or incompetency will cause the partnership to dissolve.
- D. A limited partner is an agent of the partnership and has the authority to bind the partnership to contracts.

**Correct Answer:** B

**Section:** Volume A

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Choice "b" is correct. While the general rule is that a limited partner has no liability on partnership debts except to the extent of his agreed-upon contribution, the limited partner will lose this limited liability if he takes part in control of the business, which generally means a limited partner may not manage the business on a day-to-day basis as a general partner could.

Choice "a" is incorrect. Limited partners are not personally liable for partnership debts; their liability generally is limited to their contributions.

Choice "c" is incorrect. Death or incapacity of a general partner will cause a dissolution, but the same is not true of a limited partner.

Choice "d" is incorrect. A limited partner is more like a shareholder in a corporation than like a general partner. Limited partners are not agents of their partnerships and have no authority to bind their partnership on contracts.

#### **QUESTION 53**

White, Grey, and Fox formed a limited partnership. White is the general partner and Grey and Fox are the limited partners. Each agreed to contribute \$200,000. Grey and Fox each contributed \$200,000 in cash while White contributed \$150,000 in cash and \$50,000 worth of services already rendered. After two years, the partnership is insolvent. The fair market value of the assets of the partnership is \$150,000 and the liabilities total \$275,000. The partners have made no withdrawals.

If Fox is insolvent and White and Grey each has a net worth in excess of \$300,000, what is White's maximum potential liability in the event of a dissolution of the partnership?

- A. \$62,500
- B. \$112,500C. \$125,000
- D. \$175,000



**Correct Answer: C**  
**Section: Volume A**

#### Explanation

#### Explanation/Reference:

Explanation:

Rule: The liability of a limited partner for partnership debts is limited to the extent of the capital, which he has contributed or has agreed to contribute. A general partner, however, is liable for all partnership debts and liabilities. Choice "c" is correct. In this case, both Grey and Fox are limited partners and, thus, their respective maximum liability for partnership debts may not exceed their contributions (\$200,000 each). Because White is a general partner, however, he will be personally liable for the excess of any debt remaining after assets have been applied upon a dissolution. Therefore, White will be liable for \$125,000 (the difference between the fair market value of assets (\$150,000) and partnership liabilities (\$275,000) at dissolution). Choices "a", "b", and "d" are incorrect, per the above rule.

#### QUESTION 54

Harry, Betty, and Jim decide to form a hair salon business. Betty and Jim agree to equally manage the business and have agreed to accept full personal liability for obligations of the business. Harry contributes money to help them get started. Harry does not want any personal liability but does want access to the books and records and to share in the profits. They have all agreed that unanimous consent is needed to transfer their ownership interests. Assume any necessary filings have been made.

What type of business entity best reflects the terms of their agreement? The three have formed:

- A. A limited partnership.
- B. A limited liability company.
- C. A general partnership.
- D. A corporation.

**Correct Answer: A**  
**Section: Volume A**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. A limited partnership best reflects the terms of the parties' agreement. A limited partnership has one or more general partners and one or more limited partners. The general partners are personally liable for partnership obligations and run the business (such as Betty and Jim agreed). A limited partner does not have personal liability for partnership obligations and does not take part in management; however, limited partners have a right to inspect partnership books and records relevant to their interest. Thus, a limited partnership has the attributes that Harry agreed to. Finally, all partners must unanimously consent to a transfer of an ownership interest in a limited partnership, as the parties agreed here. Thus, a limited partnership best reflects the agreement of the parties.

Choice "b" is incorrect. Members of a limited liability company are not personally liable for the company's debt. (They may agree otherwise, but this is not a general attribute of a limited liability company.) Because the facts say Betty and Jim each agreed to have full personal liability, a limited liability company does not best reflect the parties' agreement.

Choice "c" is incorrect. All partners are personally liable for all obligations of a general partnership. Because the facts say Harry did not accept personal liability, the agreement does not reflect a general partnership.

Choice "d" is incorrect. Corporate shareholders generally are not liable for the corporation's obligations. (They may agree otherwise, but this is not a basic attribute of a corporation.) As the facts say Betty and Jim share full personal liability, the agreement does not reflect a corporation.

#### QUESTION 55

White, Grey, and Fox formed a limited partnership. White is the general partner and Grey and Fox are the limited partners. Each agreed to contribute \$200,000. Grey and Fox each contributed \$200,000 in cash while White contributed \$150,000 in cash and \$50,000 worth of services already rendered. After two years, the partnership is insolvent. The fair market value of the assets of the partnership is \$150,000 and the liabilities total \$275,000. The partners have made no withdrawals.

Unless otherwise provided in the certificate of limited partnership, which of the following is correct if Fox assigns her interest in the partnership to Barr and only White consents to Barr's admission as a limited partner?

- A. Barr will not become a substituted limited partner unless Grey also consents.
- B. Barr will have the right to inspect the partnership's books.
- C. The partnership will be dissolved.
- D. Barr will become a substituted limited partner because White, as general partner, consented.

**Correct Answer: A**  
**Section: Volume A**

#### Explanation

**Explanation/Reference:**

Explanation:

Choice "a" is correct. In the absence of an agreement between all partners, the assignment of a partner's interest does not make the assignee a substitute partner; it merely transfers the assignor's rights to distributions to the assignee. Choice "b" is incorrect. Absent an agreement among the partners otherwise, an assignment of an interest in a partnership is merely an assignment of the assignor's rights to receive distributions from the partnership and does not give the assignee any right to inspect the partnership's books.

Choice "c" is incorrect. Absent an agreement among the partners otherwise, an assignment of an interest in a partnership is merely an assignment of the assignor's rights to receive distributions from the partnership; it does not make the assignee a new partner. Since there is no change in who is a partner, there is no dissolution.

Choice "d" is incorrect. All partners must agree to make someone a partner, not just the general partner.

**QUESTION 56** Under the Revised Uniform Limited Partnership Act and in the absence of a contrary agreement by the partners, which of the following events is most likely to dissolve a limited partnership?

- A. A majority vote in favor by the partners.
- B. A two-thirds vote in favor by the partners.
- C. A withdrawal of a majority of the limited partners.
- D. Withdrawal of the only general partner.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Absent a contrary agreement of the partners, a limited partnership can be dissolved by written consent of all the general partners, withdrawal or death of a general partner, or judicial decree. Thus, withdrawal of the only general partner would cause dissolution. (There has to be at least one general partner in a limited partnership.) Choice "a" is incorrect. It takes unanimous written consent of all general partners to dissolve the limited partnership, not majority vote.

Choice "b" is incorrect. It takes unanimous written consent of all general partners to dissolve the limited partnership, not two-thirds vote.

Choice "c" is incorrect. Death or withdrawal of a limited partner does not cause dissolution. Only death or withdrawal of a general partner causes dissolution.

**QUESTION 57**

Eller, Fort and Owens are members of Venture Associates, LLC. Trent Corp. brought a breach of contract suit against Venture for a contract executed by Eller as an agent of the LLC. If Trent prevails, Trent will generally be able to collect the judgment from:

- A. The LLC's assets only.
- B. The personal assets of Eller, Fort and Owens jointly.
- C. Eller's personal assets only after LLC assets are exhausted.
- D. Eller's personal assets only.

**Correct Answer:** A

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct.

Rule: Members of an LLC are not personally liable for the LLC's obligations. Moreover, an agent is not liable on a contract the agent enters into on behalf of a disclosed principal. Here, the contract was entered into by Eller on behalf of Venture, an LLC, and Eller disclosed that he was acting only as an agent of Venture. Thus, Trent Corp. can collect from the LLC'S assets only. Choices "b", "c", and "d" are incorrect, per the above rule.

**QUESTION 58**

Tim, Peter, and Rick want to form a limited liability company. What document must they file with the state?

- A. Operating Agreement.
- B. Articles of Incorporation.
- C. Bylaws.

D. Articles of Organization.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The Articles of Organization must be filed with the secretary of state.

Choice "a" is incorrect. An operating agreement is an agreement between the members containing provisions relating to management, profit sharing, transferring interests, etC. and does not need to be filed with the state. Choices "b" and "c" are incorrect. Articles of incorporation and bylaws are documents relating to corporations, and they are not required to be filed with the state.

#### QUESTION 59

The articles of organization for a limited liability company must contain everything, except the following:

- A. The name of the entity that includes some indication it is a LLC.
- B. The name and address of the registered agent.
- C. Number of shares authorized and issued.
- D. If the company is to be manager managed, a statement to that effect.

**Correct Answer:** C

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Limited liability companies do not issue "shares" held by shareholders like in a corporation. Instead, members (the owners) are said to have "interests" in the LLC.

Choices "a", "b", and "d" are incorrect. These are all required to be included in the articles of organization.

#### QUESTION 60

Unless there is an agreement to the contrary, the voting power of members in a limited liability company is determined by:

- A. Each member's salary.
- B. Each member's share of profits.
- C. When the member was admitted to the company.
- D. Each member's capital contribution.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct.

Rule: Absent an agreement otherwise, all members generally participate in management, and their voting strength is determined in proportion to ownership interest. This is calculated by comparing each member's capital contribution to that of the other members.

Choices "a", "b", and "c" are incorrect, per the above rule.

#### QUESTION 61

Heather, Erika, and Shelby are members in HES LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed \$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has originated the other 10%. Absent an agreement to the contrary among the owners, who controls the management of the HES LLC?

- A. Heather, because she works the most.
- B. Erika and Shelby equally because they contributed the most.

- C. Heather, Erika, and Shelby in proportion to their ownership interests.  
D. Erika and Shelby, because they originate most of the work.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

Rule: Absent an agreement to the contrary, the members' voting strength is proportionate to their contributions. Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 62**

Heather, Erika, and Shelby are members in HES LLC. Heather dies. Absent an agreement to the contrary, what is the result?

- A. The LLC must dissolve.  
B. The LLC ceases to exist.  
C. The LLC is dissolved unless the other members consent to continue.  
D. The LLC continues as though nothing happened.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Absent an agreement to the contrary, if a member of an LLC dies, the LLC is dissolved unless the other members consent to continue. Choice "a" is incorrect, because the LLC does not have to dissolve upon the death of a member.

Choice "b" is incorrect, because the LLC does not cease to exist immediately.

Choice "d" is incorrect, because the LLC does not continue unless the members consent to continue.

**QUESTION 63**

Heather, Erika, and Shelby are members in HES LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed \$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has originated the other 10%. Absent an agreement to the contrary, how will the LLC's \$120,000 profits be divided among the members?

	<u>Heather</u>	<u>Erika</u>	<u>Shelby</u>
A.	\$60,000	\$30,000	\$30,000
B.	\$40,000	\$40,000	\$40,000
C.	\$12,000	\$54,000	\$54,000
D.	\$24,000	\$48,000	\$48,000

- A. Option A  
B. Option B  
C. Option C  
D. Option D

**Correct Answer: D**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**

Explanation:

Rule: Absent an agreement to the contrary, the LLC's profits will be divided among the members in proportion to their contributions. Here, Heather's, Erika's and Shelby's contributions were \$30,000, \$60,000, and \$60,000, respectively. Thus, the profits will be divided in a 1:2:2 ratio (20% of \$120,000 to Heather; 40% of \$120,000 to Erika; and \$120,000 to Shelby). Choice "d" is correct.

Heather Erika Shelby  
D. \$24,000 \$48,000 \$48,000

Choices "a", "b", and "c" are incorrect, per the above rule.

**QUESTION 64** A member of a limited liability company may generally do all of the following, except:

- A. Transfer his membership in the company without the consent of the other members.
- B. Participate in the management of the company absent an agreement to the contrary.
- C. Have limited liability.
- D. Order office supplies for the company.

**Correct Answer:** A  
**Section:** Volume A

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. The transfer of a member interest requires the consent of the other members. Members may not assign their interest without the other members' consent.  
Choice "b" is incorrect. Unless the members have agreed to operate as a manager managed limited liability company, all members have the power to participate in management.  
Choice "c" is incorrect. Members in a limited liability company all have limited personal liability. Choice "d" is incorrect. Unless otherwise agreed, members have the right to manage the every day operations of a limited liability company. This can include the ordering of office supplies.

**QUESTION 65**

Jeb, a member in J & S LLC, sold his interest in the LLC to Chris without obtaining the other members' consent. Absent an agreement to the contrary, Chris:

- I. May participate in the management of J & S.
  - II. May receive Jeb's share of J & S's profits.
  - III. Is not entitled to anything since Jeb did not obtain the other members' consent.
- A. I only.  
B. I and II only.  
C. II only.  
D. III only.

**Correct Answer:** C  
**Section:** Volume A

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Absent an agreement to the contrary, if a member in the LLC sells his interest in an LLC without obtaining the other members' consent, the assignee is only entitled to receive the assignor's share of profits.  
Choices "a", "b", and "d" are incorrect, because, absent an agreement to the contrary, although a member of an LLC is allowed to assign his interest in profits and losses, an assignee of a membership interest may not participate in the management of the LLC.

**QUESTION 66** Which of the following parties generally has the most management rights?

- A. Minority shareholder in a corporation listed on a national stock exchange.

- B. Limited partner in a general partnership.
- C. Member of a limited liability company.
- D. Limited partner in a limited partnership.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Unless the articles or operating agreement provides otherwise, all members of the LLC have a right to participate in management. A member of a limited liability company has the most management rights of any of the parties listed. A minority shareholder in a corporation has no management rights (and neither does a majority shareholder). A limited partner has no day-to-day management rights but may have some rights in extraordinary circumstances. It is unclear what a limited partner in a general partnership would even be; the existence of a limited partner would make a partnership a limited partnership and not a general partnership. Choice "a" is incorrect. Stockholders have very limited rights to run the corporation. They generally only have the right to elect directors and to vote on fundamental changes in the corporation. Such fundamental changes would include dissolutions, amendments to the articles, mergers, consolidations, compulsory share exchanges, and sale of substantially all of the corporation's assets. Choice "b" is incorrect. There are no limited partners in a general partnership. There are only general partners. Since there are no limited partners, there are no management rights for limited partners. Choice "d" is incorrect. Limited partners in a limited partnership have very limited rights to participate in the management of the business. In fact, if they do participate in management, they face potential liability to those who thought they were a general partner (i.e., if a limited partner becomes involved in day-to-day management in some way (participating in control), she may be treated as a general partner and lose her limited liability).

**QUESTION 67** Case Corp. is incorporated in State A. Under the Revised Model Business Corporation Act, which of the following activities engaged in by Case requires that Case obtain a certificate of authority to do business in State B?

- A. Maintaining bank accounts in State B.
- B. Collecting corporate debts in State B.
- C. Hiring employees who are residents of state B.
- D. Maintaining an office in State B to conduct intrastate business.

**Correct Answer: D**  
**Section: Volume A**  
**Explanation**



**Explanation/Reference:**  
Explanation:

Choice "d" is correct. A domestic corporation is one created under the laws of a given state. A foreign corporation is a corporation created under the laws of another state. A foreign corporation must obtain a certificate of authority from each state in which it does intrastate business. Choices "a", "b", and "c" are incorrect because maintaining a bank account, collecting debts, and hiring employees who live within a state are not considered to be "doing business" within the state.

**QUESTION 68**

Which of the following statements is(are) correct regarding the methods a target corporation may use to ward off a takeover attempt?

- I. The target corporation may make an offer ("self-tender") to acquire stock from its own shareholders.
  - II. The target corporation may seek an injunction against the acquiring corporation on the grounds that the attempted takeover violates federal antitrust law.
- A. I only.
  - B. II only.
  - C. Both I and II.
  - D. Neither I nor II.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct.

Rule: A tender offer is a general invitation by a bidder to the shareholders of a target company to tender their shares to the bidder at a specified price during a specified time. A target of a takeover may ward off a tender offer by offering to repurchase shares from its shareholders. If a takeover will violate federal antitrust law, a court will enjoin the takeover. Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 69**

Acorn Corp. wants to acquire the entire business of Trend Corp. Which of the following methods of business combination will best satisfy Acorn's objectives without requiring the approval of the shareholders of either corporation?

- A. A merger of Trend into Acorn, whereby Trend shareholders receive cash or Acorn shares.
- B. A sale of all the assets of Trend, outside the regular course of business, to Acorn, for cash.
- C. An acquisition of all the shares of Trend through a compulsory share exchange for Acorn shares.
- D. A cash tender offer, whereby Acorn acquires at least 90% of Trend's shares, followed by a short-form merger of Trend into Acorn.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. A parent corporation owning 90% or more of a subsidiary may merge the subsidiary (short form merger) into the parent without the approval of the shareholders of either corporation or the approval of the subsidiary's board.

Choices "a", "b", and "c" all require at least one of the corporations to follow the general procedure for fundamental corporate changes (i.e., board resolution notice, approval by majority shares, and filing).

**QUESTION 70**

Under the Revised Model Business Corporation Act, which of the following statements regarding a corporation's bylaws is(are) correct?

- I. A corporation's initial bylaws shall be adopted by either the incorporators or the board of directors.
- II. A corporation's bylaws are contained in the articles of incorporation.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.



**Correct Answer:** A

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Under the Revised Model Business Corporation act, a corporation's initial bylaws may be adopted by either the incorporators or the board of directors.

Choices "b" and "c" are incorrect, because the corporation's bylaws are a separate document not included in the corporation's articles of incorporation.

Choice "d" is incorrect, because under the Revised Model Business Corporation Act, a corporation's initial bylaws may be adopted by either the incorporators or the board of directors.

**QUESTION 71**

Under the Revised Model Business Corporation Act, which of the following must be contained in a corporation's articles of incorporation?

- A. Quorum voting requirements.
- B. Names of stockholders.
- C. Provisions for issuance of par and nonpar shares.
- D. The number of shares the corporation is authorized to issue.

**Correct Answer:** D

**Section:** Volume A

**Explanation**



**Explanation/Reference:**

Explanation:

Choice "d" is correct. The articles must set out the corporation's authorized shares.

Choice "a" is incorrect. Quorum requirements, if stated at all, usually are in the bylaws; they need not be included in the articles of incorporation.

Choice "b" is incorrect. The articles need not include the names of stockholders.

Choice "c" is incorrect. The RMBCA has eliminated the concept of par value and so does not have a requirement that par value be established in the articles.

**QUESTION 72**

Under the Revised Model Business Corporation Act, a merger of two public corporations usually requires all of the following, except:

- A. A formal plan of merger.
- B. An affirmative vote by the holders of a majority of each corporation's voting shares.
- C. Receipt of voting stock by all stockholders of the original corporations.
- D. Approval by the board of directors of each corporation.

**Correct Answer: C**

**Section: Volume A**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. A merger can be effected by giving some parties cash or property; not everyone need receive voting shares.

Choice "a" is incorrect. The merger must be pursuant to a formal plan.

Choice "b" is incorrect. The majority of each corporation generally must approve a merger.

Choice "d" is incorrect. A plan of merger must be approved by the boards of the merging corporations.

**QUESTION 73**

Which of the following provisions must a for-profit corporation include in its articles of incorporation to obtain a corporate charter?

- I. Provision for the authorization of voting stock. II.  
Name of the corporation.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

**Correct Answer: C**

**Section: Volume A**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Both I and II.

Rule: In order to obtain a corporate charter, a for-profit corporation must include in its articles of incorporation the name of the corporation and a provision for the authorization of voting stock. In addition, the articles of incorporation must include the names of the incorporators and the name and address of the registered agent. Choices "a", "b", and "d" are incorrect, per the above rule.

**QUESTION 74** The corporate veil is most likely to be pierced and the shareholders held personally liable if:

- A. The corporation has elected S corporation status under the Internal Revenue Code.
- B. The shareholders have commingled their personal funds with those of the corporation.
- C. An ultra vires act has been committed.

D. A partnership incorporates its business solely to limit the liability of its partners.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Generally, a corporation is treated as an entity distinct from its shareholders and shareholders are not liable for the corporation's debts. However, where the shareholders do not treat the corporation as a distinct entity, such as where they commingle their personal funds with the corporation's funds, courts are likely to ignore the corporate form as well.

Choice "a" is incorrect. An election to be taxed like a partnership under Subchapter S is not grounds to pierce the corporate veil.

Choice "c" is incorrect. An ultra vires act is one beyond the corporation's powers. The persons who authorized the ultra vires act can be held personally liable for damages caused, but it is not a ground for piercing the corporate veil. Choice "d" is incorrect. Limiting personal liability is the main reason to incorporate. It is a ground for piercing the corporate veil only if it is done fraudulently (i.e., to avoid paying present creditors).

**QUESTION 75** Generally, a corporation's articles of incorporation must include all of the following, except the:

- A. Name of the corporation's registered agent.
- B. Name of each incorporator.
- C. Number of authorized shares.
- D. Quorum requirements.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. A corporation's articles of incorporation need not contain any information regarding quorum requirements.

Choices "a", "b", and "c" are incorrect because under the Revised Model Business Corporations Act a corporation's articles of incorporation must include:

- (1) The name of the corporation,
- (2) The name and address of the corporation's registered agent,
- (3) The names and addresses of each of the incorporators, and
- (4) The number of shares authorized to be issued.

**QUESTION 76**

Which of the following actions may a corporation take without its stockholders' consent?

- A. Consolidate with one or more corporations.
- B. Merge with one or more corporations.
- C. Dissolve voluntarily.
- D. Purchase 55% of another corporation's stock.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Directors are free to make most corporate decisions unilaterally. However, decisions that might fundamentally change the nature of the corporation require the consent of the shareholders. The purchase of 55% of another corporation's stock can be quite insignificant to the purchaser and is not a fundamental corporate change.

Choice "a" is incorrect because a consolidation is a fundamental corporate change.

Choice "b" is incorrect because a merger is a fundamental corporate change.

Choice "c" is incorrect because a dissolution is a fundamental corporate change.

**QUESTION 77**

Absent a specific provision in its articles of incorporation, a corporation's board of directors has the unilateral power to do all of the following, except:

- A. Repeal the bylaws.
- B. Declare dividends.
- C. Fix compensation of directors.
- D. Amend the articles of incorporation.

**Correct Answer: D**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Amendment of the articles of incorporation, albeit proposed by the directors, cannot usually be effected without the affirmative vote of the shareholders.

Choice "a" is incorrect. The directors ordinarily have the power to repeal bylaws unless the articles or the specific bylaw to be repealed provides otherwise.

Choice "b" is incorrect. The directors have the power to declare dividends at their discretion as long as the dividends do not violate any statute, article provision, bylaw, or contract with a creditor.

Choice "c" is incorrect. Although it seems like there would be a conflict of interest, directors do have the power to set their own compensation, limited only by the fiduciary duties owed to the corporation (e.g., the directors cannot set salaries so high as to constitute waste).

**QUESTION 78** Carr Corp. declared a 7% stock dividend on its common stock. The dividend:

- A. Must be registered with the SEC pursuant to the Securities Act of 1933.
- B. Is includable in the gross income of the recipient taxpayers in the year of receipt.
- C. Has no effect on Carr's earnings and profits for federal income tax purposes.
- D. Requires a vote of Carr's stockholders.

**Correct Answer: C**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A stock dividend means that the corporation issues its existing shareholders more stock. In essence, the corporation is merely diluting the proportional ownership interest of existing shares. This has no effect on the corporation's earnings and profits for federal income tax purposes.

Choice "a" is incorrect. There is no requirement that stock dividends be registered with the SEC because no "sale" is involved.

Choice "b" is incorrect. The receipt of a stock dividend is not the recognition of income. It merely divides the stockholders' current ownership interests into more pieces; it does not increase proportional ownership interest in the corporation.

Choice "d" is incorrect. The issuance of dividends, including stock dividends, is at the directors' discretion; shareholders do not vote on dividends.

**QUESTION 79**

Which of the following rights is a holder of a public corporation's cumulative preferred stock always entitled to?

- A. Conversion of the preferred stock into common stock.
- B. Voting rights.
- C. Dividend carryovers from years in which dividends were not paid, to future years.
- D. Guaranteed dividends.

**Correct Answer: C**

**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Cumulative preferred dividends are dividends that must be paid before any dividend can be paid to holders of non-preferred shares. The right to the dividend accumulates if it is not paid in a particular year. Choice "a" is incorrect. There is no right to convert preferred shares into common stock unless that right is specifically granted.

Choice "b" is incorrect. Preferred stock need not have voting rights.  
 Choice "d" is incorrect. Preferred dividends are not guaranteed. They must be paid before any common shareholder can be paid a dividend, but no dividend might ever be paid.

**QUESTION 80**  
 Which of the following securities are corporate debt securities?

<u>Convertible bonds</u>	<u>Debenture bonds</u>	<u>Warrants</u>
Yes	Yes	Yes
Yes	No	Yes
Yes	Yes	No
No	Yes	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer:** C  
**Section:** Volume A  
**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct.  
 Rules: Bonds are debt securities. Thus, convertible bonds and debenture bonds are debt securities. A warrant is a contractual right to purchase stock, which constitutes a share of corporate equity.  
 Choices "a", "b", and "d" are incorrect, per the above rules.

**QUESTION 81**  
 Under the Revised Model Business Corporation Act, a dissenting stockholder's appraisal right generally applies to which of the following corporate actions?

<u>Short-form Consolidations</u>	<u>Mergers</u>
Yes	Yes
Yes	No
No	Yes
No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer:** A  
**Section:** Volume A

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "a" is correct. "Yes-Yes."

Rule: Shareholders who are dissatisfied with the terms of a merger, consolidation or sale of assets are permitted to compel the corporation to buy their shares at fair market value. This is known as the right of appraisal or the dissenting right.  
Rule: A short-form merger is when a parent merges a 90% or more owned subsidiary into the parent. In this case, only the shareholders of the subsidiary have dissenting rights. Choices "b", "c", and "d" are incorrect, per the above rules.

**QUESTION 82**

For what purpose will a stockholder of a publicly held corporation be permitted to file a stockholders' derivative suit in the name of the corporation?

- A. To compel payment of a properly declared dividend.
- B. To enforce a right to inspect corporate records.
- C. To compel dissolution of the corporation.
- D. To recover damages from corporate management for an ultra vires management act.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. A derivative action is an action by a stockholder in the name of the corporation to recover damages or to seek some other remedy on behalf of the corporation when the corporation does not enforce its own rights. Such actions are often brought when the directors or officers have breached their duty to the corporation and have refused to sue themselves. An ultra vires act is an act outside of a director's or an officer's scope of authority and thus is a breach of duty to the corporation.

Choices "a", "b", and "c" are incorrect, because these would all be causes of action against the corporate directors or officers on behalf of the stockholder to recover damages or seek some other remedy against the corporate directors or officers on behalf of the stockholder, not on behalf of the corporation.

**QUESTION 83**

Under the Revised Model Business Corporation Act, when a corporation's bylaws grant stockholders preemptive rights, which of the following rights is(are) included in that grant?

	<i>The right to a proportionate share of corporate assets remaining on corporate dissolution</i>	<i>The right to purchase a proportionate share of newly issued stock</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No



- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer:** C

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Rule: Preemptive rights provide a shareholder with a right of first refusal to buy a share of newly issued shares sufficient to maintain the shareholder's proportionate share of rights in any newly issued shares.

Rule: Preemptive rights do not provide a shareholder with the right to a proportionate share of corporate assets on dissolution. Choice "c" is correct. "No - Yes."

Choices "a", "b", and "d" are incorrect, per the above rules.

**QUESTION 84**

Which of the following actions may be taken by a corporation's board of directors without stockholder approval?

- A. Purchasing substantially all of the assets of another corporation.
- B. Selling substantially all of the corporation's assets.
- C. Dissolving the corporation.
- D. Amending the articles of incorporation.

**Correct Answer:** A

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Purchasing substantially all the assets of another corporation does not require approval of the buyer's stockholders. Such a transaction would be relatively insignificant if a large corporation purchased substantially all the assets of a much smaller corporation.

Choice "b" is incorrect. Selling substantially all of the corporation's assets is considered to be a fundamental change to the corporation's structure that requires approval by a majority of the shareholders following the board of directors' approval.

Choice "c" is incorrect. Dissolving the corporation is considered to be a fundamental change to the corporation's structure that requires approval by a majority of the shareholders following the board of directors' approval.

Choice "d" is incorrect. Amending the articles of incorporation is considered to be a fundamental change to the corporation's structure that requires approval by a majority of the shareholders following the board of directors' approval.

**QUESTION 85** To which of the following rights is a stockholder of a public corporation entitled?

- A. The right to have annual dividends declared and paid.
- B. The right to vote for the election of officers.
- C. The right to a reasonable inspection of corporate records.
- D. The right to have the corporation issue a new class of stock.

**Correct Answer:** C

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Stockholders have a right to inspect certain corporate records.

Choice "a" is incorrect. Declaration of dividends is within the directors' discretion. There is no absolute right of shareholders to receive annual dividends.

Choice "b" is incorrect. Officers are appointed by the directors; they are not elected by the shareholders.

Choice "d" is incorrect. Shareholders do not have a right to force the corporation to issue a new class of stock.

**QUESTION 86**

A parent corporation owned more than 90% of each class of the outstanding stock issued by a subsidiary corporation and decided to merge that subsidiary into itself. Under the Revised Model Business Corporation Act, which of the following actions must be taken?

- A. The subsidiary corporation's board of directors must pass a merger resolution.
- B. The subsidiary corporation's dissenting stockholders must be given an appraisal remedy.
- C. The parent corporation's stockholders must approve the merger.
- D. The parent corporation's dissenting stockholders must be given an appraisal remedy.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "b" is correct. In a short form merger (one between a parent and a subsidiary 90% of which is owned by the parent), the subsidiary's shareholders have a right to dissent and take advantage of the appraisal remedy. Choice "a" is incorrect. The subsidiary's board is not required to take any action in a short-form merger. Choice "c" is incorrect. The parent corporation's shareholders have no right to approve or disapprove a short-form merger. Choice "d" is incorrect. The parent corporation's shareholders have no right to dissent to a short-form merger.

**QUESTION 87** Davis, a director of Active Corp., is entitled to:

- A. Serve on the board of a competing business.
- B. Take sole advantage of a business opportunity that would benefit Active.
- C. Rely on information provided by a corporate officer.
- D. Unilaterally grant a corporate loan to one of Active's shareholders.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. As a director of the corporation Davis may rely on information provided to him/her by a corporate officer. A corporate director is under no obligation to verify information given to him by management (corporate officers). Choice "a" is incorrect. A director is not entitled to serve on the board of a competing business. Doing so would be a breach of fiduciary duty. Choice "b" is incorrect. A director may not take sole advantage of a business opportunity that would benefit the corporation. Doing so would be a breach of fiduciary duty. Choice "d" is incorrect. A director may not unilaterally grant a corporate loan to one of the corporation's shareholders. Directors generally must act through a majority vote at a directors' meeting.

**QUESTION 88**

Knox, president of Quick Corp., contracted with Tine Office Supplies, Inc. to supply Quick's stationery on customary terms and at a cost less than that charged by any other supplier. Knox later informed Quick's board of directors that Knox was a majority stockholder in Tine. Quick's contract with Tine is:

- A. Void because of Knox's self-dealing.
- B. Void because the disclosure was made after execution of the contract.
- C. Valid because of Knox's full disclosure.
- D. Valid because the contract is fair to Quick.

**Correct Answer: D**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. If a corporation enters into a contract and a director has a conflict of interest in the transaction, the contract is voidable unless the director makes full disclosure of all of the facts to the disinterested directors or the shareholders, who then approve the transaction, or the director can prove that the transaction was fair to the corporation. The stationery purchase was fair to Quick, since it was purchased at a below-market price. Thus, the contract is valid. Choice "a" is incorrect. A director's self-dealing does not automatically make a contract void. The contract can be upheld if it was fair. Choice "b" is incorrect. A director's self-dealing does not automatically make a contract void. The contract can be upheld if it was fair. Choice "c" is incorrect. If a corporation enters into a contract and a director has a conflict of interest in the transaction, the contract is voidable unless the director makes full disclosure of all of the facts to the disinterested directors or shareholders, who then approve the transaction, or the director can prove that the transaction was fair. Mere disclosure after the contract was adopted does not automatically render the contract valid.

**QUESTION 89**

A stockholder's right to inspect books and records of a corporation will be properly denied if the purpose of the inspection is to:

- A. Commence a stockholder's derivative suit.
- B. Obtain stockholder names for a retail mailing list.
- C. Solicit stockholders to vote for a change in the board of directors.
- D. Investigate possible management misconduct.

**Correct Answer: B**



**Section: Volume A****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. In general, a shareholder has a right to inspect the books and records of a corporation for purposes related to the stockholder's interest in the corporation. This right will be denied where the purpose is not reasonably related to their status as a shareholder. Obtaining stockholder names to create a retail mailing list is a personal purpose.

Choices "a", "c", and "d" are incorrect. The following reasons for shareholders to inspect the books of the corporation are reasonably related to their status as shareholders:

- A. To commence a stockholder's derivative suit.
- C. To solicit stockholders to vote for a change in the board of directors.
- D. To investigate possible management misconduct.

**QUESTION 90**

Which of the following documents would most likely contain specific rules for the management of a business corporation?

- A. Articles of incorporation.
- B. Bylaws.
- C. Certificate of authority.
- D. Shareholders' agreement.

**Correct Answer: B**

**Section: Volume A****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. The bylaws are adopted by the incorporators or directors, are not required to be filed, and generally will contain rules desired regarding the operation of the corporation. Choice

"a" is incorrect. Articles of incorporation are filed with the state and contain information regarding the formation of the corporation.

Choice "c" is incorrect. A certificate of authority is filed with the foreign state that a business wishes to do business in and with permission from that state. Choice

"d" is incorrect. A shareholder agreement is a contract between shareholders for any rights or duties agreed upon between the parties.

**QUESTION 91** Following the formation of a corporation, which of the following terms best describes the process by which the promoter is released from, and the corporation is made liable for, pre-incorporation contractual obligations?

- A. Assignment.
- B. Novation.
- C. Delegation.
- D. Accord and satisfaction.

**Correct Answer: B**

**Section: Volume A****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. A promoter is personally liable for the contracts he or she enters into prior to incorporation. A corporation may become liable by adoption of the contract, and through the process of novation (an agreement among all of the parties), the promoter may be released from contractual obligations.

Choice "a" is incorrect. An assignment is a transfer of a contractual duty to perform. After the transfer, both the assignor and assignee may be held liable for performance. The assignor is not, thereby, released from liability.

Choice "c" is incorrect. A delegation is a transfer of a contractual duty to perform. Both the delegor and delegee are liable to perform after the assignment; it does not release the promoter from liability.

Choice "d" is incorrect. An accord is an agreement to change the performance due under a contract. Once the new terms are performed or satisfied, the original contract terms are terminated. Such an agreement does not automatically result in release of a promoter.

**QUESTION 92** Which of the following parties is liable to repay an illegal distribution to a corporation?

- A. A director not breaching his or her duty in approving the distribution and the corporation is solvent.
- B. A director not breaching his or her duty in approving the distribution and the corporation is insolvent.
- C. A shareholder not knowing of the illegality of the distribution and the corporation is solvent.
- D. A shareholder knowing of the illegality of the distribution and the corporation is insolvent.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Illegal dividends from an insolvent company must be repaid to the corporation for the benefit of the creditors. A shareholder who knowingly accepts an illegal dividend is liable to return it.

Choices "a" and "b" are incorrect. If a director does not breach any duties in approving a distribution, the director is protected by the business judgment rule and is not liable for the distribution whether the corporation is solvent or insolvent.

Choice "c" is incorrect. A shareholder of a solvent corporation who unknowingly accepts an illegal distribution is not obligated to repay the distribution.

**QUESTION 93** Which of the following may not own shares in an S corporation?

- A. Individuals.
- B. Estates.
- C. Trusts.
- D. Corporations.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Shareholders must be individuals, estates, or certain trusts. Corporations are not permitted to be shareholders of an S corporation. Choices

"a", "b", and "c" are incorrect, per the above Explanation.

**QUESTION 94** Which of the following decreases stockholder equity?

- A. Investments by owners.
- B. Distributions to owners.
- C. Issuance of stock.
- D. Acquisition of assets in a cash transaction.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Distributions to owners, typically in the form of dividends, will serve to reduce stockholders' equity.

Choice "a" is incorrect. Investments by owners, typically in the form of stock purchases or contributions, will serve to increase shareholders' equity.

Choice "c" is incorrect. Issuance of stock by sale will increase shareholders' equity, while issuance of stock dividends will have no effect on total shareholders' equity. Stock dividends will reduce the book value of each share outstanding.

Choice "d" is incorrect. Acquisition of assets with cash will have no effect on total stockholders' equity. The acquisition of assets with cash will effectively reclassify assets from one type to another without impacting liabilities or equity.

**QUESTION 95**

Food Corp. owned a restaurant called The Ambers. The corporation president, T.J. Jones, hired a contractor to make repairs at the restaurant, signing the contract, "T.J. Jones for The Ambers." Two invoices for restaurant repairs were paid by Food Corp. with corporate checks. Upon presenting the final invoice, the contractor was told that it would not be paid. The contractor sued Food Corp. Which of the following statements is correct regarding the liability of Food Corp.?

- A. It is not liable because Jones is liable.
- B. It is not liable because the corporation was an undisclosed principal.
- C. It is liable because Jones is not liable.
- D. It is liable because Jones had authority to make the contract.

**Correct Answer:** D

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Where an agent enters into a contract on behalf of a principal and discloses the existence and identity of the principal and acts with authority, the principal is liable and the agent is not liable. Here, Jones signed the contract with an indication that he was signing for the corporation. The president of a corporation is an agent of the corporation and has apparent authority to enter contracts that appear to be within the ordinary scope of the corporation's business. The restaurant repairs here appear to be with the scope of Food Corp.'s business. Therefore, Food Corp. will be bound because Jones had at least apparent authority. Choice "a" is incorrect, per the rule stated above.

Choice "b" is incorrect. The president signed as acting on behalf of the corporation, thus disclosing the principal. Choice

"c" is incorrect, per the rule stated above.

#### QUESTION 96

Which of the following statements describes the same characteristic for both an S corporation and a C corporation?

- A. Both corporations can have more than 100 shareholders.
- B. Both corporations have the disadvantage of double taxation.
- C. Shareholders can contribute property into a corporation without being taxed.
- D. Shareholders can be either citizens of the United States or foreign countries.

**Correct Answer:** C

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Either entity's shareholders may contribute property to the corporations without being taxed and may contribute such property as an exchange for stock as appraised by the directors.

Choice "a" is incorrect. An S corporation may not have more than 100 shareholders, although a C corporation may have as many shareholders as desired. Choice "b" is incorrect. Only the C corporation is subject to the double taxation disadvantage.

Choice "d" is incorrect. Only an S corporation is prohibited from having foreign country shareholders.

#### QUESTION 97

Smith was an officer of CCC Corp. As an officer, the business judgment rule applies to Smith in which of the following ways?

- A. Because Smith is not a director, the rule does not apply.
- B. If Smith makes, in good faith, a serious but honest mistake in judgment, Smith is generally not liable to CCC for damages caused.
- C. If Smith makes, in good faith, a serious but honest mistake in judgment, Smith is generally liable to CCC for damages caused, but CCC may elect to reimburse Smith for any damages Smith paid.
- D. If Smith makes, in good faith, a serious but honest mistake in judgment, Smith is generally liable to CCC for damages caused, and CCC is prohibited from reimbursing Smith for any damages Smith paid.

**Correct Answer:** B

**Section:** Volume A

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The business judgment rule applies to officers as well as directors, who in their capacity, act in a manner the officer believes to be in the best interest of the corporation, and with the care an ordinarily prudent person in a like position would exercise. If the standards of the business judgment rule are met, the officer is not liable to the company for resulting damages. Choices "a", "c", and "d" are incorrect, per the above rule.

**QUESTION 98** In which type of business entity is the entire ownership interest most freely transferable?

- A. General partnership.
- B. Limited partnership.
- C. Corporation.
- D. Limited liability company.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Among the business entities listed, entire ownership interests are most freely transferable in a corporation. Unless transferability is restricted by contract (restricted shares or voting trusts or voting agreements), there are no restrictions on the sale of corporate stock (the common stock represents the stockholders' ownership interest). The right to transfer ownership interests freely is one of the advantages of the corporate form of business.

Choice "a" is incorrect. A general partner in a general partnership may assign his or her right to receive profits or surplus. A general partner cannot assign his interest and confer partnership status on the assignee without unanimous consent of all other partners.

Choice "b" is incorrect. Both general partners and limited partners in a limited partnership may assign the right to receive profits and surplus. Neither general nor limited partners can confer general or limited partnership status on the assignee without the unanimous consent of all general and all limited partners.

Choice "d" is incorrect. In most states, limited liability company (LLC) members may not sell and confer ownership interest without the consent of all LLC members.

**QUESTION 99**

Which of the following statements is correct regarding both debt and common shares of a corporation?

- A. Common shares represent an ownership interest in the corporation, but debt holders do not have an ownership interest.
- B. Common shareholders and debt holders have an ownership interest in the corporation.
- C. Common shares typically have a fixed maturity date, but debt does not.
- D. Common shares have a higher priority on liquidation than debt.



**Correct Answer: A**  
**Section: Volume A**  
**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. Common shares represent an investment in the corporation whereby the common shareholder becomes a part owner of the corporation. A debt holder is a creditor of the corporation. The corporation has borrowed money from the debt holder and promises to repay at a later date. A debt holder is not an owner of the corporation.

Choice "b" is incorrect. Unlike a common shareholder, a debt holder does not have an ownership interest in the corporation.

Choice "c" is incorrect. Common shares do not have a fixed maturity date, but debt securities do. This answer is backwards.

Choice "d" is incorrect. Upon liquidation of a corporation, the creditors of the corporation are paid first.

After the creditors are paid, the shareholders are paid on a pro rata basis. Thus, debt holders (creditors) have a higher priority than stockholders.

**QUESTION 100**

Which of the following is an advantage of forming a limited liability company (LLC) as opposed to a partnership?

- A. The entity may avoid taxation.
- B. The entity may have any number of owners.
- C. The owner may participate in management while limiting personal liability.
- D. The entity may make disproportionate allocations and distributions to members.

**Correct Answer: C**  
**Section: Volume A**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A member in a limited liability company has limited liability and the ability to manage, while a partner in a general partnership has full liability and the ability to manage.  
Choice "a" is incorrect. Generally, both entities' profits are taxable at the ownership level, but a Limited Liability Company may be taxed as an entity if it so elects. Choice "b" is incorrect. Both entities may have any number of owners.  
Choice "d" is incorrect. Both entities may make disproportionate allocations and distributions to their owners.

**QUESTION 101** In which type of business organization are income taxes always required to be paid by the entity on profits earned as well as by the owners upon distribution thereof?

- A. General partnership.
- B. Limited liability company.
- C. Subchapter C corporation.
- D. Subchapter S corporation.

**Correct Answer: C**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. A Subchapter C corporation is taxed as an entity for income tax purposes.  
Additionally, distributions made to stockholders are treated as taxable income to the stockholders. [Note that this type of corporation is more often called a C corporation instead of a Subchapter C corporation.] Choice "a" is incorrect. A general partnership is not taxed as a separate entity for income tax purposes.  
Choice "b" is incorrect. An LLC is not taxed as a separate entity for income tax purposes unless the LLC specifically elects to be taxed like a corporation. [Of course, the word "always" in the question takes care of that.]  
Choice "d" is incorrect. A Subchapter S corporation is taxed as a partnership. Thus, it is not taxed as a separate entity for income tax purposes. [Note that this type of corporation is more often called an S corporation instead of a Subchapter S corporation.]

**QUESTION 102** Under the Revised Model Business Corporation Act, following what type of corporate acquisition does the acquiring corporation automatically become liable for all obligations of the acquired corporation?

- A. A leveraged buyout of assets.
- B. An acquisition of stock for debt securities.
- C. A cash tender offer.
- D. A merger.

**Correct Answer: D**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. A merger involves one corporation joining with another corporation. The surviving corporation has all of the rights and liabilities of the merged corporation. Thus, the acquiring corporation automatically becomes liable for all obligations of the acquired corporation.  
Choice "a" is incorrect. A leveraged buyout is a strategy involving the acquisition of another corporation using a significant amount of borrowed money (bonds or loans). Often, the assets of the corporation being acquired are used as collateral for the loans (in addition to the assets of the acquiring corporation).  
The acquiring corporation does not automatically become liable for all (or any) obligations of the acquired corporation if it merely acquires another corporation's assets.  
Choice "b" is incorrect. An acquisition of stock for debt securities does not make the acquiring corporation liable for the obligations of the acquired corporation. The acquiring corporation has simply purchased stock. In an acquisition of stock for debt securities, the acquired corporation becomes a subsidiary of the acquiring corporation and the acquired corporation remains a separate entity liable for its own obligations.  
Choice "c" is incorrect. A cash tender offer is an offer to purchase a corporation's stock directly from its shareholders at a specified price for a specified period of time. In a cash tender offer, the acquiring corporation does not automatically become liable for all obligations of the acquired corporation. In fact, if there is only an offer, there is no transaction at all.

**QUESTION 103**

Which of the following actions is required to ensure the validity of a contract between a corporation and a director of the corporation?

- A. An independent appraiser must render to the board of directors a fairness opinion on the contract.
- B. The director must disclose the interest to the independent members of the board and refrain from voting.
- C. The shareholders must review and ratify the contract.
- D. The director must resign from the board of directors.

**Correct Answer: B**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is clearly the best answer here, although it is not completely correct. Directors owe their corporation a duty of loyalty and must act solely in the best interests of the corporation. If a corporation enters into a contract and a director has a conflict of interest in the transaction, the contract is voidable unless the director makes full disclosure of all of the facts to the disinterested directors or the shareholders who then approve the transaction, or the transaction is fair. Thus, disclosing the interest to the independent members and refraining from voting is one way to ensure the validity of a contract between a director and his or her corporation, but it technically is not required as disclosure to and approval by the shareholders also ensures validity, as does making sure the transaction is fair to the corporation. Nevertheless, the other choices are clearly incorrect - making this the best choice.

Choice "a" is incorrect. A transaction with an interested director will be upheld if it is fair, but it is not necessary to hire an independent appraiser to prove fairness.

Choice "c" is incorrect. One method of approving a contract with an interested director is to disclose all of the material facts to the shareholders and seek their approval. Merely allowing the shareholders to review the contract is not sufficient.

Choice "d" is incorrect. To ensure the validity of a contract between a corporation and a director of the corporation, it is not necessary for the director to resign from the board (i.e., a director is not required to resign because of a conflict of interest). The corporation can approve the conflict if it is disclosed and the director does not participate in the approval process.

**QUESTION 104**

Which of the following statements is correct regarding the declaration of a stock dividend by a corporation having only one class of par value stock?

- A. A stock dividend is prohibited in such a corporation.
- B. A stock dividend increases a stockholder's proportionate share of corporate ownership.
- C. A stock dividend causes a decrease in the assets of the corporation.
- D. A stock dividend is a corporation's ratable distribution of additional shares of stock to its stockholders.

**Correct Answer: D**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Stock dividends are dividends in the corporation's own authorized but unissued shares given to existing shareholders on account of their shares.

Choice "a" is incorrect. Despite the fact that a stock dividend in a corporation with only one class of par value stock does not change a shareholder's proportional ownership or affect capitalization of the corporation, nothing prohibits a corporation--even a corporation with only one class of par value stock--from declaring a stock dividend.

Choice "b" is incorrect. With a stock dividend, when there is only one class of stock, each shareholder receives a proportionate amount of stock, resulting in each shareholder owning the same percentage of the corporation after the dividend is issued as he or she owned before the dividend was issued.

Choice "c" is incorrect. When a stock dividend is issued in a corporation's own stock, no assets are distributed and the solvency of the corporation remains the same.

**QUESTION 105** Which of the following corporate actions is subject to shareholder approval?

- A. Election of officers.
- B. Removal of officers.
- C. Declaration of cash dividends.
- D. Removal of directors.

**Correct Answer: D**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "d" is correct. Shareholders have the right to elect and remove directors through the voting process.

Choice "a" is incorrect. Officers are selected by the directors rather than by the shareholders.

Choice "b" is incorrect. Because officers are selected by the directors, generally they may be removed only by the directors.

Choice "c" is incorrect. Dividends generally can be declared only by the directors; shareholders usually do not have any right to declare or vote on a distribution.

#### QUESTION 106

Which of the following is a requirement for a small business corporation to elect S corporation status?

- A. It has only one class of stock.
- B. It has at least one partnership as a shareholder.
- C. It has international ownership.
- D. It has more than 75 shareholders.

**Correct Answer:** A

**Section:** Volume B

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "a" is correct. A corporation may elect to be taxed like a partnership under Subchapter S only if it has only one class of stock.

Choice "b" is incorrect. A corporation can elect S corporation status only if its shareholders are individuals, estates, or certain types of trusts.

Choice "c" is incorrect. Foreign shareholders generally are prohibited in an S corporation.

Choice "d" is incorrect. An S corporation can have up to 100 shareholders, but it may have fewer.

#### QUESTION 107

The president of a company has signed a \$10 million contract with a construction company to build a new corporate office. Which of the following corporate documents sets forth the scope of authority under which this transaction is governed?

- A. Certificate of Incorporation.
- B. Charter.
- C. Bylaws.
- D. Proxy statement.

**Correct Answer:** C

**Section:** Volume B

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "c" is correct. The bylaws usually contain the rules for running the corporation.

Choices "a" and "b" are incorrect. These are possible choices, but not as good an answer as "c". A corporation's articles of incorporation (called a charter in a few states) must set out certain information relevant to formation of the corporation, but it may include any other information that it is not illegal.

However, usually details about intracorporate power are set out in bylaws rather than in the articles or charter.

Choice "d" is incorrect. A proxy statement is a request to shareholders to allow their shares to be voted by a specified person in a specified way. It has nothing to do with a corporate president's authority.

#### QUESTION 108

A limited liability company taxed under subchapter K of the Internal Revenue Code (the partnership subchapter):

- A. Must pay federal income tax.
- B. Is generally not considered a legal entity separate and apart from its owners.
- C. Must have written articles of organization.
- D. Must provide for apportionment of liability for the company's debts.

**Correct Answer:** C

**Section:** Volume B



## Explanation

### Explanation/Reference:

Explanation:

Choice "c" is correct. A limited liability company must have written articles of organization, which must be filed with the state.

Choice "a" is incorrect. An LLC taxed under subchapter K of the Internal Revenue Code (the partnership subchapter) does not pay federal income tax; the members are taxed on their share of the LLC's income.

Choice "b" is incorrect. Unlike a general partnership, but like a corporation and a limited partnership, an LLC is considered a legal entity separate and apart from its owners. Choice "d" is incorrect. An LLC does not have to provide for apportionment of liability for LLC debts; the members of an LLC have limited liability.

**QUESTION 109** A partnership agreement must be in writing if:

- A. Any partner contributes more than \$500 in capital.
- B. The partners reside in different states.
- C. The partnership intends to own real estate.
- D. The partnership's purpose cannot be completed within one year of formation.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

### Explanation/Reference:

Explanation:

Choice "d" is correct. Under the statute of frauds, a partnership agreement must be in writing if by its terms the agreement cannot be completed within one year.

Choice "a" is incorrect. No such rule. Although the statute of frauds requires a contract for the sale of goods for \$500 or more to be evidenced by a writing, a writing is not required to contribute more than \$500 in capital to a partnership. Choice "b" is incorrect. No such rule, a far out distracter.

Choice "c" is incorrect. While a contract to buy or sell real estate will require a writing, a partnership agreement to own/buy real estate need not be in writing.

### QUESTION 110

Unless prohibited by the organization documents, a stockholder in a publicly held corporation and the owner of a limited partnership interest both have the right to:

- A. Ownership of the business' assets.
- B. Control management of the business.
- C. Assign their interest in the business.
- D. An investment that has perpetual life.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

### Explanation/Reference:

Explanation:

Choice "c" is correct. Both a shareholder in a publicly held corporation and the owner of a limited partnership interest have a right to assign (sell) their interest. While a shareholder is free to assign his whole ownership interest, a limited partner's assignable interest is limited to the limited partner's interest in profits and losses.

Choice "a" is incorrect. Neither the stockholder of a publicly held corporation nor the owner of a limited partnership interest (or indeed, even a general partnership interest) has an ownership interest in any item of the business' assets--the assets belong to the business and not to the owners of the business.

Choice "b" is incorrect. Stockholders and limited partners generally do not have the right to participate in the management of the business. Choice

"d" is incorrect. A limited partnership interest dissolves upon death of the limited partner and so is not a perpetual investment.

### QUESTION 111

Price owns 2,000 shares of Universal Corp.'s \$10 cumulative preferred stock. During its first year of operations, cash dividends of \$5 per share were declared on the preferred stock but were never paid. In the second year, dividends on the preferred stock were neither declared nor paid. If Universal is dissolved, which of the following statements is correct?

- A. Universal will be liable to Price as an unsecured creditor for \$10,000.
- B. Universal will be liable to Price as a secured creditor for \$20,000.
- C. Price will have priority over the claims of Universal's bond owners.

D. Price will have priority over the claims of Universal's unsecured judgment creditors.

**Correct Answer:** A

**Section:** Volume B

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. After a dividend is declared but not paid on cumulative preferred stock, the unpaid dividend ranks with other "unsecured" debts.

Choice "b" is incorrect. The unpaid dividend ranks as an "unsecured" not a "secured" debt and Price has no right to a dividend for the second year because no dividend was declared that year. Choice

"c" is incorrect. As an "unsecured" creditor, Price does not have priority over the company's bondholders.

Choice "d" is incorrect. The "unsecured" creditors will share in the "unsecured" category as a whole and not with any priority within the class.

#### QUESTION 112

A stockholder's right to inspect books and records of a corporation will be properly denied if the stockholder:

A. Wants to use corporate stockholder records for a personal business.

B. Employs an agent to inspect the books and records.

C. Intends to commence a stockholder's derivative suit.

D. Is investigating management misconduct.

**Correct Answer:** A

**Section:** Volume B

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. In general, a shareholder has a right to inspect the books and records of a corporation for purposes reasonably related to his or her status as a shareholder. This right will be properly denied where the purpose is not reasonably related to their status as a shareholder.

Choice "b" is incorrect. In general, a shareholder has a right to inspect the books and records of a corporation for purposes reasonably related to his or her status as a shareholder. A shareholder need not conduct the inspection personally; a shareholder may send an agent such as an attorney or an accountant.

Choices "c" and "d" are incorrect. In general, a shareholder has a right to inspect the books and records of a corporation for purposes reasonably related to his or her status as a shareholder. Choices "c" and "d" are purposes reasonably related to the shareholder's status as a shareholder. Thus, the stockholder would have a right to inspect for those reasons.

**QUESTION 113** Generally, a merger of two corporations requires:

A. That a special meeting be held and that notice and copy of the merger plan be given to all stockholders of both corporations.

B. Unanimous approval of the merger plan by the stockholders of both corporations.

C. Unanimous approval of the merger plan by the boards of both corporations.

D. That all liabilities owed by the absorbed corporation be paid before the merger.

**Correct Answer:** A

**Section:** Volume B

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. The merger of two corporations requires that a special meeting be held and that notice and copy of the merger plan be given to all stockholders of both companies. A merger generally requires the approval of both the directors and stockholders.

Choice "b" is incorrect. While the stockholders' approval is required, in most states a majority vote is required; no state requires a unanimous vote. Choice

"c" is incorrect. While the board's approval is required, a majority vote and not a unanimous vote is required.

Choice "d" is incorrect. There is no requirement that all liabilities owed by the absorbed corporation be paid before the merger because the merged corporation becomes obligated to pay such liabilities upon the merger.

#### QUESTION 114

In a member managed LLC, the apparent authority of a member to bind the LLC in dealing with third parties:

- A. Would permit a member to submit a claim against the LLC to arbitration.
- B. Must be derived from the express powers and purposes contained in the operating agreement.
- C. Will be effectively limited by a formal resolution of the members of which third parties are aware.
- D. Will be effectively limited by a formal resolution of the members of which third parties are unaware.

**Correct Answer: C**

**Section: Volume B**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. This is really an agency question on apparent authority. Apparent authority is authority that a third party reasonably believes an agent has. If the third party is aware of a restriction on the agent's authority, the third party cannot reasonably believe that the agent has the restricted authority.

Choice "a" is incorrect. Submitting a claim to arbitration is an extraordinary act and so is not within a member's apparent authority.

Choice "b" is incorrect. Apparent authority is derived from what the reasonable person believes is the authority of a member, not the express powers and purposes contained in the operating agreement. Choice "d" is incorrect. A formal resolution of the members will not be effective to destroy apparent authority if third parties are unaware of the resolution.

#### QUESTION 115

Unless otherwise provided in a general partnership agreement, which of the following statements is correct when a partner dies?

	<i>The deceased partner's executor would automatically become a <u>partner</u></i>	<i>The deceased partner's estate would be free from any partnership <u>liabilities</u></i>	<i>The partnership would be dissolved <u>automatically</u></i>
A.	Yes	Yes	Yes
B.	Yes	No	No
C.	No	Yes	No
D.	No	No	No



- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer: D**

**Section: Volume B**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. "No - No - No."

Upon the death of a general partner:

Rule: A partner's death is an event of dissociation. Where a partner dissociates, the partner's right to participate in the management ceases; the partner's executor does not take the partner's place.

Rule: The partner's estate remains liable for the partner's obligations to the partnership and has a right to the deceased partner's share of distributions.

Rule: Under the Revised Uniform Partnership Act, a partnership does not automatically dissolve on the death of a partner; rather it will dissolve only if 90 days pass and the remaining partners do not wish to continue the partnership. Choices "a", "b", and "c" are incorrect, per the above rules.

**QUESTION 116**

Under the Revised Model Business Corporation Act, which of the following actions by a corporation would entitle a stockholder to dissent from the action and obtain payment of the fair value of his/her shares?

- I. An amendment to the articles of incorporation that materially and adversely affects rights in respect of a dissenter's shares because it alters or abolishes a preferential right of the shares.
  - II. Consummation of a plan of share exchange to which the corporation is a party as the corporation whose shares will be acquired, if the stockholder is entitled to vote on the plan.
- A. I only.
  - B. II only.
  - C. Both I and II.
  - D. Neither I nor II.

**Correct Answer: C**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. "Both I and II."

Rule: Shareholders who vote against a share exchange are entitled to payment for fair value of their shares.

Rule: Preferred shareholders who dissent to having their preferential rights altered or abolished have dissenters' rights to be paid the fair value of their shares. Choices

"a", "b", and "d" are incorrect, per the above rules.

**QUESTION 117** The apparent authority of a partner to bind the partnership in dealing with third parties:

- A. Will be effectively limited by a formal resolution of the partners of which third parties are aware.
- B. Will be effectively limited by a formal resolution of the partners of which third parties are unaware.
- C. Would permit a partner to submit a claim against the partnership to arbitration.
- D. Must be derived from the express powers and purposes contained in the partnership agreement.



**Correct Answer: A**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. This is really an agency question on apparent authority. Apparent authority is authority that a third party reasonably believes an agent has. If the third party is aware of a restriction on the agent's authority, the third party cannot reasonably believe that the agent has the restricted authority.

Choice "b" is incorrect. A formal resolution of the partners will not be effective to destroy authority if a third party is aware of the resolution, but not if the third party is unaware of the resolution.

Choice "c" is incorrect. Submitting a claim to arbitration is an extraordinary act. A partner has apparent authority only to enter into transactions apparently carrying on in the usual way the business of the partnership. There is no apparent authority to enter into an extraordinary transaction.

Choice "d" is incorrect. Apparent authority is derived from what a reasonable person believes concerning the authority of a partner based on the partnership's actions toward the third party; authority derived from the express powers and purposes contained in the partnership agreement is actual authority.

**QUESTION 118**

Grey and Carr entered into a written partnership agreement to operate a hardware store. Their agreement was silent as to the duration of the partnership. Grey wishes to withdraw from the partnership. Which of the following statements is correct?

- A. Unless Carr consents to a withdrawal, Grey must apply to a court and obtain a decree allowing withdrawal.
- B. Grey may not withdraw unless Carr consents.
- C. Grey may withdraw only after notice of the proposed dissolution is given to all partnership creditors.

D. Grey may withdraw from the partnership at any time.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct.

Rule: Where a partnership agreement does not state the duration of the partnership, the partners may withdraw at any time. The partner need not obtain consent of the other partners or of the court.

Choices "a" and "b" are incorrect, per the above rule.

Choice "c" is incorrect. A partner has no duty to inform creditors of his intent to withdraw in order for the withdrawal to be effective (although notice is needed to limit the partner's personal liability).

#### QUESTION 119

The limited liability of the shareholders of a closely-held corporation will most likely be disregarded if the shareholders:

A. Lend money to the corporation.

B. Are also corporate officers, directors, or employees.

C. Undercapitalized the corporation when it was formed.

D. Formed the corporation solely to limit their personal liability.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The "corporate veil" can be pierced in situations in which the corporation was undercapitalized at formation, where it is the alter ego of the shareholders, or when it used to perpetrate a fraud.

Choice "a" is incorrect. Shareholders may lend money to their corporation. This does not make such shareholders personally liable for the corporation's debt.

Choice "b" is incorrect. Officers, directors, and employees are not personally liable for the corporation's debt, and there is no reason to change this role merely because such persons also own shares. Choice

"d" is incorrect. The desire to limit liability is a valid reason to adopt the corporate form and will not, by itself, allow the "corporate veil" to be pierced.

#### QUESTION 120

Acorn and Bean were general partners in a farm machinery business. Acorn contracted, on behalf of the partnership, to purchase 10 tractors from Cobb Corp. Unknown to Cobb, Acorn was not authorized by the partnership agreement to make such contracts. Bean refused to allow the partnership to accept delivery of the tractors and Cobb sought to enforce the contract. Cobb will:

A. Lose because Acorn's action was beyond the scope of Acorn's implied authority.

B. Prevail because Acorn had implied authority to bind the partnership.

C. Prevail because Acorn had apparent authority to bind the partnership.

D. Lose because Acorn's express authority was restricted, in writing, by the partnership agreement.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A general partner has apparent authority to bind the partnership and other partners in respect to all ordinary transactions within the apparent scope of the partnership business. A farm machinery business probably regularly purchases tractors. Thus, there was apparent authority here.

Choices "a" and "b" are incorrect. Implied authority is authority that an agent reasonably believes he or she was given by the principal along with any express authority. Because Acorn knew that he did not have express authority to make the contracts here, he could not reasonably believe that he had implied authority to do so.

Choice "d" is incorrect. The seller was not aware of Acorn's lack of express authority. Therefore, Cobb relied on Acorn's apparent authority.

#### QUESTION 121

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

- A. The ACH Associates oral partnership agreement was valid.
- B. The ACH Associates oral partnership agreement was invalid because the partnership lasted for more than one year.

**Correct Answer:** A  
**Section:** Volume B

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. A partnership agreement does not have to be in writing to be valid. If the partners want to enforce an agreement to be partners for more than one year, that agreement must be in writing, but merely having the partnership last for more than one year does not make an oral partnership agreement invalid.

#### QUESTION 122

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

- A. Anchor, Chain, and Hook jointly owning and conducting a business for profit establishes a partnership relationship.
- B. Anchor, Chain, and Hook jointly owning income producing property establishes a partnership relationship.

**Correct Answer:** A  
**Section:** Volume B

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. A partnership is defined as an association of two or more persons who agree to carry on as co-owners a business for profit. Merely owning income-producing property jointly is not sufficient.

#### QUESTION 123

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

- A. Anchor's share of ACH Associates' 1993 profits was \$20,000.
- B. Hook's share of ACH Associates' 1993 profits was \$30,000.

**Correct Answer:** B  
**Section:** Volume B

#### Explanation

#### Explanation/Reference:

Explanation:



Choice "b" is correct. Unless otherwise agreed, partners share profits equally. Here, the partners agreed to share profits on the basis of their contributions, which were in a ratio of 1:2:3 respectively for Anchor, Chain, and Hook. Thus, Anchor's share of the 1993 profits was \$10,000, Chain's share was \$20,000, and Hook's share was \$30,000.

**QUESTION 124**

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000.

For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

A. Anchor's capital account would be reduced by 1/3 of any 1994 losses.

B. Hook's capital account would be reduced by 1/2 of any 1994 losses.

**Correct Answer: B**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. If the partnership agreement is silent on how losses will be shared, they are shared in the same manner as profits. Here, the partners agreed to share profits on the basis of their contributions, which were in a ratio of 1:2:3 respectively for Anchor, Chain, and Hook. Thus, Anchor is liable for one-sixth of the loss, Chain is liable for 1/3 of the loss, and Hook is liable for 1/2 of the loss.

**QUESTION 125**

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

A. Ace Automobile Co. would lose a suit brought against ACH Associates because Hook, as a general partner, has no authority to bind the partnership.

B. Ace Automobile Co. would win a suit brought against ACH Associates because Hook's authority continues during dissolution.

**Correct Answer: B**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. A partner's authority to bind the partnership continues after dissolution to persons who have extended credit to the partnership previously and who are without notice of the dissolution. The facts state that Hook had previously purchased cars for the partnership from Ace, and presumably the purchases were on credit. Since nothing in the facts indicates that Ace was given notice of the dissolution, the partnership will be bound.

**QUESTION 126**

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000.

For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners. Determine whether (A) or (B) is correct. Select the answer that corresponds to the correct statement.

A. ACH Associates and Hook would be the only parties liable to pay any judgment recovered by Ace Automobile Co.

B. Anchor, Chain, and Hook would be jointly and severally liable to pay any judgment recovered by Ace Automobile Co.

**Correct Answer: B**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Since Ace brought suit against both the partnership and the individual partners, if judgment is rendered against the partnership, all partners could be held jointly and severally liable.

**QUESTION 127**

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers.

- A. Amber Corp. must be formed under a state's general corporation statute.
- B. Amber Corp.'s articles of incorporation must include the names of all stockholders.
- C. Amber Corp. must include its corporate bylaws in the incorporation documents filed with the state.

**Correct Answer: A**  
**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. A corporation must be formed by compliance with the state's corporation statute.  
Choice "b" is incorrect. The articles need not contain the names of the stockholders.  
Choice "c" is incorrect. Bylaws do not have to be in the articles; they are usually adopted at the first directors' meeting.

**QUESTION 128**

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s initial bylaws ordinarily would be adopted by its:

- A. Stockholders.
- B. Officers.
- C. Directors.

**Correct Answer: C**  
**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Bylaws usually are adopted by the initial directors.

**QUESTION 129**

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s directors are elected by its:

- A. Officers.
- B. Outgoing directors.
- C. Stockholders.

**Correct Answer: C**  
**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Directors are elected by the stockholders.

**QUESTION 130**

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s officers ordinarily would be elected by its:

- A. Stockholders.
- B. Directors.
- C. Outgoing officers.

**Correct Answer: B**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Officers usually are selected by the directors.

**QUESTION 131**

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s day-to-day business ordinarily would be operated by its:

- A. Directors.
- B. Stockholders.
- C. Officers.

**Correct Answer: C**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Stockholders have no day-to-day control; management power of a corporation is vested in the directors, but they usually delegate day-to-day management duties to the officers.

**QUESTION 132**

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers.

- A. Adams, Frank, and Berg must be elected as directors because they own 55% of the issued and outstanding stock.
- B. Adams, Frank, and Berg must always be elected as officers because they own 55% of the issued and outstanding stock.
- C. Adams, Frank, and Berg must always vote for each other as directors because they have a voting agreement.

**Correct Answer: C**

**Section: Volume B**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. Shareholders in a voting agreement must vote their shares in accordance with the agreement. There is no requirement that majority shareholders be elected as directors or officers.

**QUESTION 133** An increase (shift right) in aggregate demand causes:

- A. An increase in the price level and a decrease in real GDP.
- B. A decrease in the price level and an increase in real GDP.
- C. An increase in the price level and an increase in real GDP.
- D. A decrease in the price level and a decrease in real GDP.

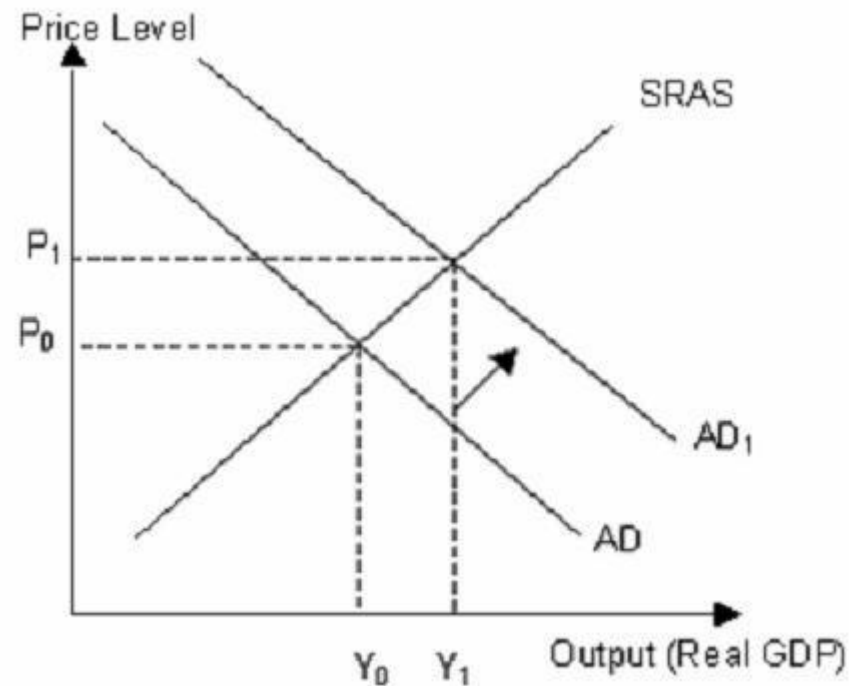
**Correct Answer:** A

**Section:** Volume B

### Explanation

#### Explanation/Reference:

Explanation:



Choice "c" is correct. As shown above, an increase in aggregate demand causes the equilibrium price level to rise and equilibrium output (real GDP) to increase. Choice

"a" is incorrect. As shown above, equilibrium output increases, not decreases.

Choice "b" is incorrect. As shown above, the equilibrium price level increases, not decreases. Choice

"d" is incorrect. As shown above, the equilibrium price level increases, not decreases.

**QUESTION 134** The trough of a business cycle is generally characterized by:

- A. Shortages of essential raw materials and rising costs.
- B. Increasing purchasing power and increasing capital investments.
- C. Unused productive capacity and an unwillingness to risk investments.
- D. Declining purchasing power and unused productive capacity.

**Correct Answer:** C

**Section:** Volume B

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The trough of a business cycle is an economic low point with no positive indicators for the future. It is characterized by unused productive capacity and an unwillingness to risk new investments.

Choice "a" is incorrect. Shortages may occur during a peak.

Choice "b" is incorrect. Increasing purchasing power and increasing capital investments come with recovery. Choice

"d" is incorrect. Declining purchasing power comes with inflation; unlikely in a trough.

**QUESTION 135**

During a recession:

- A. Output (real GDP) will be increasing.
- B. The natural rate of unemployment will increase dramatically.
- C. Potential output will exceed actual output.
- D. Actual output will exceed potential output.

**Correct Answer: C**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. During a recession, potential output (real GDP) will exceed actual output (real GDP). Choice

"a" is incorrect. Real GDP is falling during a recession.

Choice "b" is incorrect. The natural rate of unemployment will not be affected by the various phases of the business cycle. Actual unemployment will change with the cycle. Choice

"d" is incorrect. Actual output will not exceed potential output except at the peak of the cycle, and perhaps not then.

**QUESTION 136** A recession

can be caused by:

- A. An increase in aggregate demand.
- B. A decrease in aggregate supply.
- C. A decrease in aggregate demand.
- D. Both "b" and "c".

**Correct Answer: D**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Both choices "b" and "c" can cause a recession. A recession is defined as a period of falling GDP and rising unemployment. GDP will fall if there is a decrease in aggregate demand or a decrease in aggregate supply.

Choice "a" is incorrect. An increase in aggregate demand will cause GDP to increase NOT decrease. Choice "b" is incorrect, per the above Explanation. Choice "c" is incorrect, per the above Explanation.

**QUESTION 137** A period during which real GDP is rising and unemployment is

falling is called a(n):

- A. Recession.
- B. Peak.
- C. Expansion.
- D. Trough.

**Correct Answer: A**

**Section: Volume B****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. During an expansion, real GDP is rising and unemployment is falling.

Choice "a" is incorrect. A recession is when real GDP is falling NOT rising.

Choice "b" is incorrect. A peak is the highest point of economic activity. It is the point where real GDP is at its highest level in the cycle and unemployment is at its lowest level in the cycle.

Choice "d" is incorrect. A trough is the lowest level of economic activity. It is the point where real GDP is at its lowest level in the cycle and unemployment is at its highest level in the cycle.

**QUESTION 138** Which of the following might be considered the most expansionary set of fiscal policies?

- A. Increase government purchases, increase in taxes.
- B. Increase government purchases, decrease in taxes.
- C. Decrease in taxes, increase in the money supply.
- D. Increase in government purchases, increase in the money supply.

**Correct Answer: B**

**Section: Volume B****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Expansionary fiscal policy involves increasing government purchases and/or decreasing taxes. Both increases in government spending and decreases in taxes cause the aggregate demand curve to shift right and thus cause real GDP (output) to increase.

Choice "a" is incorrect. An increase in taxes is an example of contractionary fiscal policy.

Choice "c" is incorrect. An increase in the money supply is expansionary monetary policy (not fiscal policy). Choice

"d" is incorrect per above Explanation.

**QUESTION 139** An increase in government spending will tend to cause:

- A. Real GDP to fall and unemployment to rise.
- B. Real GDP to rise and unemployment to fall.
- C. Real GDP to rise and unemployment to rise.
- D. Real GDP to fall and unemployment to fall.

**Correct Answer: B**

**Section: Volume B****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. An increase in government spending causes an increase in aggregate demand (i.e., causes the aggregate demand curve to shift right). As a result, an increase in government spending causes real GDP to rise and unemployment to fall.

Choice "a" is incorrect. Real GDP will rise, not fall.

Choice "c" is incorrect. Unemployment will fall, not rise. Choice

"d" is incorrect. Real GDP will rise, not fall.

**QUESTION 140** An increase in the personal income tax will tend to cause:

- A. Real GDP to fall and unemployment to rise.



- B. Real GDP to rise and unemployment to fall.
- C. Real GDP to rise and unemployment to rise.
- D. Real GDP to fall and unemployment to fall.

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. An increase in the personal income tax will cause a decrease in aggregate demand (i.e., causes the aggregate demand curve to shift left). As a result, an increase in taxes causes real GDP to fall and unemployment to rise.

Choice "b" is incorrect. Real GDP will fall, not rise.

Choice "c" is incorrect. Real GDP will fall, not rise.

Choice "d" is incorrect. Unemployment will rise, not fall.

**QUESTION 141** Which one of the following most accurately describes the normal sequence of a business cycle?

- A. Expansion, contraction, trough, and peak. B.
- Expansion, peak, contraction, and trough. C.
- Peak, contraction, expansion, and trough.
- D. Trough, contraction, expansion, and peak.

**Correct Answer:** B

**Section:** Volume B

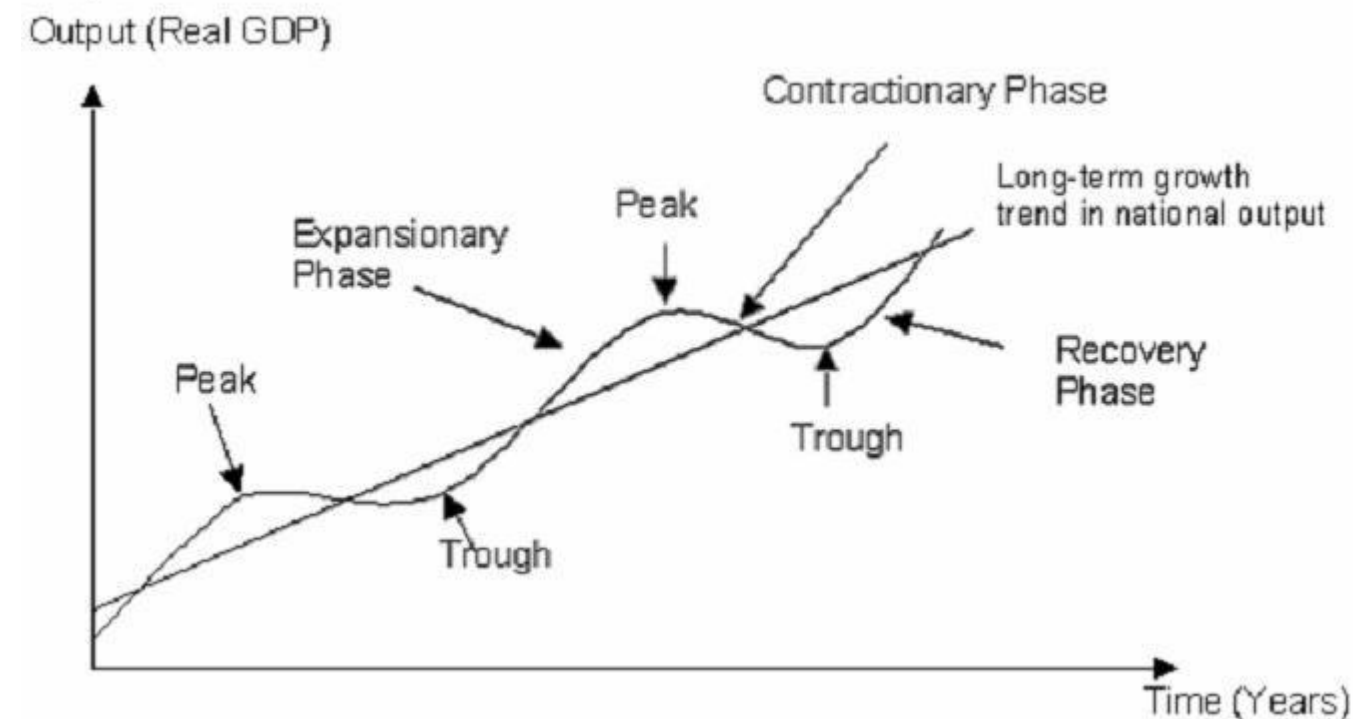
**Explanation**

**Explanation/Reference:**

Explanation:



**Graph A**



Choice "b" is correct. The sequence of a typical business cycle includes an expansionary phase, a peak of economic activity, a contractionary phase, and a trough of economic activity. Choice "a" is incorrect. A peak does not follow a trough.

Choice "c" is incorrect. A trough does not follow an expansion.  
Choice "d" is incorrect. A contraction does not follow a trough.

#### QUESTION 142

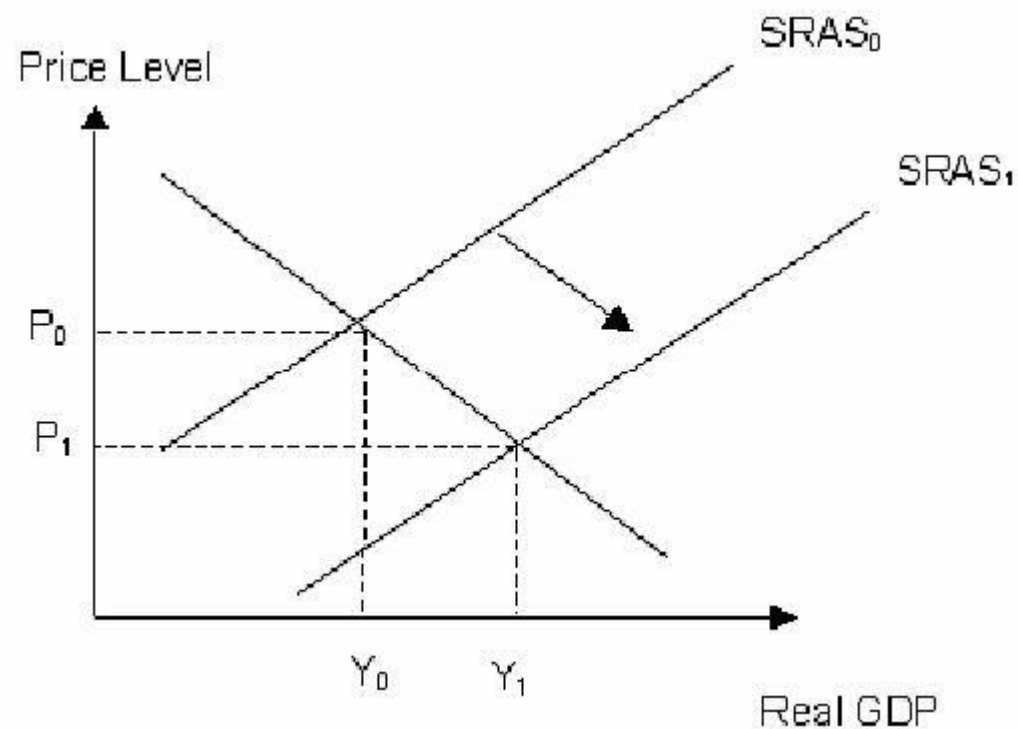
Within the framework of the aggregate demand/aggregate supply model, an increase in short run aggregate supply will cause:

- A. Real output to expand and the price level to fall.
- B. Real output to decline and the price level to rise.
- C. Real output to expand and the price level to rise.
- D. Real output to decline and the price level to fall.

**Correct Answer: A**  
**Section: Volume B**

#### Explanation

**Explanation/Reference:**  
Explanation:



Choice "a" is correct. A shift right in short run aggregate supply causes output to increase and the price level to fall.  
Choice "b" is incorrect. Real output would rise, not fall.  
Choice "c" is incorrect. The price level would fall, not rise. Choice  
"d" is incorrect. Real output would rise, not fall.

**QUESTION 143** Which one of the following is most likely to accompany a reduction in aggregate demand?

- A. An increase in the price level.
- B. A decrease in employment.
- C. An increase in real GDP.
- D. A decrease in the unemployment rate.

**Correct Answer: B**  
**Section: Volume B**

#### Explanation

**Explanation/Reference:**

Explanation:

Choice "b" is correct. As aggregate demand falls, the unemployment rate rises so employment would decrease.

Choice "a" is incorrect. The price level would fall, not rise.

Choice "c" is incorrect. Real GDP would fall, not rise.

Choice "d" is incorrect. The unemployment rate would rise, not fall.

**QUESTION 144**

If an economy is currently experiencing both full employment and price stability, a major tax reduction will probably cause:

- A. An increase in the unemployment rate.
- B. An acceleration in the inflation rate, unless government expenditures are also reduced.
- C. No change in real GDP or the price level.
- D. A decrease in consumption.

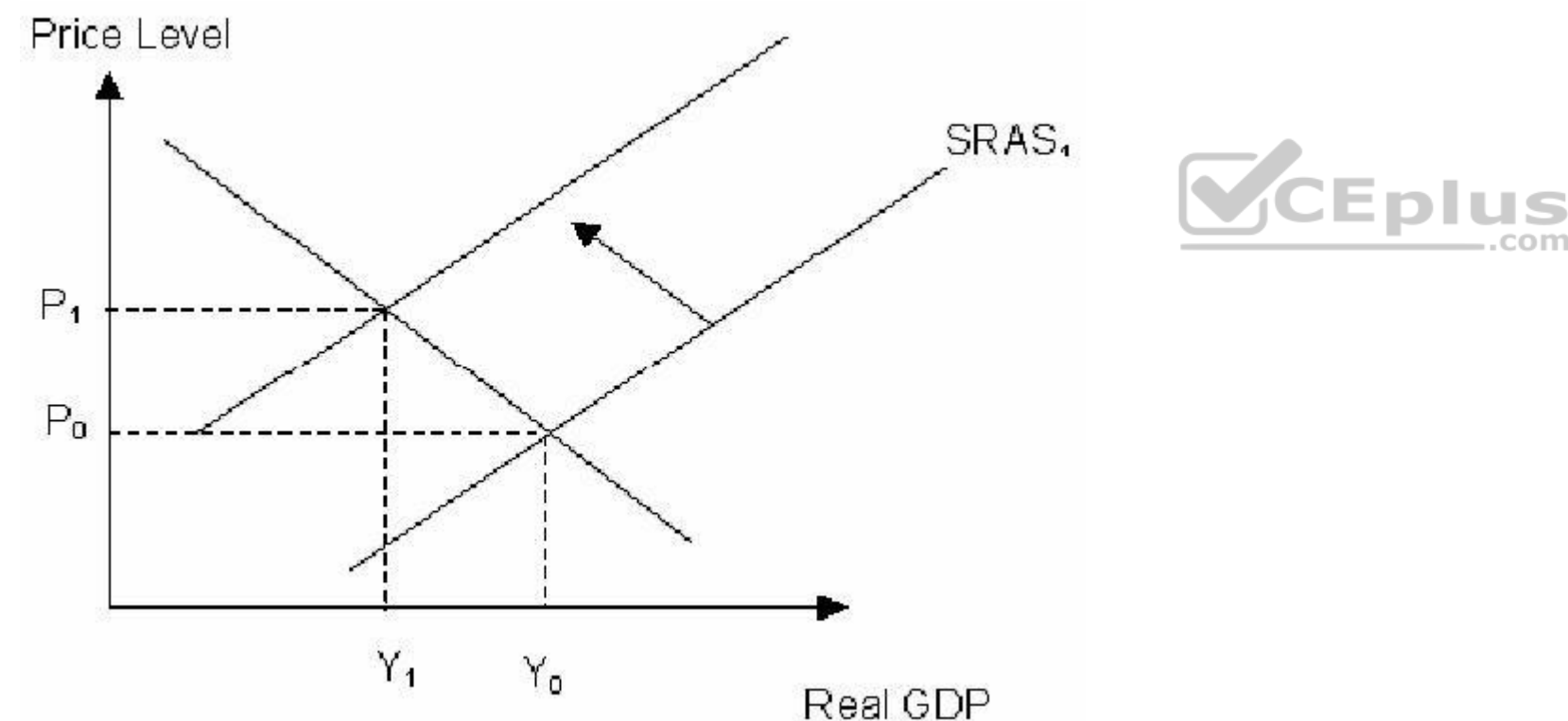
**Correct Answer: B**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "b" is correct. A tax cut shifts the aggregate demand curve to the right causing the price level and therefore the inflation rate to rise. Choice

"a" is incorrect. The unemployment rate would fall, not rise.

Choice "c" is incorrect. The price level would rise, not remain unchanged.

Choice "d" is incorrect. Consumption would rise as disposable income rises, not fall.

**QUESTION 145**

If the U.S. dollar increases in value relative to the other major currencies, aggregate demand should:

- A. Increase as U.S. goods become more attractive overseas.
- B. Decrease as U.S. goods become less attractive overseas.
- C. Depends on supply of foreign goods.

D. Not necessarily change.

**Correct Answer:** B

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. If the dollar gains in value, net exports will suffer as U.S. goods become more expensive overseas; hence aggregate demand will decrease. The supply of foreign goods domestically should increase as imports become cheaper.

Choice "a" is incorrect. Demand should decrease, not increase.

Choice "c" is incorrect. Irrelevant to the question.

Choice "d" is incorrect. Demand should decrease, not remain the same.

**QUESTION 146** A large increase in nominal wages, perhaps orchestrated by unions, would most likely result in:

A. An increase in real GDP and a decrease in the price level.

B. A decrease in real GDP and an increase in the price level.

C. A decrease in real GDP and a decrease in the price level.

D. An increase in real GDP and an increase in the price level.

**Correct Answer:** B

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. An increase in nominal wages represents an increase in input costs. This would shift the aggregate supply curve to the left resulting in a decrease in real GDP and an increase in the overall price level. Choice "a" is incorrect. Real GDP would decrease, not increase.

Choice "c" is incorrect. The price level would increase, not decrease.

Choice "d" is incorrect. Real GDP would decrease, not increase.

**QUESTION 147** Economic fluctuations (or business cycles) are best described as:

A. Long run increases in a nations standard of living.

B. Changes in the profits of a given firm from one year to the next.

C. Fluctuations of equal duration and equal severity in the level of economic activity over time.

D. Fluctuations in the level of economic activity, relative to a long-term growth trend.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. By the definition of business cycles.

Choice "a" is incorrect. This is economic growth.

Choice "b" is incorrect. Business cycles refer to overall economic activity not the activity of one firm.

Choice "c" is incorrect. Business cycles are not predictable and are not of equal duration nor of equal severity.

**QUESTION 148** Which of the following would most likely cause real GDP to increase the most:

- A. A rise in interest rates and a rise in input costs.
- B. A fall in interest rates and a fall in input costs.
- C. A rise in wealth and a rise in interest rates.
- D. A rise in consumer confidence and a fall in government spending.

**Correct Answer:** B

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A decline in interest rates would cause the aggregate demand curve to shift right, which increases real GDP. Similarly, a decline in input costs would cause the aggregate supply curve to shift right, which also increases real GDP.

Choice "a" is incorrect. Both of these events would cause real GDP to decline.

Choice "c" is incorrect. A rise in interest rates would cause real GDP to decline, not increase.

Choice "d" is incorrect. A decline in government spending would cause real GDP to decline, not increase.

**QUESTION 149** At the peak of a business cycle:

- A. Output (real GDP) tends to be below the potential level of output.
- B. There is likely to be an excess supply of labor and business inventories are likely to be high.
- C. The overall price level is likely to be falling.
- D. Capacity constraints and labor shortages are likely to put upward pressure on the overall price level.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The peak of a business cycle marks the highest point of economic activity. At that point, firms are likely to face capacity constraints and labor shortages, which will put upward pressure on the overall price level. Choice "a" is incorrect. Real GDP is likely to be above, not below, its potential level.

Choice "b" is incorrect. Business inventories are likely to be low, not high, and there is likely to be excess demand for labor not an excess supply of labor. Choice

"c" is incorrect. The overall price level is likely to be rising not falling.

**QUESTION 150** Which of the following segments of the economy will be least affected by the business cycle?

- A. Commercial construction industry.
- B. Machinery and equipment industry.
- C. Residential construction industry.
- D. Healthcare industry.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The business cycle is the rise and fall of economic activity relative to its long-term growth trend. During a contraction or a recession, most industries experience a decline in sales and profits. Similarly, during an expansion, most industries experience an increase in sales and profits.

However, health care services are typically not affected by business cycles. People need medical services regardless of whether or not the economy is doing well. Thus, the health care industry is the least affected by the business cycle.

Choice "a" is incorrect. During a downturn in economic activity (recession or contraction), firm investment in new plants and equipment typically drops off substantially. Thus, the demand for commercial construction is typically low during a contraction and high during an expansion. Thus, the commercial construction industry is sensitive to the business cycle.

Choice "b" is incorrect. During a downturn in economic activity (recession or contraction) firm investment in new plants and equipment typically drops off substantially. Thus, the machinery and equipment industry is sensitive to business cycles. Sales grow during an expansion, but they tend to decline during a contraction or recession.

Choice "c" is incorrect. The residential construction industry is sensitive to interest rates, unemployment rates, and consumer wealth. All of these fluctuate with the business cycle. As a result, the residential construction industry is sensitive to the business cycle.

**QUESTION 151** An auditor is required to obtain an understanding of the entity's business, including business cycles and reasons for business fluctuations. What is the audit purpose most directly served by obtaining this understanding?

- A. To enable the auditor to accurately identify significant deficiencies.
- B. To assist the auditor to accurately interpret information obtained during an audit.
- C. To allow the auditor to more accurately perform tests of controls.
- D. To decide whether it will be necessary to perform analytical procedures.

**Correct Answer: B**

**Section: Volume B**

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "b" is correct. As part of audit planning, the auditor should obtain an understanding of the entity's business. This understanding enables the auditor to better understand events, transactions, and practices that may affect the financial statements, to plan and perform appropriate audit tests, and to properly understand and evaluate the results of those tests.

Choice "a" is incorrect. Obtaining an understanding of the entity's business would not be particularly helpful in identifying significant deficiencies. Significant deficiencies in internal control are typically identified during the fieldwork stage of the audit.

Choice "c" is incorrect. Obtaining an understanding of the entity's business would not result in a more accurate performance of tests of controls. Accurate performance of audit tests is dependent upon factors such as existence of an appropriate audit trail, client cooperation, training and supervision of audit staff, etc.

Choice "d" is incorrect. Analytical procedures are always required in an audit during the planning and overall review stages.

#### QUESTION 152

Which of the following statements is correct if there is an increase in the resources available within an economy?

- A. More goods and services will be produced in the economy.
- B. The economy will be capable of producing more goods and services.
- C. The standard of living in the economy will rise.
- D. The technological efficiency of the economy will improve.

**Correct Answer: B**

**Section: Volume B**

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "b" is correct. If there is an increase in the resources available in an economy, the economy will be capable of producing more goods and services. This increase is really an increase in the long-run aggregate supply (potential GDP). On the aggregate supply and demand chart, the long-run aggregate supply line (LRAS) is the vertical line that represents the potential or equilibrium level of output. If that line shifts to the right, then the economy is capable of expanding, but it will not automatically expand just because the line shifts to the right.

Choice "a" is incorrect. Just because there is an increase in the resources available in an economy, it does not mean that more goods and services will automatically be produced. There would have to be increased demand (a shift upward in the aggregate demand line) for more goods and services to actually be produced.

Choice "c" is incorrect. If there is an increase in the resources available in an economy, the standard of living in the economy will not necessarily rise. It could rise, but it will not necessarily do that.

Choice "d" is incorrect. If there is an increase in the resources available in an economy, the technological efficiency of the economy will not automatically improve. This statement is backwards. An increase in technological efficiency of an economy will normally increase the resources available in the economy by increasing productivity.

#### QUESTION 153 A

period of inflation:

- A. Increases the price level, which benefits those who are entitled to receive specific amounts of money.
- B. Enhances the positive relationship between the price level and the purchasing power of money.
- C. Harms anyone who has an obligation to pay a specific amount and benefits anyone who is entitled to receive a specific amount.



D. Increases the price level, which is negatively related to the purchasing power of money.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. A period of inflation increases the price level, which is negatively related to the purchasing power of money (inflation erodes the value of money).

Choice "a" is incorrect. When price levels increase, those with fixed amounts of money are hurt.

Choice "b" is incorrect. The relationship between price levels and the purchasing power of money is negative, or inverse.

Choice "c" is incorrect. Inflation helps anyone with a fixed obligation since the debt can be repaid in inflated dollars. Those receiving a specific fixed amount are harmed.

#### QUESTION 154

Which of the following would lead to the most inflation?

A. Both aggregate demand and aggregate supply increase.

B. Both aggregate demand and aggregate supply decrease.

C. Aggregate demand increases and aggregate supply decreases.D. Aggregate demand decreases and aggregate supply increases.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Choice "c" contains both demand-pull inflation (when the aggregate demand curve shifts right) and cost-push inflation (when the aggregate supply curve shifts left). An increase in aggregate demand causes output to rise and the price level to rise. A decrease in aggregate supply causes output to fall and the price level to rise. Thus, an increase in aggregate demand and a decrease in aggregate supply is the most inflationary. Choice "a" is incorrect. If aggregate supply increases, the price level will fall (reducing inflation).

Choice "b" is incorrect. If aggregate demand decreases, the price level will fall (reducing inflation). Choice

"d" is incorrect per above Explanation.

**QUESTION 155** Which of the following is not consistent with full employment?

A. An unemployment rate greater than zero.

B. Structural unemployment.

C. Cyclical unemployment.

D. Frictional unemployment.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. When the economy is operating at full employment, there is no cyclical unemployment. When the economy is operating at full employment, there is still some unemployment known as the natural rate of unemployment, which does not include cyclical unemployment.

Choice "a" is incorrect. There is still some unemployment (frictional, structural, and seasonal) when the economy is operating at full employment. Choice

"b" is incorrect, per the above Explanation.

Choice "d" is incorrect, per the above Explanation.

**QUESTION 156** Cyclical unemployment results from:

- A. Skills of workers not corresponding to jobs available.
- B. The time it takes to match qualified workers with available jobs.
- C. Seasonal decreases in demand for labor.
- D. A recession in the economy.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Cyclical Unemployment is caused by the business cycle. It tends to rise during a recession and fall during an expansion.

Choice "a" is incorrect. This is an example of structural unemployment. Choice "b" is incorrect. This is an example of frictional unemployment.

Choice "c" is incorrect. This is an example of seasonal unemployment.

**QUESTION 157** A sharp rise in the price of oil (a major input), would result in:

- A. Cost (Push) inflation.
- B. Demand (Pull) inflation.
- C. An increase in aggregate demand.
- D. An increase in aggregate supply.

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "a" is correct. Cost (Push) inflation is inflation caused by a shift left in aggregate supply. An increase in input costs, such as a sharp increase in the price of oil, will cause the aggregate supply curve to shift left and thus increase the aggregate price level causing inflation.

Choice "b" is incorrect. Demand (Pull) inflation is inflation caused by a shift right in aggregate demand.

Choice "c" is incorrect. An increase in the price of oil causes the aggregate supply curve to shift, not the aggregate demand curve. Choice

"d" is incorrect. An increase in the price of oil will cause aggregate supply to decrease (shift left), not increase.

**QUESTION 158**

During a period of high inflation, which of the following groups in society would be most likely to gain?

- A. Those with a fixed income.
- B. Those with a fixed amount of debt.
- C. Those holding a large amount of money.
- D. Workers under contract without a cost of living adjustment.

**Correct Answer:** B

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. During a period of high inflation, those with a fixed amount of debt will repay their debt with inflated dollars and are thus likely to gain.

Choice "a" is incorrect. Those with a fixed income will see the purchasing power of their income erode and are thus likely to be hurt.

Choice "c" is incorrect. Those holding a large amount of money will see the purchasing power of their money erode and are thus likely to be hurt. Choice

"d" is incorrect. Cost of living adjustments take inflation into account, thus these individuals are likely to be unaffected.

**QUESTION 159** Frictional unemployment refers to unemployment resulting from:

- A. The skills of workers do not correspond to the skills demanded by employers.
- B. The time needed to match qualified job seekers with available jobs.
- C. Seasonal decreases in demand for labor.
- D. A recession in the economy.

**Correct Answer:** B  
**Section:** Volume B

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. Frictional unemployment is the unemployment that arises from workers routinely changing jobs or from workers being temporarily laid off. It results from the time needed to match qualified job seekers with available jobs.  
Choice "a" is incorrect. This is structural unemployment.  
Choice "c" is incorrect. This is seasonal unemployment.  
Choice "d" is incorrect. This is cyclical unemployment.

**QUESTION 160** The measure most often used to compare standards of living across countries or across time is:

- A. Government spending.
- B. Real GDP.
- C. Real consumption expenditures.
- D. Real GDP per capita.

**Correct Answer:** D  
**Section:** Volume B  
**Explanation**



**Explanation/Reference:**  
Explanation:

Choice "d" is correct. Real GDP per capita is real GDP divided by population. Real GDP per capita is typically used to compare standards of living across countries or across time. By dividing real GDP by population, this measure adjusts for differences in the size of countries and for differences in population over time.  
Choice "a" is incorrect. Government spending is not a measure of the standard of living of a country.  
Choice "b" is incorrect. Countries with larger populations tend to have higher levels of real GDP. This however does not mean they have a higher standard of living. To adjust for differences in population, real GDP per capita is typically used to compare standards of living, not real GDP.  
Choice "c" is incorrect. Real consumption expenditures are only a part of real GDP and thus do not measure all economic activity. Furthermore, real consumption expenditures do not adjust for differences in population. It is therefore not used as a measure of the standard of living.

**QUESTION 161** The determination of gross domestic product (GDP) by the expenditure approach would include:

- A. Net exports.
- B. Business profits.
- C. Compensation to employees.
- D. A capital consumption allowance.

**Correct Answer:** A  
**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The expenditure approach to computing GDP includes:

Consumption

Net exports

Government expenditures

Capital investment

Choices "b", "c", and "d" are incorrect, per the Explanation above.

**QUESTION 162** Under the expenditure approach, GDP can be calculated as the sum of:

- A. Consumption, money supply, government purchases, and exports.
- B. Consumption, investment, transfer payments, and imports.
- C. Consumption, investment, government purchases, and net exports.
- D. Consumption, investment, government purchases, and foreign exchange.

**Correct Answer: C**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Under the expenditure approach, GDP is calculated as the sum of: consumption expenditures + investment expenditures + government purchases + net exports. Choice "a" is incorrect. See definition above.

Choice "b" is incorrect. See definition above.

Choice "d" is incorrect. See definition above.



**QUESTION 163** The discount rate set by the Federal Reserve is the:

- A. Rate that commercial banks charge for loans to each other.
- B. Rate that commercial banks charge for loans to the general public.
- C. Rate that the central bank charges for loans to commercial banks.
- D. Ratio of a bank's reserves to its demand deposits.

**Correct Answer: C**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The discount rate refers to the rate established by the Federal Reserve for shortterm (often overnight) loans the Fed makes to member banks. Choice "a" is incorrect. The discount rate is the rate the Federal Reserve charges.

Choice "b" is incorrect per above Explanation.

Choice "d" is incorrect. This would be the bank's reserve ratio - not the discount rate.

**QUESTION 164** All of the following actions are valid tools that the Federal Reserve Bank uses to control the supply of money, except:

- A. Selling government securities.
- B. Changing the reserve ratio.
- C. Raising or lowering the discount rate.
- D. Printing money when the money supply appears low.

**Correct Answer:** D  
**Section:** Volume B  
**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. The treasury prints money. The Fed must increase the money supply through:

1. Federal open market committee (FOMC) purchasing or selling government securities, 2. Raising or lowering the discount rate, or
  3. Changing the reserve ratio.
- Choices "a", "b", and "c" are incorrect because they are all valid tools to control the supply of money.

**QUESTION 165**

If the Federal Reserve wanted to implement an expansionary monetary policy, which one of the following actions would the Federal Reserve take?

- A. Raise the reserve requirement and the discount rate.
- B. Purchase additional U.S. government securities and lower the discount rate.
- C. Raise the discount rate and sell U.S. government securities.
- D. Lower the discount rate and raise the reserve requirement.

**Correct Answer:** B  
**Section:** Volume B

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. Fed purchases of government securities increase the money supply (putting money into circulation), and lowering the discount rate encourages borrowing by member banks and increases the money supply. Hence, these measures would help implement an expansionary monetary policy.

Choice "a" is incorrect. Raising the reserve requirement and the discount rate would have the opposite effect of decreasing the money supply.

Choice "c" is incorrect. Raising the discount rate and selling government securities would reduce the money supply.

Choice "d" is incorrect. Raising the reserve requirement would decrease the money supply, but lowering the discount rate would increase the money supply.

**QUESTION 166** To decrease the money supply, the Fed might:

- A. Sell government securities on the open market. B. Buy government securities on the open market.
- C. Decrease the required reserve ratio.
- D. Lower the discount rate.

**Correct Answer:** A  
**Section:** Volume B

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. To decrease the money supply, the Fed can: (1) sell government securities in the open market, (2) increase the discount rate, and (3) increase the required reserve ratio. Choice "b" is incorrect. The Fed should sell (not buy) securities on the open market.

Choice "c" is incorrect. The Fed should increase (not decrease) the required reserve ratio.

Choice "d" is incorrect. The Fed should increase (not decrease) the discount rate.

**QUESTION 167** Which of the following correctly lists the three ways to increase the money supply?

- A. Raise the required reserve ratio, increase the discount rate, sell bonds in the open market.
- B. Raise the required reserve ratio, increase the discount rate, buy bonds in the open market.
- C. Lower the required reserve ratio, increase the discount rate, buy bonds in the open market.
- D. Lower the required reserve ratio, decrease the discount rate, buy bonds in the open market.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The three ways the Fed can increase the money supply are: (1) buy (purchase) government securities in the open market, (2) lower the discount rate, and (3) lower the required reserve ratio. Choice "a" is incorrect, per above Explanation.

Choice "b" is incorrect, per above Explanation.

Choice "c" is incorrect, per above Explanation.

**QUESTION 168** An increase in the money supply leads to:

- A. A decline in interest rates, an increase in investment and an increase in aggregate demand.
- B. A decline in interest rates, a decrease in investment and an increase in aggregate demand.
- C. An increase in interest rates, a decrease in investment and a decrease in aggregate demand.
- D. An increase in the money supply has no effect on interest rates or investment.

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Expansionary monetary policy results when the Fed increases the money supply. Expansionary monetary policy affects the economy through the following chain of events: (1) an increase in the money supply causes interest rates to fall, (2) falling interest rates stimulate the desired levels of firm investment and household consumption, (3) increases in desired investment and consumption cause an increase in aggregate demand, and (4) aggregate demand shifts to the right causing real GDP and the price level to rise.

Choice "b" is incorrect. An increase in the money supply causes investment to increase, not decrease.

Choice "c" is incorrect. An increase in the money supply causes interest rates to decrease, not increase, investment to increase, not decrease and aggregate demand to increase, not decrease. Choice "d" is incorrect per above Explanation.

**QUESTION 169**

Which of the following is most likely to cause an increase in the amount of frictional unemployment in an economy?

- A. An invention that renders an industry obsolete.
- B. A downturn in aggregate business activity.
- C. An increase in the average age of the work force.
- D. A reduction in the average age of the work force.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Younger workers tend to move between jobs more frequently.

Choice "a" is incorrect. This would lead to structural unemployment.

Choice "b" is incorrect. This would lead to cyclical unemployment.



Choice "c" is incorrect. Older workers tend to be voluntarily between jobs less frequently than younger workers.

**QUESTION 170** Which of the following would lead to a reduction in inflation?

- A. Increasing aggregate demand and increasing aggregate supply.
- B. Decreasing aggregate demand and increasing aggregate supply.
- C. Decreasing aggregate demand and decreasing aggregate supply.
- D. Increasing aggregate demand and decreasing aggregate supply.

**Correct Answer: B**  
**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Decreasing aggregate demand and increasing aggregate supply will reduce the inflationary pressures.  
Choice "a" is incorrect. Increasing aggregate demand causes the price level to rise.  
Choice "c" is incorrect. Decreasing aggregate supply causes the price level to rise.  
Choice "d" is incorrect. Both of these would cause the price level to rise.

**QUESTION 171**

Initially the nominal interest rate is 8 percent and the inflation rate is 6 percent. One year later, the nominal interest rate rises to 12 percent while the inflation rate rises to 10 percent. It follows that the real rate of interest:

- A. Has remained the same.
- B. Has fallen.
- C. Has risen.
- D. Insufficient information given for an answer.

**Correct Answer: A**  
**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The real interest rate equals the nominal interest rate minus the inflation rate. Thus, the real interest rate in the first year is:  $\text{real interest rate} = 8 - 6 = 2$  and the real interest rate in the next year is:  $\text{real interest rate} = 12 - 10 = 2$ .

**QUESTION 172**

If consumption is \$70b, investment \$50b, government spending \$20b, exports \$7b, and imports \$5b, what is GDP?

- A. \$152b.
- B. \$138b.
- C. \$140b.
- D. \$142b.

**Correct Answer: D**  
**Section: Volume B**  
**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. By the expenditure approach to measuring GDP, GDP equals: Consumption + Investment + Government Spending + Exports - Imports. Thus,  $\text{GDP} = 70 + 50 + 20 + 7 - 5 = 142\text{b}$ .



**QUESTION 173** When a worker quits work to stay at home with the children, it is an example of:

- A. Frictional unemployment.
- B. Structural unemployment.
- C. Cyclical unemployment.
- D. Not counted in unemployment figures.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Unemployment only tallies workers actively seeking employment; it does not count retirees or stay-at-home parents.

Choice "a" is incorrect. Frictional unemployment describes workers who leave work voluntarily to seek a better position.

Choice "b" is incorrect. Structural unemployment describes workers whose skills are no longer needed.

Choice "c" is incorrect. Cyclical unemployment describes workers unemployed due to the business cycle.

**QUESTION 174** The CPI jumps from 131 in year 1 to 136.5 in year 2. What is annual inflation rate?

- A. 4.2%
- B. 3%
- C. 1.38%
- D. 13.8%

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The inflation rate is measured as:

$$\text{Inflation Rate} = \frac{\text{CPI}_{\text{this period}} - \text{CPI}_{\text{last period}}}{\text{CPI}_{\text{last period}}} \times 100$$

$$\text{Inflation Rate} = \frac{136.5 - 131}{131} \times 100 \approx 4.2\%$$

**QUESTION 175** The

inflation rate measures:

- A. The rate at which nominal GDP increases.
- B. How the price of a particular good changes over time.
- C. How nominal interest rate changes over time.
- D. The rate at which the overall price level increases.

**Correct Answer:** D

**Section:** Volume B

**Explanation**



**Explanation/Reference:**

Explanation:

Choice "d" is correct. The inflation rate measures the rate of increase in the overall price level in the economy.

Choice "a" is incorrect. The inflation rate is associated with price level changes not changes in the nominal value of output.

Choice "b" is incorrect. Inflation refers to a sustained increase in the overall price level. Not the price of a particular good. Choice

"c" is incorrect. The inflation rate is associated with price level changes not interest rate changes.

**QUESTION 176**

Stagflation refers to:

- A. A combination of rising unemployment and rising real GDP.
- B. A combination of rising unemployment and a rising price level.
- C. High inflation rates.
- D. High unemployment rates.

**Correct Answer: B**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Stagflation occurs when the economy suffers a recession that is characterized by falling output, rising unemployment, and a rising price level.

Choice "a" is incorrect. Real GDP is falling during stagflation, not rising.

Choice "c" is incorrect. High inflation rates is just one aspect of stagflation; the other is falling output and rising unemployment.

Choice "d" is incorrect. High unemployment rates are just one aspect of stagflation; the other is a rising overall price level (high inflation).

**QUESTION 177** When the overall price level is rising, nominal interest rates tend to be:

- A. Unaffected by changes in the price level.
- B. Falling.
- C. Rising.
- D. None of the above.

**Correct Answer: C**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The relationship between nominal interest rates and inflation can be seen by rearranging the equation for real interest rates as follows:

Nominal Interest Rate = Real Interest Rate + Inflation

Thus, if real interest rates do not change, a 1% increase in the inflation rate will lead to a 1% increase in nominal interest rates.

**QUESTION 178** Inflation

can be caused by:

- A. Increases in aggregate demand only.
- B. Increases in aggregate supply only.
- C. Decreases in aggregate demand and increases in aggregate supply.
- D. Increases in aggregate demand and decreases in aggregate supply.

**Correct Answer: D**

**Section: Volume B****Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Both an increase in aggregate demand and a decrease in aggregate supply can cause inflation.  
Choice "a" is incorrect. While an increase in aggregate demand can cause inflation, it is not the only cause of inflation.  
Choice "b" is incorrect. An increase in aggregate supply would lower the overall price level, not increase the overall price level.  
Choice "c" is incorrect. A decrease in aggregate demand would lower the overall price level, not increase the overall price level.

**QUESTION 179**

To address the problem of a recession, the Federal Reserve Bank most likely would take which of the following actions?

- A. Lower the discount rate it charges to banks for loans.
- B. Sell U.S. government bonds in open-market transactions.
- C. Increase the federal funds rate charged by banks when they borrow from one another.
- D. Increase the level of funds a bank is legally required to hold in reserve.

**Correct Answer: A**

**Section: Volume B****Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. During a recession, real GDP has fallen and unemployment has risen. To stimulate the economy, the Fed can lower the discount rate. This causes the money supply to increase, which, in turn, causes aggregate demand to shift right. As a result, real GDP would increase and unemployment would decrease.  
Choice "b" is incorrect. If the Fed sells U.S. government bonds in the open market, the money supply will decrease. This causes aggregate demand to shift left. As a result, real GDP would decrease and unemployment would increase. Choice "c" is incorrect. Increasing the federal funds rate would increase interest rates. Higher interest rates cause the aggregate demand curve to shift left. As a result, real GDP would decrease and unemployment would increase.  
Choice "d" is incorrect. An increase in the required reserve ratio causes the money supply to decrease. This causes aggregate demand to shift left. As a result, real GDP would decrease and unemployment would increase.

**QUESTION 180** Which of the following actions is the acknowledged preventive measure for a period of deflation?

- A. Increasing interest rates.
- B. Increasing the money supply.
- C. Decreasing interest rates.
- D. Decreasing the money supply.

**Correct Answer: B**

**Section: Volume B****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Deflation is a general decline in the overall price level (i.e., when the inflation rate is negative). Increasing the money supply causes the overall price level to rise. As a result, it helps eliminate deflation.  
Choice "a" is incorrect. Increasing interest rates causes aggregate demand to shift left. As a result, the aggregate price level will fall even further. This will exasperate deflation.  
Choice "c" is not wrong but it is not as good an answer as "b". A decrease in interest rates causes the aggregate demand curve to shift right. As a result, the aggregate price level will rise. This helps eliminate deflation. However, there are times when interest rates are already so low that lowering interest rates is not an option. Thus, the preferred or "acknowledged" preventative measure for deflation is increasing the money supply. Choice "d" is incorrect. Decreasing the money supply causes the overall price level to fall. This would obviously exasperate deflation.

**QUESTION 181**

All of the following are components of the formula used to calculate gross domestic product, except:

- A. Household income.
- B. Foreign net export spending.
- C. Government spending.
- D. Gross investment.

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Gross domestic product (GDP) is calculated in two different ways. The first, which is the expenditure approach and can be used to answer this question, is the mnemonic GICE, or government purchases plus private domestic investment plus personal consumption expenditures plus net exports. Household income is the only one of the answers that is not included in this mnemonic.

Choice "b" is incorrect. Foreign net export spending is included in the mnemonic (E) for GDP; although, it is called simply net exports in the mnemonic and not foreign net export spending.

Choice "c" is incorrect. Government spending is included in the mnemonic (G) for GDP.

Choice "d" is incorrect. Gross investment is included in the mnemonic (I) for GDP, although it is called private domestic investment in the mnemonic.

**QUESTION 182** Gross domestic product includes which of the following measures?

- A. The size of a population that must share a given output within one year.
- B. The negative externalities of the production process of a nation within one year.
- C. The total monetary value of all final goods and services produced within a nation in one year.
- D. The total monetary value of goods and services including barter transactions within a nation in one year.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Gross domestic product (GDP) is the total dollar (monetary) value of all new final products and services produced with the economy in a given time period. The emphasis is on the final goods and services.

Choice "a" is incorrect. The size of a population that must share a given output within one year is not a part of the GDP calculation.

Choice "b" is incorrect. The negative (or positive) externalities of the production process of a nation within one year are not a part of the GDP calculation. In economics, externalities are the effects that the acts of consumers or producers have on each other. Externalities range from technological changes to changes in the range of options available to consumers. Externalities may also be regarded as the unanticipated side effects of courses of action. Choice "d" is incorrect. The total monetary value of goods and services, including barter transactions, is not a part of the GDP calculation. GDP includes only monetary value, not barter value.

**QUESTION 183**

Which of the following is correct regarding the consumer price index (CPI) for measuring the estimated decrease in a company's buying power?

- A. The CPI is measured only once every 10 years.
- B. The products a company buys should differ from what a consumer buys.
- C. The CPI measures what consumers will pay for items.
- D. The CPI is skewed by foreign currency translations.

**Correct Answer:** B

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The consumer price index measures the costs of a market basket of specific goods commonly purchased by consumers. It measures consumer buying power and is not distorted by items generally bought by industry. Choice "a" is incorrect. The Consumer Price Index (CPI) represents monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services. Choice "c" is incorrect. The Consumer Price Index measures what has been paid for items, not what consumers will pay for items. Choice "d" is incorrect. The Consumer Price Index measures what has been paid by consumers in over eighty urban areas in the United States. The amounts paid are denominated in US dollars and would not be skewed by foreign currency translations.

#### QUESTION 184

The following table contains Emerald Corp.'s quarterly revenues, in thousands, for the past three years. During that time, there were no major changes to Emerald's selling strategies and total capital investment.

<u>Year</u>	<u>1st Qtr.</u>	<u>2nd Qtr.</u>	<u>3rd Qtr.</u>	<u>4th Qtr.</u>
Year 1	500	500	550	750
Year 2	525	550	600	800
Year 3	550	525	625	850

Which of the following statements best describes the likely cause of the fluctuations in Emerald's revenues and the best response to those fluctuations?

- A. The fluctuations are from changes in the economy, and Emerald should examine its cost structure for potential changes.
- B. The fluctuations are from changes in the economy, and Emerald should manage its inventories and cash flow to match the cycle.
- C. The fluctuations are from the seasonal demand for Emerald's products, and Emerald should examine its cost structure for potential changes.
- D. The fluctuations are from the seasonal demand for Emerald's products, and Emerald should manage its inventories and cash flow to match the cycle.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Relatively stable demand over a three year period in each of the first three quarters of the year followed by an increase of between 40 and 50 percent in the final quarter of the year over average sales in the first three quarters in each of the three years presented is indicative of seasonal fluctuations in demand for Emerald's product that would require appropriate inventory management.

Choice "a" is incorrect. The consistent volume levels and fluctuation percentages displayed for the activity in each quarter for each year are indicative of changes in seasonal demand rather than changes in the economy generally.

Choice "b" is incorrect. The consistent volume levels and fluctuation percentages displayed for the activity in each quarter for each year are indicative of changes in seasonal demand rather than changes in the economy generally.

Choice "c" is incorrect. Relatively stable demand over a three year period in each of the first three quarters of the year followed by an increase of between 40 and 50 percent in the final quarter of the year over average sales in the first three quarters in each of the three years presented is indicative of seasonal fluctuations in demand for Emerald's product. The company should be more attentive to the timing of inventory purchases to meet demand, however, rather than the company's overall cost structure.

#### QUESTION 185

When markets are perfectly competitive, consumers:

- A. Have goods and services produced at the lowest cost in the long run.
- B. Must choose the brands they buy solely on the basis of informational advertising.
- C. Do not receive any consumer surplus unless producers choose to overproduce.
- D. Must search for the lowest price for the products they buy.

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Since price is barely sufficient to give a firm a normal profit and stay in business, the consumer obtains the product at as low a price as is economically feasible. In addition, every firm is forced to produce at the most efficient output rate.

Choice "b" is incorrect. Brand differentiation is present in monopolistic competition, not perfect competition.

Choice "c" is incorrect. This is a far-out distractor.

Choice "d" is incorrect. Also far out. Individual consumers are also price takers at the market equilibrium price.



**QUESTION 186** Which one of the following is not a key assumption of perfect competition?

- A. Customers are indifferent about which firm they buy from.
- B. The level of a firm's output is small relative to the industry's total output.
- C. Each firm can price its product above the industry price.
- D. There is freedom of entry into and exit out of the industry.

**Correct Answer: C**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A key assumption of perfect competition is that the firm is a "price taker," that is, it cannot fix the price. Accordingly, it is not true that each firm can price its product above the industry price. Key assumptions of perfect competition include:

- A. Customers are indifferent about which firm they buy from.
- B. The level of a firm's output is small relative to the industry's total output.
- D. There is freedom of entry into and exit out of the industry.

**QUESTION 187** In order to sell at the rate of output in markets controlled by monopolists, price is set where:

- A. Price equals marginal cost.
- B. Marginal revenue equals marginal cost.
- C. Marginal revenue equals average total cost.
- D. Price equals average total cost.



**Correct Answer: B**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. In order to sell at the rate of output in markets controlled by monopolists, the price is set where marginal revenue equals marginal cost. No matter which model is representative of the industry in which the firm operates, the firm will maximize profits by producing at  $MR = MC$ . The monopolist's price will be higher than MR.

Choice "a" is incorrect. Price exceeds both MR and MC.

Choices "c" and "d" are incorrect, which are far-out distractors.

**QUESTION 188** A natural monopoly exists because:

- A. The firm owns natural resources.
- B. Economic and technical conditions permit only one efficient supplier.
- C. The government is the only supplier.
- D. Other firms are unable to enter the industry.

**Correct Answer: B**

**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A natural monopoly exists when economic and technical conditions permit only one efficient supplier. Choice "a" is incorrect. Owning natural resources, even if they are unique, would not create a monopoly.

Substitutes for the resource may be available.

Choice "c" is incorrect. Government control may create a monopoly, but not a natural monopoly. This is a regulated monopoly. Choice "d" is incorrect. Barriers to entry help create a monopoly, but the product must be unique.

**QUESTION 189** Which one of the following statements concerning pure monopolies is correct?

- A. The demand curve of a monopolist is perfectly elastic.
- B. The price at which a monopolist maximizes its profit is where price equals both marginal cost and marginal revenue.
- C. A monopolist's marginal revenue curve lies below its demand curve.
- D. The supply curve of a monopolist is perfectly inelastic.

**Correct Answer: C**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. A monopolist's marginal revenue curve lies below its demand curve.

Choice "a" is incorrect. The demand curve of a monopolist is not perfectly elastic.

Choice "b" is incorrect. A monopolist sets its price higher than marginal revenue.

Choice "d" is incorrect. A monopolist can change the quantity supplied or fix the price but cannot do both simultaneously. In any case, its supply curve is not perfectly inelastic.

**QUESTION 190**

Karen Parker wants to establish an environmental testing company that would specialize in evaluating the quality of water found in rivers and streams. However, Parker has discovered that she needs either certification or approval from five separate local and state government agencies before she can commence business. Also, the necessary equipment to begin would cost several million dollars.

However, Parker believes that if she is able to obtain capital resources, she can gain market share from the two major competitors.

The large capital outlay necessary for the equipment is an example of a(n):

- A. Entry barrier.
- B. Minimum efficiency scale.
- C. Created barrier.
- D. External cost.

**Correct Answer: A**

**Section: Volume B**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Large capital (money) requirements are the basic example of barriers to entry. A barrier to entry effectively prevents firms from entering the market to compete against existing firms. Choice

"b" is incorrect. Minimum efficient scale is the output level at which long run average costs are minimized. Here, Parker has not even been able to enter the industry.

Choice "c" is incorrect. A created barrier is made by firms already in the industry. Here, Parker's barrier was not created.

Choice "d" is incorrect. An external cost is a cost that the company does not account for, but passes on to the detriment of society.

**QUESTION 191** Entry into monopolistic competition is:

- A. Frequent, as no obstacles exist.
- B. Difficult, with significant obstacles.
- C. Rare, as significant capital is required.

D. Relatively easy, with only a few obstacles.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The characteristics of monopolistic competition include:

- Numerous firms with differentiated products.
- Ease of entry - few barriers.
- Firms exert some influence over price and market.
- Non-price competition is frequent and critical.

Choice "a" is incorrect. Monopolistic competition has a few obstacles. A market with no obstacles is in perfect competition.

Choice "b" is incorrect. Significant obstacles are characteristic of oligopoly.

Choice "c" is incorrect. Significant capital requirements represent a significant barrier to entry, which is characteristic of oligopoly.

#### QUESTION 192

In markets that are imperfectly competitive, such as monopoly and monopolistic competition, firms produce at an output where:

- A. Price equals marginal cost.
- B. Average costs are minimized.
- C. Price equals average cost.
- D. Marginal cost equals marginal revenue.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Firms produce up to the point where marginal cost equals marginal revenue, whether the markets are perfectly competitive or imperfectly competitive.

Choice "a" is incorrect. Very close, but it's actual marginal revenue, not price. It is assumed that revenue is not fixed on a unit basis.

Choice "b" is incorrect. Beyond the point of average costs being minimized, marginal cost will rise. Still, it will make sense to increase production until marginal cost equals marginal revenue.

Choice "c" is incorrect. Marginal revenue, not price, as revenue is assumed to vary on a per unit basis, and not average cost, since it will increase profits to expand production until marginal revenue equals marginal cost.

**QUESTION 193** Monopolistic competition is characterized by:

- A. A relatively large group of sellers who produce differentiated products.
- B. A relatively small group of sellers who produce differentiated products.
- C. One or two companies producing similar products.
- D. A relatively large group of sellers who produce a homogeneous product.

**Correct Answer:** A

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Monopolistic competition is characterized by a relatively large number of sellers who produce differentiated products. There are few barriers to entry and firms exert some influence over the price and the market. Best examples are brand name consumer products.

Choice "b" is incorrect. Relatively few sellers with differentiated products would indicate an oligopoly.

Choice "c" is incorrect. One company would be a monopoly, two an oligopoly.

Choice "d" is incorrect. A relatively large number of sellers and a standardized product indicates perfect competition.

**QUESTION 194** An industry that is oligopolistic would be best characterized by:

- A. One firm selling a product with no close substitutes.
- B. Significant barriers to entry.
- C. Horizontal or flat demand curves for the output of individual firms.
- D. The absence of significant economies of scale.

**Correct Answer:** B

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Oligopoly market conditions are characterized by:

- Few firms in the market
- Significant barriers to entry
- Differentiated products
- Fixed (or semi fixed) prices
- Kinked demand curves

Choice "a" is incorrect. This is an example of monopoly.

Choice "c" is incorrect. Horizontal demand curves represent demand that is perfectly price elastic (buyers will only pay one price for any quantity of a product). This occurs in perfectly competitive markets. Choice "d" is incorrect. This is characteristic of perfect competition, as there are no barriers to entry ("size doesn't matter") in perfect competition.

**QUESTION 195** The kinked demand curve is associated with:

- A. The analysis of agricultural markets.
- B. The analysis of monopolistic competition.
- C. The analysis of pure competition.
- D. The analysis of oligopoly.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The demand curve for any individual oligopolist is kinked sharply downward. This occurs because, in oligopoly market conditions, the other firms in the market will match any price reduction so they do not lose market share but will not match any price increase of an individual firm.

Therefore, for the individual firm attempting to raise its prices beyond equilibrium, consumers will quickly buy from other firms in the market and demand will drop off sharply creating a kinked demand curve. Choices "a", "b", and "c" are incorrect, per the above Explanation.

**QUESTION 196**

Karen Parker wants to establish an environmental testing company that would specialize in evaluating the quality of water found in rivers and streams. However, Parker has discovered that she needs either certification or approval from five separate local and state government agencies before she can commence business. Also, the necessary equipment to begin would cost several million dollars.

However, Parker believes that if she is able to obtain capital resources, she can gain market share from the two major competitors.

The market structure Karen Parker is attempting to enter is best described as:

- A. Pure competition.
- B. A natural monopoly.
- C. An oligopoly.
- D. Monopolistic competition.

**Correct Answer: C**  
**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Major competitors and substantial capital requirements (high barriers to entry) are oligopolistic market conditions.  
Choice "a" is incorrect. Pure competition has small barriers to entry and numerous suppliers.  
Choice "b" is incorrect. A natural monopoly suggests that economic conditions allow only one supplier for efficiency purposes.  
Choice "d" is incorrect. Monopolistic competition has easier barriers to entry and more firms competing to supply the market than oligopoly.

**QUESTION 197** Any business firm that has the ability to control the price of the product it sells:

- A. Faces a downward-sloping demand curve.
- B. Does not have any entry or exit barriers in its industry.
- C. Has a supply curve that is horizontal.
- D. Has a demand curve that is horizontal.

**Correct Answer: A**  
**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Any business firm that has the ability to control the price of the product it sells faces a downward-sloping demand curve for the firm. Only the firm in a competitive market is a price-taker facing a horizontal demand curve at the market equilibrium price.  
Choice "b" is incorrect. Firms in competitive industries have no entry or exit barriers and are price-takers.  
Choice "c" is incorrect, this is a far-out distractor.  
Choice "d" is incorrect. Only firms in perfectly competitive markets (price-takers) face horizontal demand curves.

**QUESTION 198** If a group of consumers decide to boycott a particular product, the expected result would be:

- A. An increase in the product price to make up lost revenue.
- B. A decrease in the demand for the product.
- C. An increase in product supply because of increased availability.
- D. That companies in the industry would experience higher economic profits.

**Correct Answer: B**  
**Section: Volume B**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A consumer boycott will decrease demand for the product being boycotted.  
Choice "a" is incorrect. Increasing price will further reduce the quantity demanded. The effect on revenue is uncertain.  
Choice "c" is incorrect. Supply will be unaffected by a boycott.  
Choice "d" is incorrect. A boycott of a particular product will reduce the overall profits of the industry.

**QUESTION 199** In competitive markets, an increase in an effective minimum wage will:

- A. Have a neutral effect on the demand for labor.

- B. Decrease the supply of labor.
- C. Decrease unemployment.
- D. Increase unemployment.

**Correct Answer:** D

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. When the "minimum" wages are increased, employers may elect to hire fewer employees thereby increasing unemployment. Choice

"a" is incorrect. An increase in the minimum wage will have an effect on the demand for labor.

Choice "b" is incorrect. The supply of labor will likely go up as the wage being paid increases. Choice

"c" is incorrect. As the minimum wage increases, unemployment will increase.

**QUESTION 200** In a competitive market, an increase in the minimum wage will likely have the following effects:

- A. Firms currently paying above the new minimum wage would generally raise their pay rates (although the new minimum wage creates a new floor for employee wage bargaining purposes).
- B. Firms paying at the current minimum wage rate would generally be unaffected if the marginal revenue produced by the lowest paid workers does not exceed the new higher cost of the worker. Many firms would thus be forced to work more efficiently.
- C. Total employment will likely decrease in affected industries and generate unemployment. Employers will demand a smaller number of workers while a larger number of workers will be attracted by the higher wage.
- D. If a marginally more expensive form of capital is available to substitute for labor (e.g., due to technological advances), firms will reduce their use of labor.

**Correct Answer:** C

**Section:** Volume B

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. With an increase in the minimum wage, total employment will likely decrease in affected industries and generate unemployment. Employers will demand a smaller number of workers while a larger number of workers will be attracted by the higher wage.

Choice "a" is incorrect. Firms currently paying above the new minimum wage would generally be unaffected, not raise their pay rates.

Choice "b" is incorrect. Firms paying at the current minimum wage rate would attempt to reduce labor, not generally be unaffected. Choice

"d" is incorrect. If a marginally cheaper, not more expensive.

**QUESTION 201** Suppose the equilibrium wage for low skilled workers in California is \$6.00 an hour. If the government increases the minimum wage to \$7.00 an hour, what would be the effect on the market for low skilled labor?

- A. An excess demand for labor would result.
- B. An excess supply of labor would result.
- C. The demand for labor would decrease.
- D. The supply of labor would increase.

**Correct Answer:** B

**Section:** Volume C

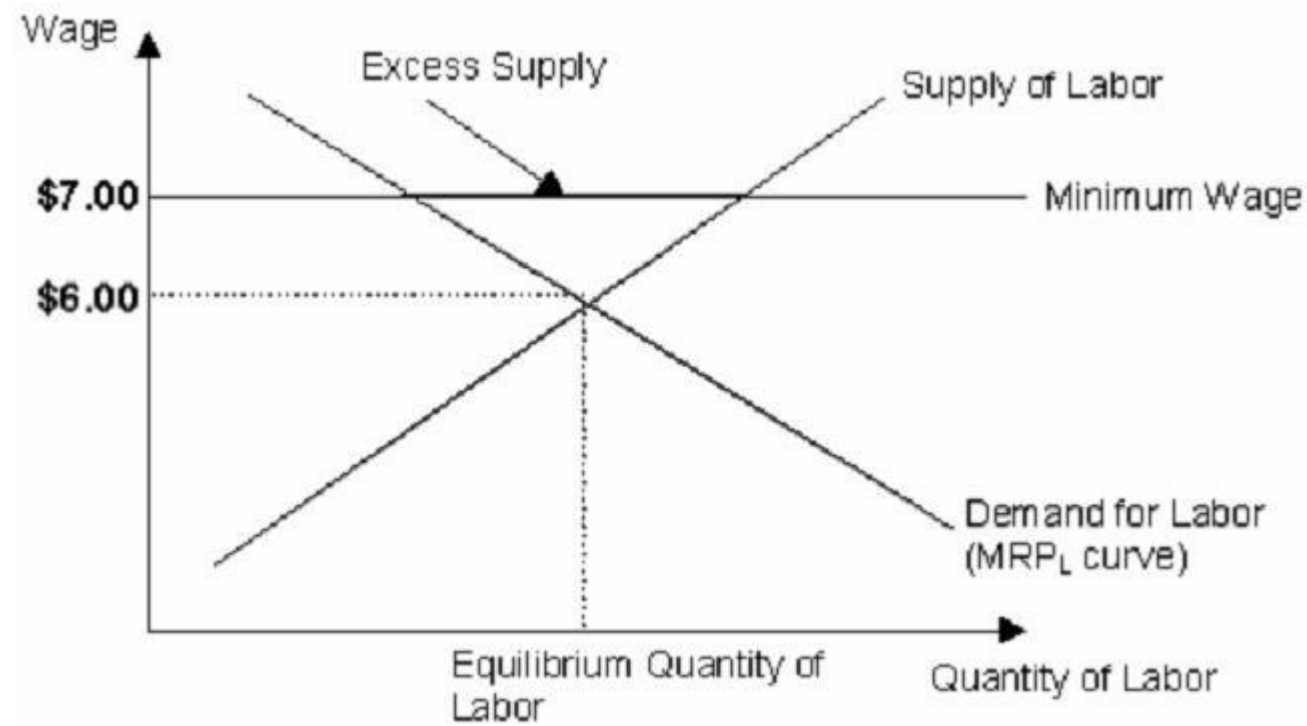
**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A minimum wage that is set above the equilibrium wage will result in an excess supply (or surplus) of labor.





Choice "a" is incorrect, since the quantity demanded of labor at \$7 is less than the quantity supplied, implying an excess supply not an excess demand. Choice "c" is incorrect. An increase in the minimum wage causes a decrease in quantity demanded of labor, not a decrease in the demand (shift in demand) for labor. Choice "d" is incorrect, per the above Explanation.

#### QUESTION 202

In a competitive labor market, a minimum wage that is set above the equilibrium wage will result in which of the following:

- A. A decrease in the quantity demanded of labor.
- B. An increase in the quantity supplied of labor.
- C. A decrease in total employment.
- D. All of the above.

**Correct Answer: D**

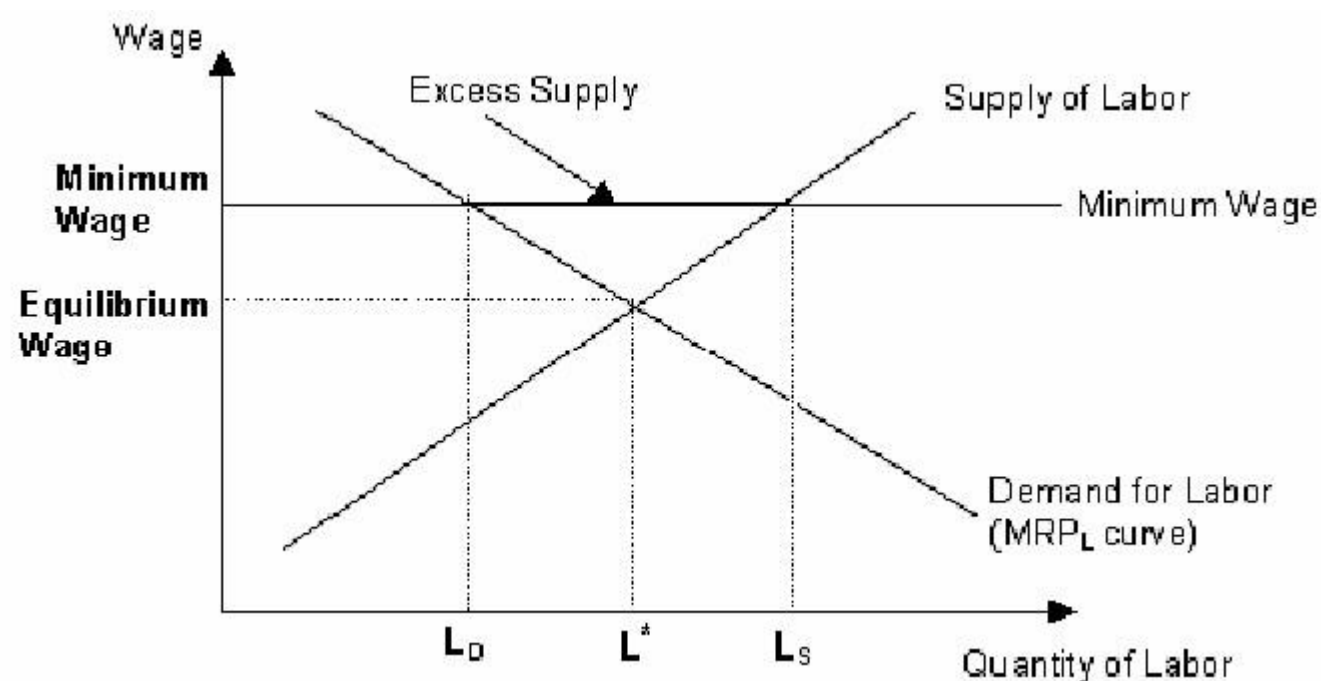
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. As illustrated in the graph, a minimum wage that is set above the equilibrium wage results in a decrease in the quantity demanded of labor (falls to LD), an increase in the quantity supplied of labor (increases to LS), and a decrease in total employment (total employment falls from L\* to LD).



Choices "a", "b", and "c" are incorrect. All are true, making choice "d" the only right answer.

#### QUESTION 203

The continual process of re-evaluating the strategic plans includes all of the following significant questions a firm should be concerned with, except:

- A. Has the firm been able to attain or maintain competitive advantage?
- B. Is the firm able to be profitable under the current strategy?
- C. Does the current strategy continue to be aligned with the established goals of the firm?
- D. Has the firm been able to adapt to the preferences of its employees?



**Correct Answer: D**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Although the firm needs to be flexible with respect to changes in many situations and then adapt to them, the ability to adapt to the preferences of its employees is not nearly as significant to the process as the other three choices, which are crucial to the success of the strategic plan.

Choices "a", "b", and "c" are incorrect because they are all significant questions a firm should be concerned with when re-evaluating the strategic plan.

**QUESTION 204** Under monopolistic competition, strategic plans focus on:

- A. Profitability from production levels that maximize profits.
- B. Maintaining the market share and being responsive to market conditions related to sales price.
- C. Maintaining the market share and planning for enhanced product differentiation.
- D. Maintaining the market share, ensuring product differentiation, and adapting to price changes or required changes in production volume.

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. Under monopolistic competition, strategic plans include maintaining the market share (as with pure competition), but they also likely include plans for enhanced product differentiation and allocation of resources to advertising, product research, etc.

Choices "a", "b", and "d" are incorrect because they are characteristics of other types of market structures.

**QUESTION 205** Under monopoly, strategic plans focus on:

- A. Profitability from production levels that maximize profits.
- B. Maintaining the market share and being responsive to market conditions related to sales price.
- C. Maintaining the market share and planning for enhanced product differentiation.
- D. Maintaining the market share, ensuring product differentiation, and adapting to price changes or required changes in production volume.

**Correct Answer:** A  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Under monopoly, strategic plans ignore market share and focus on profitability from production levels that will maximize profits. Choices "b", "c", and "d" are incorrect because they are characteristics of other types of market structures.

**QUESTION 206** With respect to price elasticity of demand:

- A. The shorter the time period, the more product demand becomes elastic because less choices are available.
- B. Product demand is more elastic when fewer substitutes are available.
- C. Product demand is more inelastic when more substitutes are available.
- D. Product demand is more elastic when more substitutes are available.



**Correct Answer:** D  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Product demand is more elastic when more substitutes are available.

Choice "a" is incorrect. The longer the time period, the more product demand becomes elastic because more choices are available.

Choice "b" is incorrect. Product demand is more elastic when more substitutes are available, not fewer substitutes. Choice "c" is incorrect. Product demand is more inelastic when few substitutes are available.

**QUESTION 207** If demand is price inelastic:

- A. An increase in price will result in a decrease in total revenue.
- B. An increase in price will result in an increase the quantity demanded that is more than the increase in price.
- C. An increase in price will result in an increase in total revenue.
- D. An increase in price will have no effect on total revenue.

**Correct Answer:** C  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. If demand is price inelastic, an increase in price will result in an increase in total revenue (positive relationship).

Choice "b" is incorrect. When demand is price inelastic, an increase in price results in a decrease in quantity demanded that is proportionately smaller than the increase in price, thus having the result of an increase in total revenue (price multiplied by quantity).

Choices "a" and "d" are incorrect, per the above statement.

**QUESTION 208** If

demand is price elastic:

- A. An increase in price will result in a decline in total revenue.
- B. An increase in price will result in a decline the quantity demanded that is less than the increase in price.
- C. An increase in price will result in an increase in total revenue.
- D. An increase in price will have no effect on total revenue.

**Correct Answer:** A

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. If demand is price elastic, an increase in price will result in a decline in total revenue (negative relationship).

Choice "b" is incorrect. When demand is price elastic, an increase in price results in a decline in quantity demanded that is proportionately larger than the increase in price, thus having the result of a decline in total revenue (price multiplied by quantity).

Choices "c" and "d" are incorrect, per the above statement.

**QUESTION 209** If

demand is unit elastic:

- A. An increase in price will result in a decline in total revenue.
- B. An increase in price will result in a decline the quantity demanded that is less than the increase in price.
- C. An increase in price will result in an increase in total revenue.
- D. An increase in price will have no effect on total revenue.

**Correct Answer:** D

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. If demand is unit elastic, a change in price will have no effect on total revenue. Choices "a", "b", and "c" are incorrect, per the above statement.

**QUESTION 210** Which of the following is incorrect with regard to government intervention in market operations?

- A. Government intervention may create a price different from the market price, thus causing either a surplus or a shortage.
- B. A price ceiling is a price that is established above the equilibrium price, which causes a surplus to develop.
- C. Price floors are minimum prices established by law, such as minimum wages and agricultural price supports.
- D. Rationing limits the availability of certain goods to a specified level, which lowers demand and prices for a given supply.

**Correct Answer:** B

**Section:** Volume C

### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is an incorrect statement and the correct choice. A price ceiling is a price that is established below the equilibrium price, which causes a shortage to develop. The statement in choice "b" defines a price floor. Choices "a", "c", and "d" are correct statements.

#### QUESTION 211

Which of the following is incorrect with regard to value chain analysis?

- A. Value chain analysis must be used in conjunction with the strategic plan of the organization.
- B. Value chain analysis is critical to assessing the competitive advantage of a firm.
- C. Value chain analysis is a strategic tool that assists the firm in determining how important the perceived value of the buyers is with respect to the market the firm operates in.
- D. The value chain starts with the firm and goes all the way through to the end users of the product.

**Correct Answer: D**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is an incorrect statement and the correct choice. The best description of a value chain is that value starts with the suppliers who provide the raw materials for a production process, continues with the firm and its strategic plan, continues with the value created by the customers, and then ends with the disposal and recycling of the materials. Choices "a", "b", and "c" are incorrect, as all are correct statements with regard to value chain analysis.

#### QUESTION 212

According to Michael Porter, which of the following are the two major categories of business activities?

- A. Demand activities and supply activities.
- B. Firm activities and customer activities.
- C. Primary activities and support activities.
- D. Internal activities and external activities.



**Correct Answer: C**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. According to Michael Porter, the two major categories of business activities are primary activities and support activities. Choices "a", "b", and "d" are incorrect, per the above statement.

**QUESTION 213** Which of the following activities is considered a support activity?

- A. Delivery of products.
- B. Procurement of materials.
- C. Product advertising.
- D. In-home warranty service.

**Correct Answer: B**

**Section: Volume C**

### Explanation

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Support activities are those activities that are performed by the support staff of an organization (e.g., purchasing of materials and supplies, development of the technology used, management of employees, accounting, finance, strategic planning, etc.).

Choices "a", "c", and "d" are incorrect, as these are all considered primary activities. Primary activities are those that are involved with the direct manufacture of products, the delivery of products through distribution channels, and the support of the product that exists after the sale is made (e.g., handling the raw materials, the manufacturing process, taking orders for the product, advertising the product, and servicing the product after it is sold).

**QUESTION 214**

When applying value chain analysis, a firm sends its production manager to visit the operations of its major supplier in an attempt to determine if there are cost-savings capabilities that could be implemented at the supplier's warehouse. The firm is performing which form of value chain analysis?

- A. Internal differentiation analysis.
- B. Internal costs analysis.
- C. Vertical linkage analysis.
- D. None of the above.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Analyzing the vertical linkage of a firm means understanding the activities of the suppliers and buyers of the product and determining where value can be created external to the firm's operations. Choices "a", "b", and "d" are incorrect, per the above Explanation.

**QUESTION 215**

Which of the following is not a type of major strategic framework that has proven useful for value chain analysis?

- A. Core competencies analysis.
- B. Customer preference analysis.
- C. Industry structure analysis.
- D. Segmentation analysis.

**Correct Answer: B**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Customer preference analysis is not a major strategic framework that has been proven to be useful for value chain analysis.

Choices "a", "c", and "d" are incorrect, as the three major types of strategic frameworks that have been proven to be useful for value chain analysis are industry structure analysis, core competencies analysis, and segmentation analysis.

**QUESTION 216**

Jordan Industries is the leader in its market for producing high-quality cat food for cats that require special diets. While it has been able to sustain competitive advantage for years, Jordan's management has implemented a strategic framework that focuses on why the firm has been so successful in its market. Jordan Industries has implemented which type of strategic framework?

- A. Industry structure analysis.
- B. Core competencies analysis.
- C. Segmentation analysis.
- D. None of the above.

**Correct Answer: B**

**Section: Volume C**



**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Analysis of the core competencies of a firm help it to determine why it is able to create, attain, and sustain new types of competitive advantage and profits and reveal what it is within the firm that enables it to obtain competitive advantage.

Choice "a" is incorrect. Industry structure analysis assists in determining what it is that makes a firm more profitable compared to another firm, and it looks at five forces that influence profitability of an industry or market and, thus, the competitive environment.

Choice "c" is incorrect. Segmentation analysis is a possibility when a firm is vertically integrated and when the industry structure and core competencies vary among activities in the value chain. Choice "d" is incorrect, as choice "b" is the answer to the question.

**QUESTION 217**

If a nation has superior conditions in which to grow coffee beans and firms are able to grow them at very low costs, which of the four major factors that Michael Porter has indicated impact the global competitive environment would allow this nation to fare better with respect to global competitive advantage?

- A. Conditions of the factors of production.
- B. Conditions of domestic demand.
- C. Related and supporting industries.
- D. Firm strategy, structure, and rivalry.

**Correct Answer:** A

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. If a nation has a strong set of factors of production (such as low cost, high quality raw material inputs), that are required in a given industry, it will fare better with regard to competitive advantage.

Choice "b" is incorrect. Conditions of domestic demand relate to the nation's domestic demand for the product, which is directly related to the ability of the nation to fare better with regard to competitive advantage.

Choice "c" is incorrect. The factor of related and supporting industries deals with whether there are suppliers of material inputs that exist within a nation or whether there are rival firms who are competitive in the international environment, both of which would increase the nation's competitive advantage.

Choice "d" is incorrect. The factor of firm strategy, structure, and rivalry relates to the practices of a nation with respect to how the companies are managed and organized, long with the laws of the nation that regulate the formation of the companies, and how intense the rivalry is with respect to competing firms in the nation.

**QUESTION 218**

Factors internal to the organization that impact strategy and are sources of strengths and weaknesses include all of the following, except:

- A. Marketing effectiveness.
- B. Competence of management.
- C. Innovation of product lines.
- D. Regulations and laws.

**Correct Answer:** D

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Regulations and laws are external factors of opportunities and threats that affect the overall industry. Choices

"a", "b", and "c" are incorrect, as all of these factors are examples of internal factors of an organization.

**QUESTION 219** When does competition not become an even stronger force impacting the profitability of a firm?

- A. The market consists of several equal-sized firms.

- B. Customers do not have strong brand preferences.
- C. The market is fast-growing.
- D. The costs of exiting the market exceed the costs of continuing to operate.

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "c" is correct, as it is not a factor that would cause market competitiveness to be even stronger.

Choices "a", "b", and "d" are incorrect because they are all reasons that competition becomes an even stronger force that impacts the firm's profitability. The following are situations that would cause competition to be an even stronger force impacting the profitability of a firm:

- The market is not growing fast.
- There are several equal-sized firms in the market.
- Customers do not have strong brand preferences.
- The costs of exiting the market exceed the costs of continuing to operate.
- Some firms profit from making certain moves to increase market share.
- The various firms in the market use different types of strategic plans.

**QUESTION 220** Which of the following statements regarding the existence of substitute products is correct?

- A. The impact of substitutes will have more of an effect on the competitive environment of a firm if the substitutes are difficult for customers to obtain.
- B. When the cost of buyers switching to new products is high, the effect of substitutes on the competitive environment of a firm is high.
- C. If few substitutes exist, buyers have little choice of products and may be willing to pay a higher price for the products that are available.
- D. If few substitutes exist, buyers may have a limit on the maximum price that they are willing to pay and may choose to not purchase the firm's product if the price is too high.

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. If few substitutes exist, buyers have little choice of products and may be willing to pay a higher price for the products that are available.

Choice "a" is incorrect. The impact of substitutes will have more of an effect on the competitive environment of a firm if the substitutes are readily available to consumers (not difficult to obtain).

Choice "b" is incorrect. When the cost of buyers switching to new products is low (not high), the effect of substitutes on the competitive environment of a firm is high.

Choice "d" is incorrect. If many (not few) substitutes exist, buyers may have a limit on the maximum price that they are willing to pay and may choose to not purchase the firm's product if the price is too high.

**QUESTION 221** Which of the following is not considered a factor that increases the bargaining power of the customer?

- A. Much information is available to the customer to compare and contrast features of all products on the market.
- B. One group of customers makes up a large volume of the firm's business.
- C. Buyers have low switching costs of changing products.
- D. The firm is unable to change suppliers easily.

**Correct Answer: D**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. When a firm is unable to change suppliers easily, that is a factor that increases the bargaining power of the suppliers. Choices "a", "b", and "c" are incorrect because they all are factors that increase the bargaining power of the customer, which are:

- Customers make up a large volume of a firm's business.
- There is much information available to customers.
- The buyers have low switching costs.
- There are a high number of alternate suppliers.

**QUESTION 222** When do cost leadership strategies fail?

- A. Buyers have large amounts of bargaining power in the market.
- B. Heavy price competition exists in the market.
- C. Buyers become less price sensitive and start to have brand loyalty.
- D. New entry firms are able to influence buyers to switch to their product by cutting the price of their product for a period of time in an effort to gain market share and increase profits.

**Correct Answer:** C

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. If firms overlook the fact that few customers care about the fact that a product is priced lower than others and care more about brand loyalty, cost leadership strategies will fail. Choices "a", "b", and "d" are incorrect, as these are all situations in which cost leadership strategies work well.

**QUESTION 223** Which of the following is not correct regarding best cost provider strategies?

- A. The overall lowest cost in the industry is not a viable option in best cost strategies because the firm could not compete profit-wise with its differentiation strategy component.
- B. When generic products are not acceptable to buyers, yet they still remain price sensitive to the value they are receiving for their money, the best cost strategy may work well.
- C. The best cost strategy is a combination of the benefits of the cost leadership and differentiation strategies.
- D. The best cost strategy strives to have the firm evaluate and change its value chain such that it can achieve the highest cost among its closest competitors with a quality differentiated product in an effort to obtain the highest profits.

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct because it is not a correct statement. The best cost strategy strives to have the firm evaluate and change its value chain such that it can achieve the lowest (not highest) cost among its closest competitors while matching them on the features desired by consumers.

Choices "a", "b", and "c" are incorrect, as they are all true statements regarding best cost provider strategies.

**QUESTION 224** Considering the SCOR Model of supply chain operations, which of the following key management processes does managing accounts receivable and collections from customers fall into?

- A. Plan.
- B. Source.
- C. Make.
- D. Deliver.

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The "deliver" process encompasses all the activities of getting the finished product into the hands of the ultimate consumers to meet their planned demand. Managing accounts receivable and collections from customers falls into the "deliver" process.

Choices "a", "b", and "c" are incorrect, per the above Explanation.

**QUESTION 225** Considering the SCOR Model of supply chain operations, which of the following key management processes does assessing the ability of the suppliers to supply resources fall into?

- A. Plan.
- B. Source.
- C. Make.
- D. Deliver.

**Correct Answer: A**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. The process of planning consists of developing a way to properly balance aggregate demand and aggregate supply within the goals and objectives of the firm and plan for the necessary infrastructure. Assessing the ability of the suppliers to supply resources is part of the "plan" process. Choices "b", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 226** Considering the SCOR Model of supply chain operations, which of the following key management processes does implementing changes in engineering fall into?

- A. Plan.
- B. Source.
- C. Make.
- D. Deliver.



**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The "make" process encompasses all the activities that turn the raw materials into finished products that are produced to meet a planned demand. Implementing changes in the engineering process falls into the "make" process.

Choices "a", "b", and "d" are incorrect, per the above Explanation.

**QUESTION 227** Considering the SCOR Model of supply chain operations, which of the following key management processes does collecting and processing vendor payments fall into?

- A. Plan.
- B. Source.
- C. Make.
- D. Deliver.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Once demand has been planned, it is necessary to procure the resources required to meet it and to manage the infrastructure that exists for the sources. Collecting and processing vendor payments falls into the "source" process.

Choices "a", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 228**

In which stage of supply chain management will management move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service?

- A. Cross-functional teams.
- B. Integrated enterprise.
- C. Extended supply chain.
- D. Supply chain communities.

**Correct Answer: B**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. In the integrated enterprise stage of supply chain management, the firm's management will move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service.

Choice "a" is incorrect. In the cross-functional teams stage of supply chain management, the firm's management will turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, and the focus will be on customer service.

Choice "c" is incorrect. In the extended supply chain stage of supply chain management, integration moves external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth.

Choice "d" is incorrect. In the supply chain communities stage of supply chain management, the extended supply chain forms a single competitive entity with a synchronized supply chain and a complex system of networks.

**QUESTION 229** In which stage of supply chain management will integration move external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth?

- A. Cross-functional teams.
- B. Integrated enterprise.
- C. Extended supply chain.
- D. Supply chain communities.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. In the extended supply chain stage of supply chain management, integration moves external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth.

Choice "a" is incorrect. In the cross-functional teams stage of supply chain management, the firm's management will turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, and the focus will be on customer service.

Choice "b" is incorrect. In the integrated enterprise stage of supply chain management, the firm's management will move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service.

Choice "d" is incorrect. In the supply chain communities stage of supply chain management, the extended supply chain forms a single competitive entity with a synchronized supply chain and a complex system of networks.

**QUESTION 230** An increase in the quantity demanded for a product would be associated with a(n):

- A. Increase in the price of a complementary product.

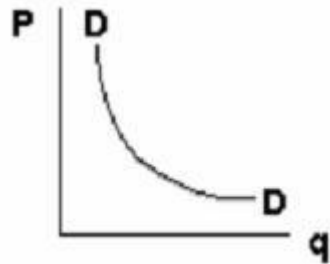
- B. Increase in average household income.
- C. Decrease in the price of that product.
- D. Decrease in the price of a substitute product.

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:



Choice "c" is correct. The fundamental law of demand holds that there is an inverse relationship between price of the product and the quantity demanded. We move along the demand curve D-D.  
 Choice "a" is incorrect. An increase in complementary product prices would decrease the demand curve (e.g., if PC prices increase, the demand for printers and other peripherals decrease).  
 Choice "b" is incorrect. Increases in consumers and consumer income shift the demand curve itself.  
 Choice "d" is incorrect. A decrease in price for a substitute product (like Pepsi) decreases demand for the other product (Coke).

**QUESTION 231** An increase in the market supply of beef would result in a(n):

- A. Decrease in the quantity of beef demanded.
- B. Increase in the price of beef.
- C. Decrease in the demand for beef.
- D. Increase in the quantity of beef demanded.

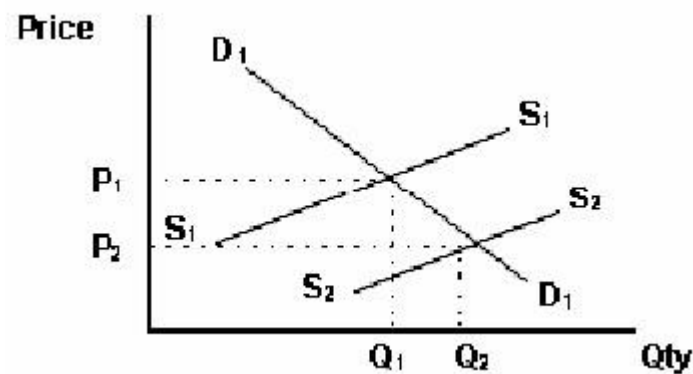


**Correct Answer: D**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:



Choice "d" is correct. As illustrated above, a shift outward (increase) in supply, increases quantity demanded (Q2) at equilibrium, accompanied by a decline in price. Thus, an increase in the market supply of beef would result in an increase in the quantity of beef demanded.

Choices "a" and "b" are incorrect, as seen in the graph above. There is an increase in the quantity of beef demanded and a decrease in the price of beef.

Choice "c" is incorrect, because there is no information in the question pertaining to any "shift" in the beef demand curve or in the demand for any complimentary products (e.g., pork).

**QUESTION 232** In competitive markets, an increase in demand for a product causes a(n):

- A. Increase in product supply.
- B. Reduction in purchases by consumers.
- C. Reduction in the number of buyers of the product.
- D. Increase in the price of the product.

**Correct Answer:** D

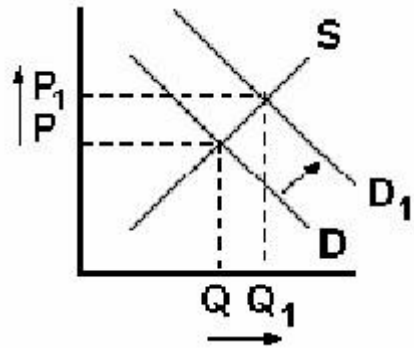
**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

Rule of economic reasoning: "Draw the graph!"



Choice "d" is correct. When demand increases and supply has not increased (as implied by the question), suppliers will raise the price of the product and more product will be bought (but the supply curve does not change). Because consumers are demanding more product than is available, they are "willing" to pay a higher price.

Choice "a" is incorrect. Although buyers would pay higher prices and purchase more products, the supply "curve" has not changed. Therefore, the quantity supplied remains the same.

Choice "b" is incorrect. Because consumer demand has increased (not decreased).

Choice "c" is incorrect. An increase in demand has an indeterminate (and irrelevant) impact on the number of buyers. For example, there could be the same number of buyers in the market, but that each demands a higher quality.

**QUESTION 233** Which one of the following statements about supply and demand is true?

- A. If supply increases and demand remains constant, equilibrium price will rise.
- B. If demand increases and supply increases, equilibrium quantity will fall.
- C. If demand increases and supply decreases, equilibrium price will increase.
- D. If demand increases and supply remains constant, equilibrium price will fall.

**Correct Answer:** C

**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. If quantity demanded for a product goes up, this drives price up. Additionally, if supply decreases, this will also drive prices up. Therefore, it is a certainty that price will be driven up, given an increase in demand and a decrease in supply.

Choice "a" is incorrect. Increased supply will reduce (not increase) prices, assuming demand remains constant.

Choice "b" is incorrect. Increased demand will increase price, and increased supply will reduce price.

The net impact on price cannot be determined without more facts.

Choice "d" is incorrect. Increased demand will increase (not reduce) price, assuming supply remains constant.

#### QUESTION 234

The local video store's business increased by 12 percent after the movie theater raised its prices from \$6.50 to \$7.00. This is an example of:

- A. Substitute goods.



- B. Superior goods.
- C. Complementary goods.
- D. Independent goods.

**Correct Answer: A**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. For substitute goods, as the price of one good goes up, the demand for another, substitute good increases as consumers desire the lower-priced substitute good.

Choice "b" is incorrect. Superior goods. Just as the demand for inferior goods declines with an increase in the income level of a consumer, superior goods will experience a spurt in demand as prices are raised.

Choice "c" is incorrect. The demands for mutually "complementary goods" fluctuate together (e.g., more cereal purchases are accompanied by an increase in the demand for milk). Choice "d" is incorrect.

Independent goods have unrelated demand functions (e.g., bread and vacuum cleaners).

**QUESTION 235**

An increase in the price of crude oil will have what affect on the equilibrium price and quantity of gasoline?

- A. Price will fall and quantity will rise. B. Price will rise and quantity will fall.
- C. Price will fall and quantity will fall.
- D. Price will rise and quantity will rise.

**Correct Answer: B**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Crude oil is an input to the production of gasoline. When the price of an input increases, supply shifts left, causing equilibrium price to rise and equilibrium quantity to fall.

Choice "a" is incorrect, since price will rise and quantity will fall.

Choice "c" is incorrect, since price will rise.

Choice "d" is incorrect, since quantity will fall.

**QUESTION 236** When the supply of and demand for a good both increase:

- A. Equilibrium price will increase.
- B. Equilibrium price will decrease.
- C. Equilibrium price may increase, decrease, or remain unchanged.
- D. Equilibrium quantity may increase, decrease, or remain unchanged.

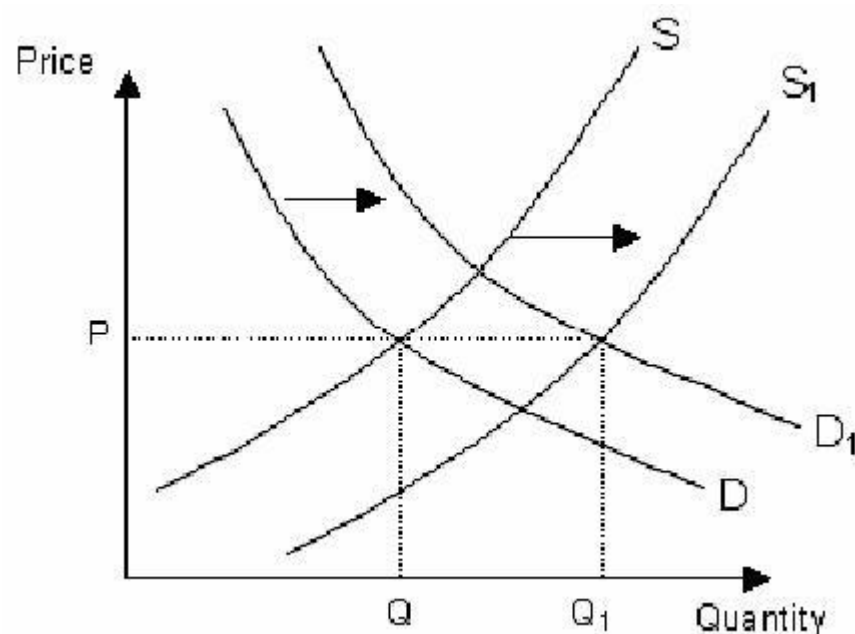
**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:





Choice "c" is correct. When the supply of and demand for a good both increase, equilibrium quantity increases. However, the impact on price is indeterminate. If demand and supply increase by the same amount, price will remain unchanged (as illustrated above). However, if demand increases by more than supply, price will increase. Conversely, if supply increases by more than demand, price will decrease. Choices "a" and "b" are incorrect, since the impact on price is indeterminate.

Choice "d" is incorrect, since equilibrium quantity will increase.

**QUESTION 237** A basic determinant of the elasticity of demand for a normal good is the:

- A. Length of time producers have to respond to market changes.
- B. Number of substitutes available for the product.
- C. Number of sellers of the product.
- D. Number of complements available for the product.



**Correct Answer: B**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The change in demand for a product, based upon a given change in that product's price, is dependent on whether or not other (presumably cheaper) goods can be substituted for the product.

Choice "a" is incorrect. The elasticity of supply (not demand) would take into account the response time producers might have to market changes. Choice "c" is incorrect. The number of sellers is irrelevant when calculating the elasticity of demand.

Choice "d" is incorrect. A complement good's demand is the same as the primary good. For example, an increase in the demand for a given food would cause the demand for its complement to also increase. The increased demand of the complement is irrelevant when calculating the elasticity of demand.

#### QUESTION 238

If the elasticity of demand for a normal good is estimated to be 1.5, then a 10% reduction in its price would cause:

- A. Total revenue to fall by 10%.
- B. Total revenue to fall by 15%.
- C. Quantity demanded to rise by 15%.
- D. Demand to decrease by 10%.

**Correct Answer: C**  
**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The elasticity of demand is calculated as:

% Change in demand

% Change in price

If the elasticity of demand is 1.5 (assumed to be the absolute value, as the elasticity of demand for a normal good is always negative), then a 10% price reduction would cause an increase in the quantity demanded by 15% (a ratio of 15 to 10 or 1.5).

Choices "a", "b", and "d" are incorrect, per Explanation above.

**QUESTION 239**

If the demand for a normal good is inelastic, then the sales price of the product would increase following a(n):

- A. Decrease in the price of a substitute good.
- B. Increase in the supply of the product.
- C. Decrease in the supply of the product.
- D. Increase in the number of suppliers of the product.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. If demand is perfectly inelastic (or not price sensitive), there will be no change in quantity demanded for a change in price. This means that consumers of the product will demand a constant quantity, regardless of the price. If the quantity supplied is reduced (presumably below an equilibrium point where supply equals demand), there will be excess demand for the product and sales price will go up. The increase in sales price will have no impact on demand (because demand is assumed to be perfectly price inelastic). Choices "a", "b", and "d" are incorrect, per the above Explanation.

**QUESTION 240**

The Waymand family typically ate hamburger as a regular staple in their diet. In the last few years, the family income has doubled, and they have now replaced hamburger with steak as a regular staple in their diet. This is an example where the demand for hamburger:

- A. Is relatively elastic.
- B. Is perfectly elastic.
- C. Responds as an inferior good.
- D. Is perfectly inelastic.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. An inferior good is one for which the demand declines as income increases. A normal good would experience an increase in demand in response to an increase in income. Because the demand for hamburger went down as income increased, it is an inferior good.

Choices "a", "b", and "d" are incorrect. The elasticity of demand for a good is calculated by measuring the change in quantity demanded over the change in price (not income). The question does not have sufficient information to calculate the elasticity of the demand for hamburger.

**QUESTION 241** A perfectly inelastic supply curve in a competitive market:

- A. Means the equilibrium price must be zero.
- B. Implies a vertical demand curve.

- C. Exists when firms cannot vary input usage.
- D. Says the market supply curve is horizontal.

**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Price elasticity of supply is calculated the same way as demand except that quantity supplied is measured:

$$\text{Price elasticity of supply \%} = \frac{\% \text{ Change in Q supplied}}{\text{Change in price}}$$

Perfectly inelastic supply curves are also vertical representing that supply is insensitive to changes in price; i.e., the quantity supplied will not change as price changes. Perfectly inelastic supply curves would exist if firms cannot vary input usage. Regardless of price, the firm has to use all inputs if it produces at all. Choices "a", "b", and "d" are incorrect, as they are far-out distractors.

**QUESTION 242** In the pharmaceutical industry where a diabetic must have insulin no matter what the cost and where there is no substitute, the diabetic's demand curve is best described as:

- A. Perfectly elastic.
- B. Perfectly inelastic.
- C. Elastic.
- D. Indifferent.

**Correct Answer: B**  
**Section: Volume C**



**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. When a good is demanded, no matter what the price, demand is described as perfectly inelastic. The demand "curve" is a vertical line at the quantity demanded with price making no difference. Choices "a" and "c" are incorrect. There is no such thing as perfect elasticity. However, the more elastic demand is, the greater the change in quantity demanded for price changes. Choice "d" is incorrect. Diabetics are indifferent to changes in the price of insulin, and to economists, this is perfectly inelastic demand.

**QUESTION 243** Demand for a product tends to be price inelastic if:

- A. The product is considered a luxury item.
- B. Few good complements for the product are available.
- C. People spend a large share of their income on the product.
- D. Few good substitutes are available for the product.

**Correct Answer: D**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. Demand for a product tends to be price inelastic if few good substitutes are available for the product. Even if price increases, consumers are then unable to switch to substitute goods, because there aren't any. Choice "a" is incorrect. Luxury items may have good substitutes available. Choice "b" is incorrect. Complementary goods are those whose demand fluctuates in unison; substitute goods are more relevant here. Choice "c" is incorrect. If consumers spend a large share of their income on the product, they will be very sensitive to any price changes and hence product demand would be more "elastic".

#### QUESTION 244

Long Lake Golf Course has raised green fees to a nine-hole game due to an increase in demand.

	Previous Rate	New Rate	Average Games Played at Previous Rate	Average Games Played at New Rate
Regular weekday	\$10	\$11	80	70
Senior citizen	6	8	150	82
Weekend	15	20	221	223

Which of the following is correct?

- A. The regular weekday and weekend demand is inelastic.
- B. The regular weekday and weekend demand is elastic.
- C. The senior citizen and weekend demand is inelastic.
- D. The senior citizen demand is elastic and weekend demand is inelastic.

**Correct Answer: D**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "d" is correct. Demand is elastic if a decline in price (P) results in an increase in total revenue (TR); or if an increase in P results in a decline in TR. On the other hand, if demand is inelastic, a decline in P will result in a decline in TR or an increase in P will result in an increase in TR.

First, the total revenues at both the new and the previous rate must be computed. The (new or previous) rate\* average games played (AGP) = the total revenue. As a result, TR at the previous rate (PR) is 800 for regular weekday (RW), 900 for senior citizen (SC), and 3315 for the weekend (WE). TR at the new rate (NR) is 770 for RW, 656 for SC, and 4460 for WE.

So, demand for RW and SC is elastic because the increase in P results in a decline in total revenue. The demand for WE is inelastic because the increase in P results in an increase in TR. As a result, choices "a", "b", and "c" are incorrect.

Note: if TR remains constant after a change in P, the demand is unit elastic.

#### QUESTION 245

In the long run in a competitive market, a maximum or ceiling price set below the equilibrium price will:

- A. Cause a surplus to be produced.
- B. Have no effect on the market.
- C. Cause a shortage to be created.
- D. Result in a decrease in price.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Setting a ceiling price below the price dictated by market forces (which is the equilibrium price set by the supply and demand curves) would create excess demand for the product (at its reduced price) and, consequently, a shortage.

Choice "a" is incorrect. A surplus would be produced if a floor price (under which no supplier could sell) were set above the equilibrium price, because suppliers would supply excess product at the inflated price. Choices "b" and "d" are incorrect, per the above Explanation.

**QUESTION 246** If the federal government were to regulate a product or service in a competitive market by setting a maximum price that is below the equilibrium price, then in the long run this action will:

- A. Result in a surplus.
- B. Result in a shortage.
- C. Cause a decrease in price.
- D. Have no effect on the market.

**Correct Answer:** B

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Setting a maximum or ceiling price, which is below the equilibrium price dictated by a competitive market, would result in a shortage as a result of excess demand. Choices "a", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 247** A government price support program will:

- A. Lead to surpluses.
- B. Lead to shortages.
- C. Improve the rationing function of prices.
- D. Not influence the rationing function of prices.

**Correct Answer:** A

Choice "a" is correct. A government price support program acts as a subsidy that will encourage suppliers to increase supply beyond an equilibrium point (the point where supply and demand curves intersect). This excess of supply over demand will create surpluses in the market.

Choices "b", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 248** Strategic planning activities normally involve which of the following efforts:

- I. Strategic Positioning.
- II. Value Chain Analysis.
- III. Balance Scorecard Development.

- A. I.
- B. I and II.
- C. I and III.
- D. I, II, and III.

**Correct Answer: D**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Strategic planning activities are normally acknowledged to include each of three operations including:

- I. Strategic positioning. Strategic positioning includes the process of identifying mission, identifying overall strategy, identifying factors critical to succeeding given the assumed strategy and identifying internal and external factors that contribute or detract from achieving the strategy.
- II. Value chain analysis. Value chain analysis includes the process of identifying the functional characteristics of an organization and the manner in which each one of those functions adds value to the firm's customers.
- III. Balanced scorecard development. Development of a balanced scorecard identifies measurements of value that are both financial and non-financial to be used to monitor and evaluate performance.

Choice "a" is incorrect. All three activities are integral to strategic planning.

Choice "b" is incorrect. All three activities are integral to strategic planning. Choice

"c" is incorrect. All three activities are integral to strategic planning.

#### QUESTION 249

Economic theory identifies two basic types of goods: inferior goods and superior goods. As consumer income rises, a lower percentage of earnings are expended on inferior goods while a higher percentage of earnings are spent on superior goods. Overall strategies for achieving organizational missions would most likely match with types of goods as follows:

- A. Cost leadership strategies for superior goods, differentiation strategies for inferior goods.
- B. Cost leadership strategies for inferior goods, differentiation strategies for superior goods.
- C. Cost leadership strategies would most likely be used for both inferior and superior goods.
- D. Differentiation strategies would most likely be used for both inferior and superior goods.

**Correct Answer: B**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Rule: Overall strategies are divided into two different types that are defined as follows:

Cost leadership: Organization seeks to capture market share through maintaining the lowest cost.

Differentiation: Organization seeks to capture market share by demonstrating product value.

Choice "b" is correct. Organizations that sell economically inferior goods (necessities such as cotton swabs, light bulbs, etc.) are more likely to posture themselves as cost leaders than organizations that sell economically superior goods (luxuries such as cruise packages, fine china, jewelry, etc.) who will likely seek to differentiate the value of their product as part of their strategy.

Choice "a" is incorrect. Economically inferior products would likely be associated with cost leadership, not differentiation while economically superior products would likely be associated with differentiation. Choice

"c" is incorrect. Economically inferior products would likely be associated with cost leadership, not differentiation while economically superior products would likely be associated with differentiation.



**Section: Volume C**  
**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is incorrect. Economically inferior products would likely be associated with cost leadership, not differentiation while economically superior products would likely be associated with differentiation.

**QUESTION 250** Having identified their mission, overall strategy, and critical success factors, organizations often review the internal and external factors that will contribute to their success. This analysis is often referred to as:

- A. TOC evaluation.
- B. Brainstorming.
- C. Balanced scorecard review.
- D. SWOT analysis.

**Correct Answer: D**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Evaluation of internal and external factors contributing to an organization's success is referred to as Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis. Strengths and weaknesses focus on internal factors while opportunities and threats relate to external factors.

Choice "a" is incorrect. The acronym TOC stands for Theory of Constraints, which is an evaluation technique for optimizing throughput time, it does not relate to overall strategy evaluation.

Choice "b" is incorrect. Brainstorming is a meeting technique used to generate ideas. Although brainstorming could be used as part of an organization's approach to SWOT analysis, it is not, itself, the evaluation of internal and external factors.

Choice "c" is incorrect. A review of the balanced scorecard, which summarizes measures of achievement of critical success factors, does not represent the objective review of internal and external factors that may impact achievement of strategy.

**QUESTION 251** Under which of the following conditions is the supplier most able to influence or control buyers?

- A. When the supplier's products are not differentiated.
- B. When the supplier does not face the threat of substitute products.
- C. When the industry is controlled by a large number of companies.
- D. When the purchasing industry is an important customer to the supplying industry.

**Correct Answer: B**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. When there are few good substitutes for a supplier's product, the supplier has market power (think of a monopoly). As a result, the supplier is better able to control buyers and act as a price setter rather than a price taker.

Choice "a" is incorrect. When supplier's products are not differentiated, buyers will be indifferent about which supplier they purchase from. In other words, if firms sell identical products (think of perfect competition) the product of one firm is a perfect substitute for the product of another firm. In this case, firms are price takers, not price setters.

Choice "c" is incorrect. When there are a large number of firms, no one firm has much market power.

This is the case of either perfect competition (if all firms sell identical products) or monopolistic competition (if all firms sell slightly differentiated products).

Choice "d" is incorrect. If the purchasing industry is an important customer of the supplier, the purchasing industry (i.e. the buyer) will have some market power. This will diminish the ability of the supplier to influence or control the buyer.

**QUESTION 252**

Which of the following inputs would be most beneficial to consider when management is developing the capital budget?

- A. Supply/demand for the company's products.
- B. Current product sales prices and costs.
- C. Wage trends.
- D. Profit center equipment requests.

**Correct Answer: D**

Choice "d" is correct. In developing its capital budget, management would find the employee input associated with equipment requests from various profit centers most helpful. Departmental requests, appropriately justified, would provide key insights into the capital requirements of the business that are not otherwise known.

Choice "a" is incorrect. Supply and demand for company products is a crucial strategic input in forecasting the future capital requirements. Current year capital budgeting would not benefit as directly from this information, however, as profit center equipment requests.

Choice "b" is incorrect. Current product sales prices and costs represent operating data most relevant to operating rather than capital budgeting. Choice

"c" is incorrect. Wage trends represent operating data most relevant to operating than capital budgeting.

**Comments:**

Some people have questioned why the answer is not choice "a." However, the answer to the question is very clear.

The question really is what are the best (most beneficial to consider) inputs to a capital budget. The "supply and demand for the company's products" is very indirect. The demand for the company's products may or may not result in the company spending any capital money because the demand may be able to be satisfied with the current capital equipment. But, equipment requests, if approved, will most likely result in spending money (assuming that the money in the budget is actually spent) and thus should go into the capital budget. The supply and demand might affect future capital budgets if the demand is not able to be satisfied with the current capital equipment. But the question asks for the best inputs for presumably the current capital budget.

**QUESTION 253** A city ordinance that freezes rent prices may cause:

- A. The demand curve for rental space to fall.
- B. The supply curve for rental space to rise.
- C. The quantity demanded of rental space exceeds the quantity supplied.
- D. The quantity supplied of rental space exceeds the quantity demanded.

**Correct Answer: C****Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. A city ordinance that freezes rent prices (such as rent control and rent stabilization in New York City) may cause the quantity demanded for rental space to exceed the quantity supplied.

This occurs if the rent controlled price is set below the market clearing price. At the controlled price, the quantity supplied will be constrained due to the low rent prices for the rent-controlled and rent-stabilized properties; builders will not want to build and rent properties for less than they are worth on the open market. The quantity demanded for the rental space will still be artificially high due to the city ordinance, which sets the controlled price below the market price. Thus, the quantity demanded will exceed the quantity supplied. New York City rent control is a perfect example of the effect of a price ceiling and the problems that it can cause.

Choice "a" is incorrect. A city ordinance that freezes rent prices will not cause the demand curve for rental space to fall. Price changes cause movements along the demand curve, not shifts in the demand curve.

Choice "b" is incorrect. A city ordinance that freezes rent prices will not cause the supply curve for rental space to rise. Price changes cause movements along the supply curve, not shifts in the supply curve. Choice

"d" is incorrect. A city ordinance that freezes rent prices will not cause the quantity supplied to exceed the quantity demanded. This choice is backwards.

**QUESTION 254** What is strategic planning?

- A. It establishes the general direction of the organization.
- B. It establishes the resources that the plan will require.
- C. It establishes the budget for the organization.
- D. It consists of decisions to use parts of the organization's resources in specified ways.

**Correct Answer: A****Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Strategic planning is the creation of an overall strategic plan for an organization to achieve its overall "business objectives." The strategic plan will establish the general direction of the organization.

Choice "b" is incorrect. Strategic planning will not establish the resources that the plan will require. The resources that the plan will require are part of the implementation of the strategic plan, not part of the plan itself. Choice

"c" is incorrect. Strategic planning will not establish the budget for the organization. Budgets are even further down implementing the plan than are the resources that the plan will require.

Choice "d" is incorrect. Strategic planning does not consist of decisions to use parts of the organization's resources in specified ways. Again, these decisions are part of the implementation of the strategic plan, not part of the plan itself.

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

**QUESTION 255**

In evaluating the impact of relative inflation rates on the demand for a foreign currency, which of the following is true?

- A. Inflation is irrelevant to currency demand.
- B. As inflation associated with a foreign economy increases in relation to a domestic economy, demand for the foreign currency falls.
- C. As inflation associated with a foreign economy increases in relation to a domestic economy, demand for the foreign currency increases.
- D. As inflation associated with a foreign economy decreases in relation to a domestic economy, demand for the foreign currency falls.

**Correct Answer: B****Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. As inflation associated with a foreign currency increases in relation to a domestic economy, demand for the foreign currency falls. Inflation weakens the foreign currency in relation to the domestic currency and makes foreign products more expensive and reduces demand. Reduced demand for a foreign import will reduce the demand for its currency.

Choice "a" is incorrect. Inflation, along with interest rates and trade restrictions are significant determinants of exchange rates.

Choice "c" is incorrect. As inflation associated with a foreign currency increases in relation to a domestic economy, demand for the foreign currency falls. Inflation weakens the foreign currency in relation to the domestic currency and makes foreign products more expensive and reduces demand. Reduced demand for a foreign import will reduce the demand for its currency, not increase demand.

Choice "d" is incorrect. As inflation associated with a foreign currency decreases in relation to a domestic economy, demand for the foreign currency rises. Inflation weakens the domestic currency in relation to the foreign currency and makes foreign products less expensive and increases demand. Increased demand for a foreign import will increase the demand for its currency, not decrease demand.

**QUESTION 256**

Which of the following is not correct about the purchasing power parity theory of explaining changes in exchange rates?

- A. Purchasing power of a common currency in different economies for similar products will remain the same.
- B. Inflationary forces on foreign and domestic currencies will cause the exchange rates to automatically adjust to ensure that a common currency will have identical or similar purchasing power in each economy for similar goods.
- C. Interest rates include a premium or discount that ensures purchasing power parity.
- D. The purchasing power parity theory is presented in both absolute and relative form.

**Correct Answer: C****Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The purchasing power parity theory holds that inflation will cause exchange rates to automatically adjust to ensure that an equal amount of a common currency will purchase similar goods in separate economies. The International Fischer effect considers the premium or discount on interest rates as an indicator of inflation.

Choice "a" is incorrect. The basic idea underlying the purchasing power parity theory is that the purchasing power of a common currency in different economies for similar products will remain the same and that inflation in any particular economy will cause exchange rates to adjust until parity is consistently achieved.

Choice "b" is incorrect. The purchasing power parity theory holds that inflationary forces on foreign and domestic currencies will cause the exchange rates to automatically adjust to ensure that a common currency will have identical or similar purchasing power in each economy for similar goods.

Choice "d" is incorrect. The purchasing power parity theory is presented as both an absolute theory of parity determination regardless of market imperfections and as a relative concept that considers market imperfections.

**QUESTION 257** Which of the following methods of measuring transaction exposure to exchange rate risk uses standard deviation, coefficient of correlation and other formal statistical techniques?

- I. Measurement of currency variability.
- II. Measurement of currency correlations.

- A. I only.
- B. II only.

- C. Both I and II.  
D. Neither I and II.

**Correct Answer: C**

Choice "c" is correct. The currency variability approach uses standard deviations as a means of predicting future exchange rates while the currency correlation approach is often applied to circumstances involving multiple currencies and evaluates exposure in relation to the statistically computed degree of correlation between the movements of different currencies. Choices "a", "b", and "d" are incorrect, per above Explanation.

#### QUESTION 258

Which of the following methods is designed to measure transaction exposure in terms of the maximum one day loss related to holdings denominated in foreign currency?

- I. Measurement of currency variability.  
II.Measurement of currency correlations.III. Value at risk.

- A. I only.  
B. II only.  
C. III only.  
D. I, II, and III.

**Correct Answer: C**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. The value at risk method seeks to quantify the exposure of business to a one day loss in the value of its positions in foreign currencies. Choices "a", "b", and "d" are incorrect, per above Explanation.

#### QUESTION 259

Atlas Worldwide Industries conducts business in a number of different countries and is trying to evaluate its economic exposure to exchange rate risk. Which of the following statements is not correct?

- A. Atlas will suffer an economic loss in the event it has net cash outflows of a foreign currency and the foreign currency appreciates. B. Atlas will enjoy an economic gain in the event it has net cash outflows of a foreign currency and the foreign currency depreciates.  
C. Atlas will suffer an economic loss in the event it has net cash inflows of a foreign currency and the foreign currency appreciates.  
D. Atlas will suffer an economic loss in the event it has net cash inflows of a foreign currency and the foreign currency depreciates.

**Correct Answer: C**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Domestic Currency	Foreign Currency	
	Net inflows	Net outflows
Appreciation	Loss	Gain
Depreciation	Gain	Loss

Choice "c" is correct. Atlas will benefit from an economic gain in the event that it has net cash inflows of a foreign currency and the foreign currency appreciates (the domestic currency depreciates). Atlas will collect a more valuable currency that can buy more of its domestic currency.

Choices "a", "b", and "d" are incorrect because they are correct statements.

#### QUESTION 260

Universal Industries limits its operations to exports to foreign countries. What can be said about Universal's exposures to exchange rate risk?

**Section: Volume C**  
**Explanation**

**Explanation/Reference:**

Explanation:

- A. Universal is subject to potential transaction, economic and translation exposures to exchange rate risk.
- B. Universal is subject to potential transaction and economic exposures to exchange rate risk.
- C. Universal is subject to economic and translation exposures to exchange rate risk.
- D. Universal is subject transaction and translation exposures to exchange rate risk.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Universal is subject to transaction risks associated with settlement of export transactions and is subject to economic risks associated with the satisfaction of domestic expenses denominated in domestic currencies with imported revenues denominated in a foreign currency. No translation exposure exists since there is no foreign investment or subsidiary. Choices "a", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 261**

Hedgehog International owes 500,000 local currency units to its foreign supplier in 90 days. The current spot rate of the local currency unit is \$.60. Hedgehog purchases a call option to buy the local currency unit in 90 days for \$.61 for a premium of \$.005. The exchange rate for the local currency increases to \$.63 in 90 days. What will Hedgehog do on the payables' settlement date?

- A. Hedgehog will exercise its option and settle the payables with proceeds from the option contract at a gain.
- B. Hedgehog will not exercise the option and settle the payables after purchase of the local currency unit at the spot rate.
- C. Hedgehog will be indifferent as to whether it exercises the option or not.
- D. Hedgehog will sell the option at the settlement date and use its proceeds along with local currency units purchased at the spot rate to satisfy the amount payable.

**Correct Answer: A**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Hedgehog will exercise its option and liquidate the payables associated with the proceeds. The exercise of the option represents a less costly alternative than acquisition of proceeds at the spot rate at the time the payables are due. The net impact of exercise of the option is computed as follows:

	Required LCU	Exchange @ Settlement	Call Price	Premium	Total	Payables Settlement
Settlement at spot	500,000	\$0.63	\$ -	\$ -	\$ -	\$315,000
Settlement with option	500,000	\$ -	\$0.61	\$0.005	\$0.615	307,500
<b>Net effect: Gain (Loss)</b>						<b>\$ 7,500</b>

The premium is a sunk cost and is irrelevant to the decision. Note that the premium is a factor in determining the net gain (loss) but not in deciding whether to exercise the option. Choices "b", "c", and "d" are incorrect, per computation above.

**QUESTION 262**

Hedgehog International has a receivable valued at 500,000 local currency units from its foreign customer due in 90 days. The current spot rate of the local currency unit is \$.60. Hedgehog purchases a put option to sell the local currency unit in 90 days for \$.61 for a premium of \$.005. The exchange rate for the local currency increases to \$.63 in 90 days. What will Hedgehog do on the receivable's settlement date?

- A. Hedgehog will exercise its option and sell the proceeds of its accounts receivable collection under the provisions of the option contract at a gain.
- B. Hedgehog will not exercise the option and sell local currency units collected from its receivable at the spot rate.
- C. Hedgehog will be indifferent as to whether it exercises the option or not.
- D. Hedgehog will sell the option at the settlement date and combine its proceeds along with local currency units purchased at the spot rate to maximize its revenue.

Correct Answer: B  
Section: Volume C





## Explanation

### Explanation/Reference:

Explanation:

Choice "b" is correct. Hedgehog will not exercise its option and will, instead convert the local currency units collected from the receivables to its domestic currency by selling that currency at the spot rate at the time of collection. The exercise of the option represents a less profitable alternative than sale of the accounts receivable proceeds at the spot rate at the time the receivables are collected. The exercise of the option in comparison to allowing the option to expire is computed as follows:

	Required LCU	Exchange @ Settlement	Put Price	Premium	Total	Payables Settlement
Settlement at spot	500,000	\$0.63	\$—	\$—	\$—	\$315,000
Settlement with option	500,000	\$—	\$0.61	\$0.005	\$0.615	307,500
<b>Net effect: Gain (Loss)</b>						<b>&lt;7,500&gt;</b>

The premium is a sunk cost and is irrelevant to the Explanation. Note that the premium is a factor in determining the net gain (loss) but not in deciding whether to exercise option. Choices "a", "c", and "d" are incorrect, per computation above.

### QUESTION 263

Hedgehog International has numerous foreign exchange transactions. Management has elected to hedge transactions as a means of mitigating transaction exposure to exchange rate risk. What is the most effective means that Hedgehog International can use to avoid overhedging?

- A. Hedgehog should acquire parallel loans to provide a means for liquidating unneeded hedge securities.
- B. Hedgehog should acquire the maximum amount required to hedge known and projected transactions.
- C. Hedgehog should acquire the minimum amount required to hedge known transactions.
- D. Hedgehog should enter into a cross hedging agreement.

**Correct Answer: C**

**Section: Volume C**



## Explanation

### Explanation/Reference:

Explanation:

Choice "c" is correct. Hedgehog should only acquire the minimum amount of hedge contracts needed to offset the effect of known transactions.

Choice "a" is incorrect. Parallel loans represent a swap contract for hedging long-term transaction exposure and are not specifically designed to mitigate the risk of overhedging.

Choice "b" is incorrect. Acquisition of the maximum number of hedge contracts for known and projected transactions exposes the organization to greater risk of overhedging since projected transactions might not materialize. Choice

"d" is incorrect. Cross hedging involves techniques related to currencies that do have hedge instruments available to mitigate risk and are not specifically designed to avoid overhedging.

**QUESTION 264** An American importer expects to pay a British supplier 500,000 British pounds in three months. Which of the following hedges is best for the importer to fix the price in dollars?

- A. Buying British pound call options.
- B. Buying British pound put options.C. Selling British pound put options.
- D. Selling British pound call options.

**Correct Answer: A**

**Section: Volume C**

## Explanation

### Explanation/Reference:

Explanation:

Choice "a" is correct. To fix a price in dollars to buy British pounds, British pound call options should be purchased. Call options would allow, but not require, the purchaser of the call to acquire the currency (British pounds) for a specified price at or before a specified time in the future. If the price goes down, the purchaser (the importer) would exercise the options; if not, the purchaser (importer) would buy the British pounds in the market and let the options expire. British pound futures could also be used, but that was not one of the choices listed.

Choice "b" is incorrect. Buying British pound put options would allow, but not require, the purchaser of the put to sell the currency for a specified price at a specified time in the future. Since the importer needs British pounds, buying put options would not work. The importer needs to end up with British pounds.



Choice "c" is incorrect. Selling British pound put options would not work. The importer needs to end up with British pounds. Selling put options could work, but the option would be exercised, or not, by the purchaser and not by the importer. If the options were not exercised, the importer could end up with nothing (other than the option premium).

Choice "d" is incorrect. Selling British pound call options would not work. The importer needs to end up with British pounds; if call options are sold, the other party can exercise the options or let them expire, and if the options were exercised, the importer would have to supply the British pounds. This answer is backwards.

**QUESTION 265**

What is the effect when a foreign competitor's currency becomes weaker compared to the U.S. dollar?

- A. The foreign company will have an advantage in the U.S. market.
- B. The foreign company will be disadvantaged in the U.S. market.
- C. The fluctuation in the foreign currency's exchange rate has no effect on the U.S. company's sales or cost of goods sold.
- D. It is better for the U.S. company when the value of the U.S. dollar strengthens.

**Correct Answer:** A

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. As a foreign competitor's currency becomes weaker compared to the U.S. dollar, the product becomes less expensive in U.S. dollars. The less expensive product will have the advantage in the U.S. market. Choice "b" is incorrect. As a foreign competitor's currency becomes weaker compared to the U.S. dollar, the product becomes less expensive in U.S. dollars. The less expensive product will have the advantage in the U.S. market, not a disadvantage.

Choice "c" is incorrect. Foreign currency exchange rates impact both sales and possibly cost of goods sold of a competing domestic company. Sales within U.S. markets will deteriorate as the currency of foreign competitors deteriorates and makes the domestic company's goods more expensive. As a foreign competitor's currency appreciates, sales within U.S. markets by a domestic company should also increase as goods manufactured in the U.S. become less expensive. Cost of goods sold may fluctuate if foreign suppliers are used.

Choice "d" is incorrect. It is better for a U.S. company when the value of the U.S. dollar weakens, not strengthens. A weak U.S. dollar makes domestic goods relatively less expensive than imported goods.

**QUESTION 266** Compared to firms in a perfectly competitive market, a monopolist tends to:

- A. Produce substantially less but charge a higher price.
- B. Produce substantially more and charge a higher price.
- C. Produce the same output and charge a higher price.
- D. Produce substantially less and charge a lower price.

**Correct Answer:** A

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Compared to firms in a perfectly competitive market, a monopolist tends to produce substantially less but charge a higher price. Choices "b", "c", and "d" are incorrect, per above Explanation.

**QUESTION 267**

Patents are granted in order to encourage firms to invest in the research and development of new products. Patents are an example of:

- A. Market concentration.
- B. Entry barriers.
- C. Exclusionary practices.
- D. Collusion.

**Correct Answer:** B

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Patents are an example of entry barriers. Patents prevent other rival firms (without patents) from entering the market and consequently, are a form of entry barriers. Patents can be "process-related" or "product-related." Choices "a", "c", and "d" are incorrect, per above Explanation.

**QUESTION 268** An oligopolist faces a "kinked" demand curve. This terminology indicates that:

- A. When an oligopolist lowers its price, the other firms in the oligopoly will match the price reduction, but if the oligopolist raises its price, the other firms will ignore the price change.
- B. An oligopolist faces a non-linear demand for its product, and price changes will have little effect on demand for that product.
- C. An oligopolist can sell its product at any price, but after the "saturation point," another oligopolist will lower its price and, therefore, shift the demand curve to the left.
- D. An oligopolist is similar to a monopolist, and as the quantity demanded for its product increases, the demand curve for that firm shifts to the right.

**Correct Answer:** A

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. In an oligopoly, each firm faces a "kinked" demand curve. Others will match price cuts, but ignore price increases. The "kink" is at the prevailing price. Best real world examples of oligopoly are the airline and auto industries.

Choice "b" is incorrect. An oligopolist's demand curve is linear but "kinked." Above the "kink," demand is highly elastic. Below, very inelastic.

Choice "c" is incorrect. An oligopolist cannot sell at any price. There is no "saturation point."

Choice "d" is incorrect. A change in quantity demanded indicates a movement along the demand curve, not a shift in the curve.

**QUESTION 269** An increase in the minimum wage:

- I. Will move employers down the labor demand curve, causing the quantity of labor demanded to fall.
- II. Is likely to increase the supply of labor, as more people will be willing to work for the higher wage.

- A. Only I.
- B. Only II.
- C. Both I and II.
- D. Neither I nor II.

**Correct Answer:** D

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct; neither statement I nor statement II are correct. Statement I is incorrect, as an increase in the minimum wage will move employers up, not down, the labor demand curve, causing the quantity of labor demanded to fall.

Statement II is incorrect, as an increase in the minimum wage leads to a decrease in the quantity demanded of labor and an increase in the quantity supplied of labor. It does not increase the supply of labor, only the quantity supplied of labor.

Choices "a", "b", and "c" are incorrect, per the above.

**QUESTION 270** In a competitive market an increase in the minimum wage will likely have the following effects:

- A. The general (or aggregate) demand for labor will increase; however, the quantity demanded will remain unchanged.
- B. The general (or aggregate) supply of labor will increase; however, the quantity supplied will remain unchanged.
- C. The general (or aggregate) demand for labor will remain unchanged; however, the quantity demanded will decrease.
- D. The general (or aggregate) supply of labor will remain unchanged; however, the quantity supplied will decrease.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The general (or aggregate) demand for labor will remain unchanged; however, the quantity demanded will decrease.

Choice "a" is incorrect, per Explanation for choice "c" above.

Choices "b" and "d" are incorrect. The general (or aggregate) supply of labor will remain unchanged; however, the quantity supplied will increase.

**QUESTION 271** An increase in the minimum wage will benefit specific economic wage groups as outlined below:

I. Employees at the minimum wage rate who remain employed will benefit, since they will receive more money.

II. Many of the unskilled could lose their jobs. There would be fewer jobs for the currently unemployed such as less educated and untrained personnel (e.g., teenagers) who will have more difficulty finding work as firms reduce their laborforce and pursue more efficiency.

- A. Only I.
- B. Only II.
- C. Both I and II.
- D. Neither I nor II.

**Correct Answer: A**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Only I.

Choices "b", "c", and "d" are incorrect, since II is a disadvantage - not a benefit.



**QUESTION 272** The movement along the demand curve from one price-quantity combination to another is called a(n):

- A. Change in demand.
- B. Shift in the demand curve.
- C. Change in the quantity demanded.
- D. Increase in demand.

**Correct Answer: C**

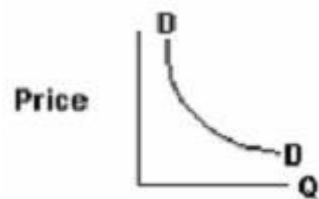
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

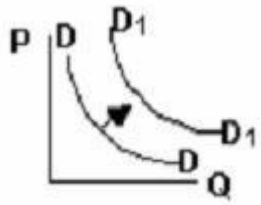
Explanation:

Choice "c" is correct. References to the change in quantity demanded refer to a single demand curve, which is downward sloping to the right.



Changes in the quantity demanded result from changes in price.

Choices "a", "b", and "d" are incorrect. All refer to changes in the demand curve itself, like an outward shift from curve D - D to D1 - D1.



**QUESTION 273** Which one of the following would cause the demand curve for a commodity to shift to the left?

- A. A rise in the price of a substitute product.
- B. A rise in average household income.
- C. A rise in the price of a complementary commodity.
- D. A rise in the population.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A rise in the price of a complementary commodity would cause a shift to the left in any demand curve (representing decrease in demand, at all price levels, for that product). With respect to complementary goods, the demand for the primary product is directly impacted by the demand (and hence the price changes) for the complementary goods. For instance, if the price of gasoline goes up, the demand for cars will decrease, causing the demand curve for cars to shift left.

Choice "a" is incorrect. A rise in the price of a substitute product will make the demand curve shift to the right.

Choice "b" is incorrect. A rise in average household income would make the demand curve shift to the right, representing an increase in demand.

Choice "d" is incorrect. A rise in population, or a change in consumers' tastes in favor of the commodity are also changes that may cause an increase in demand, making the demand curve shift to the right.

**QUESTION 274** In any competitive market, an equal increase in both demand and supply can be expected to always:

- A. Increase both price and market-clearing quantity.
- B. Increase market-clearing quantity.
- C. Increase price.
- D. Decrease price.

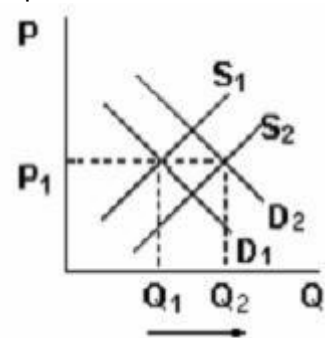
**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "b" is correct. As illustrated above, a shift outward (increase) in supply increases quantity supplied at equilibrium. As illustrated, this is true even when demand increases. Choice "a" is incorrect. As illustrated, price may stay the same but quantity will increase. Draw the graph! Choices "c" and "d" are incorrect. Price may remain the same, but quantity will "always" increase.

**QUESTION 275**

When the federal government imposes health and safety regulations on certain products, one of the most likely results is:

- A. Greater consumption of the product.
- B. Lower prices for the product.
- C. Higher prices for the product.
- D. Increased supply of the product.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. One of the consequences of greater government regulation of certain products is the resulting higher cost to the consumer when the government imposes health and safety regulations on certain products it is likely that expenses will increase and that the added costs will be passed on to consumers in terms of higher prices. The total output for the product may decrease. Choice "a" is incorrect. Since the price goes up, consumption will decrease.

Choice "b" is incorrect. The price can be expected to increase (see choice "c" Explanation above). Choice "d" is incorrect. Since the price goes up, supply goes down.

**QUESTION 276** Tennis rackets and tennis balls are:

- A. Substitute goods.
- B. Independent goods.
- C. Inferior goods.
- D. Complementary goods.



**Correct Answer: D**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Complementary goods are ones whose demand fluctuates together. If Good A and Good B are complements, then if the demand for Good A increases, the demand for Good B will also increase, tennis rackets and tennis balls are complements.

Choice "a" is incorrect. For substitutive goods, as the price of one of the goods increases, the other good experiences an increase in demand as it is substituted for the first good. An example of substitute goods is apple and orange juice.

Choice "b" is incorrect. Independent goods have demand functions that are not interrelated. An example would be bread and vacuum cleaners.

Choice "c" is incorrect. Inferior goods experience a decrease in demand when income levels rise. An example is hamburger, which experiences decrease in demand as incomes rise and buyers switch to higher priced meats.

**QUESTION 277** All of the following are complementary goods, except:

- A. Margarine and butter.
- B. Gas and motor oil.
- C. Cameras and rolls of film.
- D. VCRs and video cassettes.

**Correct Answer: A**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Margarine and butter are substitute goods. If the price of one goes up, demand for the substitute increases.

Choices "b", "c", and "d" are incorrect. They are complements. Two goods are complements if they are used together or their demand curves move together (breakfast cereal and milk, e.g., or tennis balls and tennis racquets). Thus, if the price of one complement goes up, demand for the other good goes down.

**QUESTION 278** Utility companies can generally price their product, a good that establishes a comfortable life-style (i.e., electricity, gas for home heating) based on the fact that the demand:

- A. Is relatively elastic.
- B. Is perfectly elastic.
- C. Is relatively inelastic.
- D. Is perfectly inelastic.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Goods that are important for a comfortable life-style would be relatively price insensitive (i.e., inelastic). For example, demand for electricity would only decrease if there were an enormous increase in price (people might then use other forms of energy - such as solar). Only goods that are absolute necessities (a theoretical example is water) have perfectly inelastic demand curves.

That is, no matter what price is charged, people will still buy the product because they need it to stay alive. Choices

"a", "b", and "d" are incorrect, per Explanation for choice "c" above.

**QUESTION 279** Product demands become more elastic the:

- A. Greater the number of substitute products available.
- B. Greater the consumer income.
- C. Greater the elasticity of supply.
- D. Shorter the time period considered.

**Correct Answer: A**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Product demands become more elastic the greater the number of substitutes available. With price increases, consumers will switch to substitute goods. Choice

"b" is incorrect. Consumer income will not affect demand elasticity.

Choice "c" is incorrect. Elasticity of supply and demand is unrelated.

Choice "d" is incorrect. Product demand is more elastic the longer the time period, since more choices become available.

**QUESTION 280** If a product's demand is elastic and there is a decrease in price, the effect will be:

- A. A decrease in total revenue.
- B. No change in total revenue.
- C. A decrease in total revenue and the demand curve shifts to the left.
- D. An increase in total revenue.

**Correct Answer: D**

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. If demand is relatively elastic, then the reduction in price will, by definition, produce a proportionately greater increase in quantity demanded. Hence, total revenue will increase.

Choices "a", "b", and "c" are incorrect, per Explanation above.

**QUESTION 281** If a product has a price elasticity of demand of 2.0, the demand is said to be:

- A. Perfectly elastic.
- B. Perfectly inelastic.
- C. Relatively elastic.
- D. Relatively inelastic.

**Correct Answer: C**

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. A price elasticity of demand of 2.0 means demand will change by 2x (as a percentage) for any change in price. This is called elastic.

Choice "a" is incorrect. Perfectly elastic demand does not exist.

Choice "b" is incorrect. Perfectly inelastic demand means the quantity demanded will not change when price changes. Choice

"d" is incorrect. Inelastic demand responds less than 1x (as a percentage) for a change in price.

**QUESTION 282**

In the pharmaceutical industry where a diabetic must have insulin no matter what the cost, the diabetic's demand is considered to be:

- A. Perfectly elastic.
- B. Perfectly inelastic.
- C. Relatively elastic.
- D. Relatively inelastic.

**Correct Answer: B**

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. When a good is demanded, no matter the price, demand is described as perfectly inelastic. The demand "curve" is a vertical line at the quantity demand with price making no difference.

Choices "a" and "c" are incorrect. There is no such thing as perfect elasticity. However, the more elastic demand is, the greater the change in quantity demand for price changes. Choice "d" is incorrect. Insulin is an example of perfectly inelastic.

**QUESTION 283**

If, in a competitive market, a price ceiling is imposed establishing a maximum price below the market equilibrium price, this price ceiling would result in:

- A. Shortages because the quantity demanded would exceed the quantity supplied.
- B. No effect on the quantity supplied or demanded.
- C. Surpluses because the quantity supplied would exceed the quantity demanded.
- D. Surpluses because the supply curve would shift to the right.



**Correct Answer:** A  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "a" is correct. Setting a ceiling price below the price dictated by the market (as established by the equilibrium price) would create excess demand and a shortage. Choices "b", "c", and "d" are incorrect, per above Explanation.

**QUESTION 284**

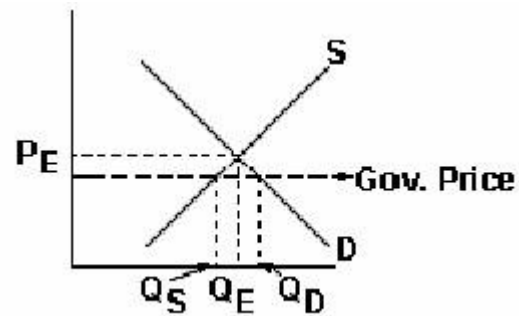
Government price regulations in competitive markets that set maximum or ceiling prices below the equilibrium price will in the short run:

- A. Cause demand to increase.
- B. Cause supply to increase.
- C. Create shortages of that product.
- D. Produce a surplus of the product.

**Correct Answer:** C  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
 Explanation:



Choice "c" is correct. Government price regulations in competitive markets that set maximum or ceiling prices below the equilibrium price will create shortages of that product in the short run because quantity supplied will be less than quantity demanded at that price.

Choice "a" is incorrect. Quantity demand will increase at the lower price.

Choice "b" is incorrect. Quantity supplied will decrease at the lower price.

Choice "d" is incorrect. A price set below the market's equilibrium price causes shortages, not surpluses, per the graph above.

**QUESTION 285** Which of the following activities is considered a primary activity?

- A. Delivery of products.
- B. Procurement of materials.
- C. Human resources.
- D. Accounting.

**Correct Answer:** A  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "a" is correct. Primary activities are those that are involved with the direct manufacture of products, the delivery of products through distribution channels, and the support of the product that exists after the sale is made (e.g., handling the raw materials, the manufacturing process, taking orders for the product, advertising the product, and servicing the product after it is sold).

Choices "b", "c", and "d" are incorrect, as these are all considered support activities. Support activities are those activities that are performed by the support staff of an organization (e.g., purchasing of materials and supplies, development of the technology used, management of employees, accounting, finance, strategic planning, etc.).

**QUESTION 286** When applying value chain analysis, a firm asks its accounting department to perform an analysis of the sources of profits and costs of activities that exist within the firm. The firm is performing which form of value chain analysis?

- A. Internal differentiation analysis.
- B. Internal costs analysis.
- C. Vertical linkage analysis.
- D. None of the above.

**Correct Answer: B**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. Internal costs analysis includes analyzing the internal value-creating ability of a firm, so the sources of profit and costs of the internal activities of the firm must be analyzed. Choices "a", "c", and "d" are incorrect, per the above Explanation.

#### QUESTION 287

If a nation has many rival domestic firms which are all competitive in the global marketplace for a product, which of the four major factors that Michael Porter has indicated impact the global competitive environment would allow this nation to fare better with respect to global competitive advantage?

- A. Conditions of the factors of production.
- B. Conditions of domestic demand.
- C. Related and supporting industries.
- D. Firm strategy, structure, and rivalry.



**Correct Answer: C**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. The factor of related and supporting industries deals with whether there are suppliers of material inputs that exist within a nation or whether there are rival firms who are competitive in the international environment, both of which would increase the nation's competitive advantage.

Choice "a" is incorrect. If a nation has a strong set of factors of production (such as low-cost, high quality raw material inputs), that are required in a given industry, it will fare better with regard to competitive advantage. However, this factor is different from the "many rival domestic firms which are all competitive in the global marketplace for a product" as stated in the question.

Choice "b" is incorrect. The factor of conditions of domestic demand related to the nation's domestic demand for the product, which is directly related to the ability of the nation to fare better with regard to competitive advantage. However, this factor is different from the "many rival domestic firms which are all competitive in the global marketplace for a product" as stated in the question.

Choice "d" is incorrect. The factor of firm strategy, structure, and rivalry relates to the practices of a nation with respect to how the companies are managed and organized, along with the laws of the nation that regulate the formation of the companies, and how intense the rivalry is with respect to competing firms in the nation. However, this factor is different from the "many rival domestic firms which are all competitive in the global marketplace for a product" as stated in the question.

#### QUESTION 288

Which of the following is not an external factor that directly affects the competitive environment of the firm?

- A. Barriers to market entry.
- B. Bargaining power of suppliers.
- C. Political issues.
- D. Existence of substitute products.

**Correct Answer:** C  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Political issues are external factors that affect the overall industry, not simply the competitive environment of the firm. Choices "a", "b", and "d" are incorrect, as all of these factors directly affect the competitive environment of the firm.

**QUESTION 289** When does competition not become an even stronger force impacting the profitability of a firm?

- A. Various firms use various types of strategic plans.
- B. Customers do not have strong brand preferences.
- C. The market is not growing fast.
- D. The costs of exiting the market are less than the costs of continuing to operate.

**Correct Answer:** D  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is the proper choice, as it is not a factor that would cause market competitiveness to be even stronger. Choices "a", "b", and "c" are incorrect because they are all reasons that competition becomes an even stronger force that impacts the firm's profitability. Following are situations that would cause competition to be an even stronger force impacting the profitability of a firm:

- The market is not growing fast.
- There are several equal-sized firms in the market.
- Customers do not have strong brand preferences.
- The costs of exiting the market exceed the costs of continuing to operate.
- Some firms profit from making certain moves to increase market share.
- The various firms in the market use different types of strategic plans.

**QUESTION 290** Which of the following statements regarding the existence of substitute products is true?

- A. The impact of substitutes will have more of an effect on the competitive environment of a firm if the substitutes are readily available for customers to obtain.
- B. When the cost of buyers switching to new products is high, the effect of substitutes on the competitive environment of a firm is high.
- C. If many close substitutes exist, buyers have little choice of products and may be willing to pay a higher price for the products that are available.
- D. If substitutes have equal performance and are priced at or below the firm's product, the competitive force of substitutes with respect to the firm is weak.

**Correct Answer:** A  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. The impact of substitutes will have more of an effect on the competitive environment of a firm if the substitutes are readily available to consumers. Choice "b" is incorrect. When the cost of buyers switching to new products is low (not high), the effect of substitutes on the competitive environment of a firm is high. Choice "c" is incorrect. If few (not many close) substitutes exist, buyers have little choice of products and may be willing to pay a higher price for the products that are available. Choice "d" is incorrect. If substitutes have equal performance and are priced at or below the firm's product, the competitive force of substitutes with respect to the firm is strong (not weak).

**QUESTION 291**

Which of the following is not considered a factor that increases the bargaining power of the customer?

- A. Much information is available to the customer to compare and contrast features of all products on the market.
- B. One group of customers makes up a large volume of the firm's business.
- C. Strategic alliances have been formed with suppliers and other firms.
- D. Several alternate suppliers (sellers) of the product exist.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. When strategic alliances exist between a supplier and other firms that is a situation, which increases the bargaining power of the suppliers. Choices "a", "b", and "d" are incorrect because they all are factors that increase the bargaining power of the customer, which are:

- Customers make up a large volume of a firm's business.
- There is much information available to customers.
- The buyers have low switching costs.
- There are a high number of alternate suppliers (sellers) of the product.

**QUESTION 292** Which of the following statements regarding competitive advantage is not true?

- A. The two major forms of competitive advantage are product differentiation and cost leadership.
- B. If the manufacturing costs of a firm are less than those of close rivals, then the firm has a competitive market advantage.
- C. Cost leadership advantage may be the best be obtained by a firm when a firm builds market shares or matches the price of its rivals.
- D. Differentiation advantage may best be obtained by a firm when a firm builds market share or increases its price.

**Correct Answer: B**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is the proper choice, as it is not a true statement. Simply because the manufacturing costs of a firm are less than those of close rivals, this does not necessarily mean that the firm has a competitive market advantage. Only if TOTAL costs to a firm are less than those of close rivals will a firm have a competitive market advantage. Choices "a", "c", and "d" are incorrect, as they are all true statements.

**QUESTION 293** In which stage of supply chain management will the firm's management turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, with a focus on customer service?

- A. Cross-functional teams.
- B. Integrated enterprise.
- C. Extended supply chain.
- D. Supply chain communities.

**Correct Answer: A**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. In the cross-functional teams stage of supply chain management, the firm's management will turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, and the focus will be on customer service.

Choice "b" is incorrect. In the integrated enterprise stage of supply chain management, the firm's management will move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service.

Choice "c" is incorrect. In the extended supply chain stage of supply chain management, integration moves external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth.

Choice "d" is incorrect. In the supply chain communities stage of supply chain management, the extended supply chain forms a single competitive entity with a synchronized supply chain and a complex system of networks.

#### QUESTION 294

Strategy is a broad term that usually means the selection of overall objectives. Strategic analysis would generally exclude the:

- A. Trends that will affect the entity's markets.
- B. Target product mix and production schedule to be maintained during the year.
- C. Forms of organizational structure that would best serve the entity.
- D. Best ways to invest in research, design, production, distribution, marketing, and administrative activities.

**Correct Answer: B**  
**Section: Volume C**

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "b" is correct. Target product mix and production scheduling would be operational plans.

Strategy is much more general and conceptual.

Choices "a", "c", and "d" are incorrect, which are parts of strategy.

**QUESTION 295** Which one of the following management considerations is usually addressed first in strategic planning?

- A. Overall goals of the firm.
- B. Organizational structure.
- C. Recent annual budgets.
- D. Being an industry leader.

**Correct Answer: A**  
**Section: Volume C**

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "a" is correct. Setting the overall goals of the firm is usually the starting point in strategic planning.

Choice "b" is incorrect. The organizational structure will be partially determined by the goals of the firm.

Choice "c" is incorrect. Recent annual budgets may be reviewed as an aid in planning, but they are not the first consideration in strategic planning. In fact, they often are ignored. Choice "d" is incorrect. Being an industry leader may be or become a goal of the firm, but that would be determined during the strategic planning process.

**QUESTION 296** All of the following are characteristics of the strategic planning process, except the:

- A. Emphasis on both the short and long run.
- B. Review of the attributes and behavior of the organization's competition.
- C. Analysis and review of departmental budgets.
- D. Analysis of consumer demand.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Analysis and review of departmental budgets is not a part of the strategic planning process. Budgets are operational and much more specific than the things that are part of strategic planning.

Choices "a", "b", and "d" are incorrect. All of these are part of the strategic planning process: A.

Emphasis on both the short and long run.

B. A review of competition.

D. Analysis of consumer demand.

**QUESTION 297** Strategic planning, as practiced by most modern organizations, includes all of the following, except:

A. Top-level management participation.

B. Strategies that will help in achieving long-range goals.

C. Analysis of the current month's actual variances from budget.

D. Identification of long-term key variables including external influences.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Analysis of the current month's actual variances from budget is not a part of strategic planning. It is too short-term and looks at the past. Strategic planning has a long-term focus and is forward-looking. Strategic planning includes:

A. Top-level management participation.

B. Strategies that will help in achieving long-range goals.

D. Identification of long-term key variables including external influences.

**QUESTION 298** The key difference between strategic goals and tactical goals is that tactical goals are:

A. Usually attainable.

B. Developed by top management.

C. Concerned with issues other than profit.

D. Short-term in nature.

**Correct Answer: D**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Tactical goals are the means for attaining strategic goals and are short-term in nature. Strategic goals are overall objectives and relatively long-term. Choice

"a" is incorrect. Both strategic and tactical goals are usually attainable.

Choice "b" is incorrect. Development of all goals are best accomplished with the involvement of employees at all levels.

Choice "c" is incorrect. Tactical goals are the means for achieving strategic goals. Both are concerned with profit and other issues.

**QUESTION 299**

Eugene Entrepreneur developed his waste collections and disposal business from one truck 20 years ago to a fleet of 2,000 trucks serving an entire region today. Gene is looking to retire and knows that he cannot find a suitable buyer for the entire business. Gene has developed a series of short range plans with his senior management group that include generous bonuses, funded in part by deferred repair and maintenance expenses and prior earnings, sales of business segments where possible or transfers of assets to the counties and municipalities that had engaged the waste collection and disposal service.

Gene has frozen all new capital investment. The mission that Eugene Entrepreneur has mapped out for his company can best be described as:

- A. Build.
- B. Hold.
- C. Harvest.
- D. Sunset.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Eugene Entrepreneur has mapped out a harvest mission for his company. As Gene retires and pulls assets and value from the company, he is clearly taking a short-term view toward reaping immediate benefit.

Choice "a" is incorrect. A "build" mission anticipates that the business is positioned to expand markets or market share and is characterized by a long-term view that promotes investment.

Choice "b" is incorrect. A "hold" mission contemplates that the business is trying to hold on to current market share and is characterized by appropriate investment and competitive positioning. Choice

"d" is incorrect. The term "sunset" mission is a distracter.

**QUESTION 300**

Anson Industries, a vertically integrated producer and retailer of high end audio visual equipment has mapped out its overall business process as beginning with product development followed by product testing then raw materials purchasing then manufacturing and assembly, and, finally, sales and service.

Finance staff at Anson Industries are trying to evaluate the efficiency and the effectiveness of each process and the relationship between each process. This evaluation is often referred to as:

- A. Process improvement.
- B. Continuous quality improvement.
- C. Value chain analysis.
- D. Benchmarking.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The process of developing macro level flow charts of business processes that produce products or services and then identifying the value added by each process is referred to as value chain analysis.

Choice "a" is incorrect. Process improvement represents the results of total quality management efforts.

Choice "b" is incorrect. Continuous quality improvement represents an unswerving focus on customer satisfaction and quality, not necessarily the specific steps associated with value chain analysis. Choice

"d" is incorrect. Benchmarking relates to determining best practices and, often, using those practices as standards.

**QUESTION 301**

A market with many independent firms, low barriers to entry, and product differentiation is best classified as:

- A. A natural monopoly.
- B. Monopolistic competition.
- C. An oligopoly.
- D. Pure competition.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:



Choice "b" is correct. A market with many independent firms, low barriers to entry, and product differentiation is best classified as monopolistic competition. There are few barriers to entry and firms exert some influence over price in such a market. Best examples are brand name consumer products.

Choice "a" is incorrect. A natural monopoly exists when economic and technical conditions permit only one efficient supplier.

Choice "c" is incorrect. The presence of only one company indicates a monopoly; the presence of a few companies would indicate an oligopoly. Choice

"d" is incorrect. Market conditions characterizing pure competition include homogeneous, not differentiated, products.

#### QUESTION 302

Which tool would most likely be used to determine the best course of action under conditions of uncertainty?

- A. Cost-volume-profit analysis.
- B. Expected value (EV).
- C. Program evaluation and review technique (PERT).
- D. Scattergraph method.

**Correct Answer: B**

**Section: Volume C**

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "b" is correct. Probability and expected value formulate quantitative models to address the issue of appropriate course of action in an environment of uncertainty. The expected value is a weighted average of all values and variables. The course of action with the highest expected monetary value should be selected.

Choice "a" is incorrect. Cost-volume profit analysis is a method used to evaluate operating decisions.

Choice "c" is incorrect. PERT is a technique used in project management that focuses on the time required to complete each step in a project. It allows a project manager to monitor a project's progress and identify potential bottlenecks or delays that will postpone the completion date.

Choice "d" is incorrect. The scattergraph method is used in statistical analysis to plot relationships between variables to determine a line function that best describes those relationships.

#### QUESTION 303

In situations when management must decide on accepting or rejecting one-time-only special orders, where there is sufficient idle capacity, which one of the following is not relevant to the decision?

- A. Absorption costs.
- B. Direct costs.
- C. Variable costs.
- D. Incremental costs.

**Correct Answer: A**

**Section: Volume C**

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "a" is correct. Absorption costs are not relevant in situations when management must decide on accepting or rejecting one-time-only special orders, and where there is sufficient idle capacity. All of the following costs are relevant in such situations:

- B. Direct costs
- C. Variable costs
- D. Incremental costs

#### QUESTION 304

Dough Distributors has decided to increase its daily muffin purchases by 100 boxes. A box of muffins costs \$2 and sells for \$3 through regular stores. Any boxes not sold through regular stores are sold through Dough's thrift store for \$1.

Dough assigns the following probabilities to selling additional boxes:

<u>Regular Store Sales</u>	<u>Thrift Store Sales</u>	<u>Probability</u>
60	40	.6
100	0	.4

What is the expected value of Dough's decision to buy 100 additional boxes of muffins?

- A. \$28
- B. \$40
- C. \$52
- D. \$68

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. The expected value of a decision is computed by multiplying the probability of each outcome by its value or profit. Each outcome is then added.

There is a 60% probability that Dough will sell 60 of the 100 additional boxes through regular stores and that means that Dough would have a 60% chance of making a profit of \$20 (60 boxes at a \$1 profit (\$3 - \$2) sold through the regular stores and 40 boxes at a \$1 loss (\$1 - \$2) sold through the thrift stores).

There is a 40% probability that Dough will have a profit of \$40 (100 boxes at a \$1 profit through the regular store sales and zero boxes sold at a loss through the thrift store).

$$\begin{array}{rcl}
 60\% \text{ probability of } \$20 \text{ profit} & = & \$12 \\
 40\% \text{ probability of } \$100 \text{ profit} & = & \underline{40} \\
 & & \underline{\$52}
 \end{array}$$



Choice "a" is incorrect. The expected value of a decision is computed by multiplying the probability of each outcome by its value or profit.

Choice "b" is incorrect. The expected value of a decision is computed by multiplying the probability of each outcome by its value or profit.

Choice "d" is incorrect. The expected value of a decision is computed by multiplying the probability of each outcome by its value or profit.

#### QUESTION 305

A vendor offered Wyatt Co. \$25,000 compensation for losses resulting from faulty raw materials.

Alternately, a lawyer offered to represent Wyatt in a lawsuit against the vendor for a \$12,000 retainer and 50% of any award over \$35,000. Possible court awards with their associated probabilities are:

<u>Award</u>	<u>Probability</u>
\$75,000	0.6
0	0.4

Compared to accepting the vendor's offer, the expected value for Wyatt to litigate the matter to verdict provides a:

- A. \$4,000 loss.
- B. \$18,200 gain.C. \$21,000 gain.
- D. \$38,000 gain.

**Correct Answer: A**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct.

**Step 1:**

Cost of award if Wyatt wins:

Retainer	12,000
Add: $(\$75,000 - \$35,000) \times 50\%$	<u>20,000</u>
	<u>32,000</u>

Cost if Wyatt loses retainer \$12,000.

**Step 2:**

<u>Award</u>	<u>Cost</u>	<u>Net to Wyatt</u>	<u>Probability</u>	<u>Expected</u>
75,000	– 32,000	= 43,000	× .60	= 25,800
0	– (12,000)	= (12,000)	× .40	= <u>(4,800)</u>
				<u>21,000</u>

**Step 3:**

Expected value of litigation	21,000
Less: Settlement offer	<u>(25,000)</u>
Loss from choosing to litigate	<u>(4,000)</u>

Choices "b", "c", and "d" are incorrect based on the above Explanation.



**QUESTION 306**

Under frost-free conditions, Cal Cultivators expects its strawberry crop to have a \$60,000 market value. An unprotected crop subject to frost has an expected market value of \$40,000. If Cal protects the strawberries against frost, then the market value of the crop is still expected to be \$60,000 under frostfree conditions and \$90,000 if there is a frost. What must be the probability of a frost for Cal to be indifferent to spending \$10,000 for frost protection?

- A. .167
- B. .200
- C. .250
- D. .333

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. If there is no frost, then there is no difference between Cal's income with or without the insurance-the crop is worth \$60,000 either way. However, if the insurance is purchased and a frost occurs, Cal earns \$50,000 more with insurance ( $\$90,000 - \$40,000$ ) than he would without the insurance. The expected value of having the insurance is therefore:

Probability of frost x \$50,000 + Probability of no frost x \$0

Cal will be indifferent to spending \$10,000 for frost protection when the expected value of the insurance equals the cost of the insurance: Probability

of frost x \$50,000 = \$10,000

Probability = 20%

Choices "a", "c", and "d" are incorrect based on the above Explanation.

**QUESTION 307**

During 1994, Deet Corp. experienced the following power outages:

<i>Number of outages per month</i>	<i>Number of months</i>
0	3
1	2
2	4
3	3
	<u>12</u>

Each power outage results in out-of-pocket costs of \$400. For \$500 per month, Deet can lease an auxiliary generator to provide power during outages. If Deet leases an auxiliary generator in 1995, the estimated savings (or additional expenditures) for 1995 would be:

- A. (\$3,600)
- B. (\$1,200)
- C. \$1,600
- D. \$1,900

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "c" is correct.

Savings:

1 outage × 2 mo	=	2
2 outage × 4 mo	=	8
3 outage × 3 mo	=	<u>9</u>
		19

Out-of-pocket cost	× 400
Cost to be saved	\$7,600
Cost of generator (\$500 × 12)	<u>(6,000)</u>
Estimated net savings	<u>\$1,600</u>



Choice "a" is incorrect. The estimated savings is dependent on the number of outages and on the number of months, since there are two costs involved.  
Choice "b" is incorrect. The estimated savings is not the difference between the out-of-pocket costs and cost of generator, times 12 months. Choice "d" is incorrect. The cost of the generator is a monthly cost, not dependent on the number of power outages.

#### QUESTION 308

What would be the primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt?

- A. To cause the price of the company's stock to rise.
- B. To lower the company's bond rating.
- C. To reduce the risk for existing bondholders.
- D. To reduce the interest rate on the bonds being sold.

**Correct Answer: D**

## Section: Volume C

### Explanation

#### Explanation/Reference:

Explanation:

Note: The material tested in this question does not appear specifically on-point in our textbook, as the topic has rarely shown up on the CPA exam. The topics are covered in general in parts of our textbook, so we believe that our students would have answered this question correctly given the information they had. However, we have expanded our Explanation of this question to provide you with more detailed information.

Choice "d" is correct. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is to reduce the interest rate on NEW bonds being sold. A debt covenant is a provision in a bond indenture (contract between the bond issuer and the bond holders) that the bond issuer will either do (affirmative covenants) or not do (negative covenants) certain things. In this question, the issuer would agree not to issue bonds in the future over a certain percentage of its long-term debt.

Such a provision would be good for the potential bondholders and would probably reduce the interest rate on the bonds being sold.

Choice "a" is incorrect. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is not to cause the price of the company's stock to rise. Bond covenants affect bonds, not equity (at least not directly).

Choice "b" is incorrect. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is not to lower the company's bond rating. Such a covenant might raise, not lower, a company's bond rating because there would be less risk. Besides, why would a bond covenant be signed if it would lower the company's bond rating?

Choice "c" is incorrect. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is not to reduce the risk of existing bondholders, although a reduction in the risk of the existing bondholders certainly might result from such a covenant. As a general rule, more debt means more risk, less debt means less risk. So less debt would reduce the risk of all bondholders. This answer is a very close second.

#### QUESTION 309

Super Sets, Inc. manufactures and sells television sets. All sales are finalized on credit with terms of 2/10, n/30. Seventy percent of Super Set customers take discounts and pay on day 10, while the remaining 30% pay on day 30. What is the average collection period in days?

- A. 10
- B. 16
- C. 24
- D. 40



**Correct Answer: B**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The average collection period represents the weighted average of the periods that accounts receivable are outstanding and is computed as follows:

Customers paying on day 10 x 70% =	7
Customers paying on day 30 x 30% =	9
<b>Average collection period in days</b>	<b><u>16</u></b>

Choice "a" is incorrect, per the above computation.

Choice "c" is incorrect. This proposed solution mismatches the percentages and the days and represents the sum of the products of 30 x 70 % and 10 x 30%. Choice

"d" is incorrect. This proposed solution is purely the sum of the two customer payment patterns presented, 10 and 30.

#### QUESTION 310

All of the following capital budgeting analysis techniques use cash flows as the primary basis for the calculation, except for the:

- A. Net present value.
- B. Internal rate of return.
- C. Discounted payback period.



D. Accounting rate of return.

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The accounting rate of return does not use cash flows as the primary basis for the calculation. It measures the accrual accounting return instead of cash flows:

$$\text{Accounting rate of return} = \frac{\text{Increase in expected average annual net income}}{\text{Average investment}}$$

Choice "a" is incorrect. Net present value method discounts cash flows for an investment over its life to time period zero using a desired or minimum rate of return.

Choice "b" is incorrect. Internal rate of return (IRR) determines the compound interest rate of an investment where the present value of the cash inflows equals the present value of the cash outflows. The IRR is the discount rate that results in a net present value of zero.

Choice "c" is incorrect. The discounted payback period is the time period required for discounted cash inflows to equal the initial investment. The time value of money is considered.

#### QUESTION 311

Under which one of the following conditions is the internal rate of return method less reliable than the net present value technique?

- A. When the net present value of the project is equal to zero.
- B. When income taxes are considered in the analysis.
- C. When both benefits and costs are included, but each is separately discounted to the present.
- D. When there are several alternating periods of net cash inflows and net cash outflows.

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The internal rate of return (IRR) method is less reliable than the net present value (NPV) technique when there are several alternating periods of net cash inflows and net cash outflows or the amounts of cash flows differ significantly. The IRR is strictly a percentage measure of return, while the NPV is an absolute measure. Due to this difference, the timing or amount of cash flows under IRR can be misleading when compared to the NPV method. Example: If an investment of \$50 earns \$100. Then,  $100/50 = 200\%$  return

If an investment of \$50,000 earns \$25,000 then,  $25,000/50,000 = 50\%$  return

IRR suggests it is best to invest \$50 to earn \$100 and a 200% return while the NPV method will indicate a larger NPV for the \$50,000 investment. Choices

"a", "b", and "c" are incorrect. These conditions do not make the IRR method less reliable than the NPV method.

#### QUESTION 312

In order to increase production capacity, Gunning Industries is considering replacing an existing production machine with a new technologically improved machine effective January 1, 1997. The following information is being considered by Gunning Industries.

- The new machine would be purchased for \$160,000 in cash. Shipping, installation, and testing would cost an additional \$30,000.
- The new machine is expected to increase annual sales by 20,000 units at a sales price of \$40 per unit. Incremental operating costs are comprised of \$30 per unit in variable costs and total fixed costs of \$40,000 per year.
- The investment in the new machine will require an immediate increase in working capital of \$35,000.
- Gunning uses straight-line depreciation for financial reporting and tax reporting purposes. The new machine has an estimated useful life of five years and zero salvage value.
- Gunning is subject to a 40 percent corporate income tax rate.

Gunning uses the net present value method to analyze investments and will employ the following factors and rates.

<u>Present</u>	<u>Present Value of \$1 at 10%</u>	<u>Present Value of an Ordinary Annuity of \$1 at 10%</u>
1	.909	.909
2	.826	1.736
3	.751	2.487
4	.683	3.170
5	.621	3.791

The overall discounted cash flow impact of Gunning Industries' working capital investment for the new production machine would be:

- A. \$(7,959)  
 B. \$(10,680)C. \$(13,265)  
 D. \$(35,000)

**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. \$(13,265) overall discounted cash flow impact of working capital investment.



<u>Period</u>	<u>Cash Flow</u>		<u>PV Interest Factor</u>		<u>PV of Cash Flow</u>	
0	35,000	×	1,000	=	(35,000)	PV of cash outflow (increase in working capital) in year 1
5	35,000	×	(.621)	=	<u>21,735</u>	PV of cash inflow release of working capital) in year 5
					(13,265)	Overall discounted cash flow impact of working capital investment

**QUESTION 313**



The Moore Corporation is considering the acquisition of a new machine. The machine can be purchased for \$90,000; it will cost \$6,000 to transport to Moore's plant and \$9,000 to install. It is estimated that the machine will last 10 years, and it is expected to have an estimated salvage value of \$5,000. Over its 10-year life, the machine is expected to produce 2,000 units per year with a selling price of \$500 and combined material and labor costs of \$450 per unit. Federal tax regulations permit machines of this type to be depreciated using the straight-line method over 5 years with no estimated salvage value. Moore has a marginal tax rate of 40 percent.

What is the net cash outflow at the beginning of the first year that Moore Corporation should use in a capital budgeting analysis?

- A. \$(85,000) B. \$(90,000)
- C. \$(96,000) D. \$(105,000)

**Correct Answer: D**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. \$(105,000) net cash outflow at the beginning of the first year.

\$ (90,000)	Purchase price
(6,000)	Transportation cost
(9,000)	Installation cost
<u>\$(105,000)</u>	Net cash outflow at the beginning of the first year

#### QUESTION 314

The Moore Corporation is considering the acquisition of a new machine. The machine can be purchased for \$90,000; it will cost \$6,000 to transport to Moore's plant and \$9,000 to install. It is estimated that the machine will last 10 years, and it is expected to have an estimated salvage value of \$5,000. Over its 10-year life, the machine is expected to produce 2,000 units per year with a selling price of \$500 and combined material and labor costs of \$450 per unit. Federal tax regulations permit machines of this type to be depreciated using the straight-line method over 5 years with no estimated salvage value. Moore has a marginal tax rate of 40 percent.

What is the net cash flow for the third year that Moore Corporation should use in a capital budgeting analysis?

- A. \$68,400
- B. \$64,200
- C. \$53,700
- D. \$47,400

**Correct Answer: A**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. \$68,400 net cash flow for the third year.

$$\frac{\$90,000 + 6,000 + 9,000}{5 \text{ years}} = \frac{\$105,000 \text{ tax}}{5 \text{ years}} = \$21,000 \text{ tax DEPRN}$$

	Unit			
	Qty	Value	Tax Calc	Cash Flow
In year 3:				
Cash inflow from sales	(2,000 × \$500)	=	\$1,000,000	1,000,000
Cash outflow For mat'l & labor	(2,000 × \$450)	=	<u>(900,000)</u>	<u>(900,000)</u>
Cash inflow from operations in year 3			100,000	100,000
Less tax				
Depreciation expense			<u>(21,000)</u>	
Taxable income			79,000	
Marginal tax rate			× 40%	
Tax to be paid			<u>31,600</u>	<u>31,600</u>
Net cash flow in year 3 after taxes				<u>\$ 68,400</u>

Alternate Computation:

In year 3, Moore will generate a \$100,000 profit from the incremental sales (2000 units × (\$500 - \$450)). This profit will be taxed at 40%, so the net after-tax increase in cash flow is \$60,000 BEFORE the depreciation tax shield is considered. Depreciation is not a cash outflow, but it will reduce the amount of tax the company has to pay (by 40% of the depreciation), and this has an effect on the cash-flow for the company. Depreciation, as calculated above, is \$21,000 per year (\$105,000 cost of the machine divided by 5 years). The depreciation tax shield is \$8,400 (\$21,000 × 40%), so the total after-tax cash flows in year 3 for the new machine is \$60,000 + \$8,400 = \$68,400.

#### QUESTION 315

The Moore Corporation is considering the acquisition of a new machine. The machine can be purchased for \$90,000; it will cost \$6,000 to transport to Moore's plant and \$9,000 to install. It is estimated that the machine will last 10 years, and it is expected to have an estimated salvage value of \$5,000. Over its 10-year life, the machine is expected to produce 2,000 units per year with a selling price of \$500 and combined material and labor costs of \$450 per unit. Federal tax regulations permit machines of this type to be depreciated using the straight-line method over 5 years with no estimated salvage value. Moore has a marginal tax rate of 40 percent.

What is the net cash flow for the tenth year of the project that Moore Corporation should use in a capital budgeting analysis?

- A. \$81,000
- B. \$68,400
- C. \$63,000
- D. \$60,000

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. \$63,000 net cash flow for the tenth year.

In year 10:		
Cash inflow from sales	$(2,000 \times \$500) =$	\$1,000,000
Cash outflow for mat'l & labor	$(2,000 \times \$450) =$	<u>(900,000)</u>
Cash inflow from operations		
In year 10 (taxable income)		100,000
Taxes to be paid at 40% $\times$ 100,000		<u>(40,000)</u>
Cash inflow from operations after taxes		60,000
Salvage value of equipment in year 10		5,000
Taxes paid at 40% $\times$ \$5,000		<u>– (2,000)</u>
Cash inflow from sale of equipment after taxes		<u>3,000</u>
Total cash inflow after taxes		<u>\$63,000</u>



Alternate Computation:

In year 10, Moore will generate a \$100,000 profit from the incremental sales (2000 units  $\times$  (\$500 - \$450)). This profit will be taxed at 40%, so the net after-tax increase in cash flow is \$60,000. The machine is fully depreciated in year 10 because it was depreciated over a 5-year life. The tax basis of the machine is zero on the date Moore receives a \$5,000 salvage value for the machine. The gain on the machine of \$5,000 (\$5,000 SV – \$0 Basis) is taxed at 40%, or \$2,000 in total tax outflow for the gain, so the net inflows on the salvage is \$3,000. Therefore, the total after-tax cash flows in year 10 for the new machine is \$60,000 + \$3,000 = \$63,000.

#### QUESTION 316

For the next 2 years, a lease is estimated to have an operating net cash inflow of \$7,500 per annum, before adjusting for \$5,000 per annum tax basis lease amortization, and a 40% tax rate. The present value of an ordinary annuity of \$1 per year at 10% for 2 years is \$1.74. What is the lease's after-tax present value using a 10% discount factor?

- A. \$2,610
- B. \$4,350C. \$9,570
- D. \$11,310

**Correct Answer: D**  
**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Present value is based on the cash flows of an activity. Amortization is a non-cash expense that is considered only for its tax shield; therefore, the only relevant amounts are the \$7,500 operating net cash inflow and the tax paid.

PV of cash inflow, $\$7,500 \times 1.74$	\$13,050
PV of cash outflow for tax $(\$7,500 - \$5,000) \times 40\% \times 1.74$	(1,740)
After-tax PV	<u>\$11,310</u>

After-tax PV \$11,310 Choice "a" is incorrect. Amortization expense of \$5,000 is a non-cash expense and is not used to compute after-tax present value. It is used to determine the cash paid for taxes.  
 Choice "b" is incorrect. Amortization is a non-cash expense. It is not considered in the calculation, except to the extent it creates a tax shield. The tax shield reduces the amount of taxes paid out by the company.  
 Choice "c" is incorrect. Present value is based on the cash flows of an activity. Amortization is a noncash expense that is considered only for its tax shield; therefore, the only relevant amounts are the \$7,500 operating net cash inflow and the tax paid.

#### QUESTION 317

Pole Co. is investing in a machine with a 3-year life. The machine is expected to reduce annual cash operating costs by \$30,000 in each of the first 2 years and by \$20,000 in year 3. Present values of an annuity of \$1 at 14% are:

Period	1	0.88
	2	1.65
	3	2.32

Using a 14% cost of capital, what is the present value of these future savings?

- A. \$59,600
- B. \$60,800
- C. \$62,900
- D. \$69,500

**Correct Answer: C**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. The facts of the question provide annuity factors, yet the question only provides one "annuity" - the \$30,000 for the first two years. Therefore, to calculate the present value of the savings for years 1 and 2, the factor for the present value of an annuity of \$1 for two periods (1.65) is used. To calculate the present value of the savings for year 3, the factor for the lump sum of a present value of \$1 for three periods is required; however, it is not directly provided. The factor must be calculated as the difference between the factors for the present value of an annuity of \$1 for three periods (2.32) and for two periods (1.65), or .67.

Years 1 & 2	$\$30,000 \times 1.65$	\$49,500
Year 3	$\$20,000 \times (2.32 - 1.65)$	13,400
		<u>\$62,900</u>

Review your knowledge of how the annuity and lump sum factors work together, as follows:

PV of Year 1: $\$30,000 \times 0.88$	=	\$26,400
PV of Year 2: $\$30,000 \times 0.77$ [1.65 - 0.88]	=	23,100
PV of Year 3: $\$20,000 \times 0.67$ [2.32 - 1.65]	=	<u>13,400</u>
<b>Total PV of Future Savings</b>		<b><u>\$62,900</u></b>

#### QUESTION 318

An advantage of the net present value method over the internal rate of return model in discounted cash flow analysis is that the net present value method:

- A. Computes a desired rate of return for capital projects.



- B. Can be used when there is no constant rate of return required for each year of the project.
- C. Uses a discount rate that equates the discounted cash inflows with the outflows.
- D. Uses discounted cash flows whereas the internal rate of return model does not.

**Correct Answer: B**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. When using the net present value method of capital budgeting, different hurdle rates can be used for each year of the project.  
Choice "a" is incorrect. The desired rate of return for capital projects is established by management.  
Choice "c" is incorrect. The internal rate of return determines the discount rate that will equate the discounted cash inflows with the outflows, thus resulting in no gain or loss (breakeven). Choice "d" is incorrect. Both the net present value method and the internal rate of return model are discounted cash flow methods.

**QUESTION 319**

In evaluating a capital budget project, the use of the net present value model is generally not affected by the:

- A. Method of funding the project.
- B. Initial cost of the project.
- C. Amount of added working capital needed for operations during the term of the project.
- D. Amount of the project's associated depreciation tax allowance.

**Correct Answer: A**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. The method of funding the project has no effect on the net present value model. NPV uses a hurdle rate to discount cash flows. If the NPV is positive, the project is acceptable. The method of financing the project, and the cost, are independent of the process of screening the project for acceptability.  
Choice "b" is incorrect. The initial cost is one of the most important items in the calculation of NPV.  
Choice "c" is incorrect. Added working capital requirements and salvage value affect cash flow. All cash flows are used in the NPV model.  
Choice "d" is incorrect. The tax depreciation allowance will provide a "tax shield" or tax savings that impacts cash flow and must be considered in NPV analysis.

**QUESTION 320**

The capital budgeting model that is generally considered the best model for long-range decision making is the:

- A. Payback model.
- B. Accounting rate of return model.
- C. Unadjusted rate of return model.
- D. Discounted cash flow model.

**Correct Answer: D**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. The discounted cash flow model is the best for long-term decisions. Discounted cash flow methods include NPV, IRR, and profitability index.  
Choice "a" is incorrect. Payback and bailout payback do not consider the time value of money or the return after the initial investment is recovered. The difference between the two methods is that bailout payback takes salvage value into account in calculating cash flows.  
Choice "b" is incorrect. Accounting rate of return is based on accrual income rather than cash flows. It does not consider the time value of money and is considered inferior to the discounted cash flow methods. Choice "c" is incorrect. There is no unadjusted rate of return model.

# **QUESTION 321**

Para Co. is reviewing the following data relating to an energy saving investment proposal:

Cost	\$50,000
Residual value at the end of 5 years	10,000
Present value of an annuity of 1 at 12% for 5 years	3.60
Present value of 1 due in 5 years at 12%	0.57

What would be the annual savings needed to make the investment realize a 12% yield?

- A. \$8,189
- B. \$11,111C. \$12,306
- D. \$13,889

**Correct Answer: C**

**Section: Volume C**

## **Explanation**

### **Explanation/Reference:**

Explanation:

Choice "c" is correct. The annual savings needed to make the investment realize a 12% yield is where the present value of the cash savings/inflows equals the present value of the net cash outflows. Use algebra to calculate the annual savings, as follows:

$$\begin{aligned}
 \text{PV cash savings/inflows} &= \text{PV net cash outflows} \\
 \text{annual savings} \times 3.60 &= \$50,000 - \$10,000(.57) \\
 \text{annual savings} &= (\$50,000 - \$5,700)/3.60 \\
 &= \$12,306
 \end{aligned}$$



Choice "a" is incorrect. The annual savings needed to make the investment realize a 12% yield is where the present value of the cash savings/inflows equal the present value of the net cash outflows. Choice "b" is incorrect. Subtract the present value of \$10,000 due in 5 years at 12%, or  $\$10,000 \times .57 = \$5,700$ . Don't subtract the entire \$10,000. Choice "d" is incorrect. Subtract the present value of the \$10,000 residual value from the \$50,000 cost.

**QUESTION 322** A project's net present value, ignoring income tax considerations, is normally affected by the:

- A. Proceeds from the sale of the asset to be replaced.
- B. Carrying amount of the asset to be replaced by the project.
- C. Amount of annual depreciation on the asset to be replaced.
- D. Amount of annual depreciation on fixed assets used directly on the project.

**Correct Answer: A**

**Section: Volume C**

## **Explanation**

### **Explanation/Reference:**

Explanation:

Choice "a" is correct. A project's net present value is a function of current and future cash flows, including proceeds from the sale of the old asset. Choice "b" is incorrect. A project's net present value is a function of current and future cash flows. The carrying amount of the asset does not affect cash flows. Choice "c" is incorrect. A project's net present value is a function of current and future cash flows. Depreciation is a noncash item and does not affect cash flows. Choice "d" is incorrect. A project's net present value is a function of current and future cash flows. Depreciation is a noncash item and does not affect cash flows.

**QUESTION 323**

Managers that anticipate greater return for greater risk are referred to as having what attitude toward risk?

- A. Risk indifferent.
- B. Risk averse.
- C. Risk seeking.
- D. Cautious.

**Correct Answer: B**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Risk averse behavior describes managers who demand more return on an investment as risk increases. These managers expect to be compensated for increased risk.

Choice "a" is incorrect. Risk indifferent behavior describes a manager who is neutral with regard to the return associated with a particular investment. Typically, the amount of a risk free rate of return associated with an investment of a given amount compared to a higher return associated with higher risk is viewed as having equal value.

Choice "c" is incorrect. Risk seeking behavior describes managers who seek reduced return for higher risk.

Choice "d" is incorrect. The term "cautious" is a distracter. Although caution is an attitude, it is not a technical term.

**QUESTION 324** The profitability index is a variation on which of the following capital budgeting models?

- A. Internal rate of return.
- B. Economic value-added.
- C. Net present value.
- D. Discounted payback.

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The profitability index is a variation on the net present value capital budgeting model.

RULE: The profitability index is the ratio of the present value of net future cash inflows to the present value of the net initial investment. The profitability index is also referred to as the "excess present value index" or simply the "present value index." Companies hope that this ratio will be over 1.0, which means that the present value of the inflows is greater than the present value of the outflows.

$$\frac{\text{Present value of net future cash inflows}}{\text{Present value of net initial investment}} = \text{Profit ability index}$$

Choice "a" is incorrect. The profitability index is a companion computation to net present value, not internal rate of return, which measures percentage return.

Choice "b" is incorrect. The profitability index is a companion computation to net present value, not economic value added.

Choice "d" is incorrect. The profitability index is a companion computation to net present value, not the discounted payback method, which measures years to payback.

**QUESTION 325**

A divisional manager receives a bonus based on 20% of the residual income from the division. The results of the division include: Divisional revenues, \$1,000,000; divisional expenses, \$500,000; divisional assets, \$2,000,000; and the required rate of return is 15%. What amount represents the manager's bonus?

- A. \$200,000
- B. \$140,000
- C. \$100,000
- D. \$40,000



**Correct Answer:** D  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct as shown in the computation below:

Divisional revenues	1,000,000	
Divisional expenses	<u>(500,000)</u>	
Divisional income		500,000
Division assets	2,000,000	
Required return	<u>15%</u>	
Hurdle		(300,000)
Residual income		200,000
Bonus rate		<u>20%</u>
Bonus amount		<u><u>40,000</u></u>

Choice "a" is incorrect. The amount of the residual income itself is not the amount of the bonus.

Choice "b" is incorrect. The difference between revenues (before consideration of divisional expenses) and the hurdle amount is not residual income. The bonus would be improperly calculated if residual income were to be inflated by divisional expenses as suggested by this answer.

Choice "c" is incorrect. The difference between the hurdle amount and the residual income (\$100,000) is not the bonus amount.

**QUESTION 326**

A multiperiod project has a positive net present value. Which of the following statements is correct regarding its required rate of return?

- A. Less than the company's weighted average cost of capital.
- B. Less than the project's internal rate of return.
- C. Greater than the company's weighted average cost of capital.
- D. Greater than the project's internal rate of return.

**Correct Answer:** B  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The required rate of return must be less than the project's internal rate of return (IRR). The IRR is the rate earned by an investment that equates to a net present value (NPV) of zero. By definition, a project with a positive NPV will have an IRR greater than the required rate of return used to compute that NPV.

Choice "a" is incorrect. Typically, a company will use its own weighted-average cost of capital (WACC) as the hurdle rate for computing net present value (NPV). A positive NPV would not likely give any indication of the relationship between required rate of return and WACC. The required rate of return and WACC are likely equal.

Choice "c" is incorrect. Typically, a company will use its own weighted-average cost of capital (WACC) as the hurdle rate for computing net present value (NPV). A positive NPV would not likely give any indication of the relationship between required rate of return and WACC. The required rate of return and WACC are likely equal.

Choice "d" is incorrect. The required rate of return must be less than the project's internal rate of return (IRR). The IRR is the rate earned by an investment that equates to a net present value (NPV) of zero. By definition, a project with a positive NPV will have an IRR greater than the required rate of return used to compute that NPV.

**QUESTION 327** Which of the following statements is true regarding the payback method?

- A. It does not consider the time value of money.
- B. It is the time required to recover the investment and earn a profit.
- C. It is a measure of how profitable one investment project is compared to another.
- D. The salvage value of old equipment is ignored in the event of equipment replacement.

**Correct Answer:** A  
**Section:** Volume C

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. The payback method determines the number of years that it will take for a company to recoup or be paid back for its investment. The payback method does not consider the time value of money.

Choice "b" is incorrect. The payback method determines the number of years that it will take for a company to recoup or be paid back for its investment. Although the payback method focuses on liquidity and measures risk, project cash flows after the initial investment are not considered; thus, profitability is ignored.

Choice "c" is incorrect. The payback method determines the number of years that it will take for a company to recoup or be paid back for its investment. Although the payback method focuses on liquidity and measures risk, project cash flows after the initial investment are not considered; thus, profitability is ignored.

Choice "d" is incorrect. Salvage value is specifically considered as part of payback computations because it contributes to the incoming cash flow when the asset is sold.

#### QUESTION 328

In order to increase production capacity, Gunning Industries is considering replacing an existing production machine with a new technologically improved machine effective January 1, 1997. The following information is being considered by Gunning Industries.

- The new machine would be purchased for \$160,000 in cash. Shipping, installation, and testing would cost an additional \$30,000.
- The new machine is expected to increase annual sales by 20,000 units at a sales price of \$40 per unit. Incremental operating costs are comprised of \$30 per unit in variable costs and total fixed costs of \$40,000 per year.
- The investment in the new machine will require an immediate increase in working capital of \$35,000.
- Gunning uses straight-line depreciation for financial reporting and tax reporting purposes. The new machine has an estimated useful life of five years and zero salvage value.
- Gunning is subject to a 40 percent corporate income tax rate.

Gunning uses the net present value method to analyze investments and will employ the following factors and rates.

Period	Present Value of \$1 at 10%	Present Value of an Ordinary Annuity of \$1 at 10%
1	.909	.909
2	.826	1.736
3	.751	2.487
4	.683	3.170
5	.621	3.791

Gunning Industries' discounted annual depreciation tax shield for the year 1997 would be:

- A. \$13,817 B. \$15,200
- C. \$16,762 D. \$20,725

**Correct Answer:** A  
**Section:** Volume C

#### Explanation

**Explanation/Reference:**

Explanation:

Choice "a" is correct. \$13,817 discounted annual depreciation tax shield for the year 1997.

$$\frac{\text{Depreciable cost}}{\text{Useful life}} = \frac{190,000}{5 \text{ yrs}} = 38,000 \text{ Annual depreciation expense}$$

Therefore:

38,000	Depreciation expense in 1997
× .40	Tax rate
15,200	Amount of the depreciation tax shield
× .909	PV factor for 1 year @ 10%
<u>\$13,817</u>	Discounted annual depreciation tax shield for the year 1997

Choices "b", "c", and "d" are incorrect based on the above Explanation.

**QUESTION 329**

In order to increase production capacity, Gunning Industries is considering replacing an existing production machine with a new technologically improved machine effective January 1, 1997. The following information is being considered by Gunning Industries.

- The new machine would be purchased for \$160,000 in cash. Shipping, installation, and testing would cost an additional \$30,000.
- The new machine is expected to increase annual sales by 20,000 units at a sales price of \$40 per unit. Incremental operating costs are comprised of \$30 per unit in variable costs and total fixed costs of \$40,000 per year.
- The investment in the new machine will require an immediate increase in working capital of \$35,000.
- Gunning uses straight-line depreciation for financial reporting and tax reporting purposes. The new machine has an estimated useful life of five years and zero salvage value.
- Gunning is subject to a 40 percent corporate income tax rate.

Gunning uses the net present value method to analyze investments and will employ the following factors and rates.

Period	Present Value of \$1 at 10%	Present Value of an Ordinary Annuity of \$1 at 10%
1	.909	.909
2	.826	1.736
3	.751	2.487
4	.683	3.170
5	.621	3.791

The acquisition of the new production machine by Gunning Industries will contribute a discounted net-of-tax contribution margin of:

- A. \$242,624
- B. \$303,280
- C. \$363,936
- D. \$454,920

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. \$454,920 discounted net-of-tax contribution margin.

	\$ per unit	×	units	=	\$ In total @ 20,000 units	
Sales	40	×	20,000	=	800,000	Annual incremental revenue
Variable cost	(30)	×	20,000	=	(600,000)	Annual incremental expense
Contribution margin	10	×	20,000	=	200,000	Annual incremental contrib. margin
Less tax at 40%					<u>80,000</u>	
Net-of-tax contribution margin					120,000	
PV of annuity for 5 years					<u>×</u> 3.791	
Discounted net-of-tax contribution margin					<u>\$454,920</u>	

Choices "a", "b", and "c" are incorrect based on the above Explanation.

#### QUESTION 330

RLF Corporation had income before taxes of \$60,000 for the year 1991. Included in this amount was depreciation of \$5,000, a charge of \$6,000 for the amortization of bond discounts, and \$4,000 for interest expense. The estimated cash flow for the period is:

- A. \$66,000
- B. \$49,000
- C. \$71,000
- D. \$65,000

**Correct Answer: C**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. Cash flow is computed from net income by adding back non-cash expenses like depreciation and amortization. Presumably, interest expense has been paid (i.e., is not "accrued" interest) and should not be added back.

Net Income	\$60,000
Add: Depreciation expense	\$ 5,000
Amortization expense	\$ 6,000
Cash flow	<u>\$71,000</u>

Choices "a", "b", and "d" are incorrect, per above.

#### QUESTION 331 A

depreciation tax shield is:

- A. An after-tax cash outflow.
- B. A reduction in income taxes.
- C. The expense caused by depreciation.
- D. Caused by the fact that depreciation does not affect cash flow.

**Correct Answer: B**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. Whenever depreciation protects income from taxation, it is known as a depreciation tax shield.

Choice "a" is incorrect. A depreciation tax shield may result in after-tax cash inflow, but not outflow. Choice "c" is incorrect, per above.

Choice "d" is incorrect. A depreciation tax shield is caused by the tax deductibility of the depreciation expense, not by the fact that depreciation does not affect cash flow.

#### QUESTION 332

Wendy's Sandwich Shop purchased an asset for \$100,000 that has no salvage value and a 10-year life.

Wendy's effective income tax rate is 40 percent, and it uses the straight-line depreciation method for income tax reporting purposes. Wendy's annual depreciation tax shield from the asset would be:

- A. \$10,000
- B. \$6,000C. \$4,000
- D. \$2,000

**Correct Answer: C**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. \$4,000 annual depreciation tax shield.

$$\frac{\text{Cost of the asset}}{\text{Estimated useful life}} = \frac{\$100,000}{10} = \$10,000 \text{ annual depreciation}$$

Annual depreciation	\$10,000
X tax rate	× .40
Annual depreciation tax shield	<u>\$ 4,000</u>



Choices "a", "b", and "d" are incorrect, per the above calculation.

#### QUESTION 333

In considering the payback period for three projects, Fly Corp. gathered the following data about cash flows:

	<u>Cash Flows by Year</u>				
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Project A	(\$10,000)	\$3,000	\$3,000	\$3,000	\$3,000
Project B	(25,000)	15,000	15,000	(10,000)	15,000
Project C	(10,000)	5,000	5,000		

Which of the projects will achieve payback within three years?

- A. Projects A, B, and C.
- B. Projects B and C.
- C. Project B only.
- D. Projects A and C.

**Correct Answer: B**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:



Choice "b" is correct. Projects B and C achieve payback in three years. The payback period for Project A is somewhere between the end of Year 4 and Year 5. For all three projects, Year 1 appears to be a combination of cash outflows (initial cost) and cash inflows (return of investment), but it really does not make any difference. When the cumulative cash flow (both inflow and outflow) is zero, the project has paid back. Choice "a" is incorrect. Project A does not pay back within 3 years even though Projects B and C do. Choice "c" is incorrect. Projects B and C, not just Project B, pay back within 3 years. Choice "d" is incorrect. Project A does not pay back within 3 years even though Project C does.

#### QUESTION 334

Harvey Co. is evaluating a capital investment proposal for a new machine. The investment proposal shows the following information:

Initial cost	\$500,000
Life	10 years
Annual net cash inflows	\$200,000
Salvage value	\$100,000

If acquired, the machine will be depreciated using the straight-line method. The payback period for this investment is:

- A. 3.25 years.
- B. 2.67 years.
- C. 2.5 years.
- D. 2 years.

**Correct Answer: C**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. With even cash flows, payback period is calculated as initial cost / annual net cash inflows. That is,  $\$500,000 / \$200,000 = 2.5$ .

Choice "a" is incorrect. We could not determine an obvious approach to obtain this answer. It is incorrect per the calculation above.

Choice "b" is incorrect. This answer is calculated as follows:  $(\text{initial cost} - \text{salvage value}) / (\text{annual net cash inflows} - \text{annual depreciation})$  or  $(\$500,000 - \$100,000) / (\$200,000 - \$50,000) = \$400,000 / \$150,000 = 2.67$ . With the payback period, depreciation should only be considered to the extent that it represents a tax shield.

Choice "d" is incorrect. This answer appears to be the initial cost less salvage value divided by the annual net cash inflows  $((\$500,000 - \$100,000) / \$200,000 = 2.0)$ . Salvage value is not included in the correct calculation.

#### QUESTION 335

Net present value as used in investment decision-making is stated in terms of which of the following options?

- A. Net income.
- B. Earnings before interest, taxes, and depreciation.
- C. Earnings before interest and taxes.
- D. Cash flow.

**Correct Answer: D**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Net present value, like most capital budgeting techniques, focuses on cash flow. Cash flow is a pure measure of financial performance that isolates relevant information for decision making. The amount of cash the firm takes in and pays out for an investment affects the amount of cash the firm has available for operations and other activities.

Choice "a" is incorrect. Net present value focuses on cash flows. Net income distorts financial results useful for capital budgeting decisions with non-cash items, such as depreciation, as well as with sunk costs.

Choice "b" is incorrect. Net present value focuses on cash flows. Earnings before interest, taxes, and depreciation often approximates cash flow but still distorts financial results with earnings rather than the cash flow data most useful for capital budgeting.

Choice "c" is incorrect. Net present value focuses on cash flows. Earnings before interest and taxes distort financial results with non-cash data (depreciation) as well as earnings data rather than the cash flow data most useful for capital budgeting.



### QUESTION 336

A project has an initial outlay of \$1,000. The projected cash inflows are:

Year 1	\$200
Year 2	200
Year 3	400
Year 4	400

What is the investment's payback period?

- A. 4.0 years.
- B. 3.5 years.
- C. 3.4 years.
- D. 3.0 years.

**Correct Answer:** B  
**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The payback period is computed as the number of years required to fully recover the original investment with out respect to the time value of money. With uneven cash flows, the payback period is computed by development of a cumulative payback balance converted to years as follows:

	<u>Cash Inflow</u>		<u>Years Required</u>		<u>Adjusted Cash Inflow</u>	<u>Cumulative Cash Inflow</u>
Year 1	\$200	x	1.0	=	\$200	\$ 200
Year 2	\$200	x	1.0	=	\$200	\$ 400
Year 3	\$400	x	1.0	=	\$400	\$ 800
Year 4	\$400	x	<u>0.5</u>	=	\$200	\$1,000
<b>Payback period</b>			<u><b>3.5</b></u>			

Choice "a" is incorrect. Although the payback occurs in the fourth year, only half the year is required. The payback period is 3.5, not 4.0 years.

Choice "c" is incorrect. Although the payback occurs in the fourth year, half the year is required. The payback period is 3.5, not 3.4 years.

Choice "d" is incorrect. The payback occurs in the fourth year. The payback period is 3.5, not 3.0 years. Strategies for Short-term and Long-term Financing

### QUESTION 337

If an investor's certainty equivalent is greater than the expected value of an investment alternative, the investor is said to be:

- A. Risk indifferent.
- B. Risk averse.
- C. Risk seeking.
- D. Cautious.

**Correct Answer:** C  
**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. If an investor's certainty equivalent, the point at which they are indifferent to risk, exceeds the expected return on an investment, then the investor is actually seeking lower return for higher risk. This behavior represents risk seeking behavior.

Choice "a" is incorrect. Risk indifferent behavior occurs when an investor's certainty equivalent is equal to the expected return on the investment.

Choice "b" is incorrect. Risk averse behavior occurs when an investor's certainty equivalent is less than the expected rate of return. The investor seeks higher returns for more risk. Choice

"d" is incorrect. Cautious is not a technical term used in risk behavior classifications.

**QUESTION 338** Investment managers develop portfolios of different investments to combine, offset, and thereby reduce overall risk. Not all risks can be eliminated by development of a portfolio. Risks that cannot be eliminated through a portfolio are called:

- A. Non-market risks.
- B. Unsystematic risks.
- C. Firm-specific risks.
- D. Systematic risks.

**Correct Answer: D**

**Section: Volume C**

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Rule: Portfolio theory is concerned with construction of an investment portfolio that efficiently balances its risk with its rate of return. Risk is often reduced by diversification, the process of mixing investments of different or offsetting risks. The broad categories of risk are summarized in the following mnemonic to get us DUNS.

Diversifiable

Unsystematic (non market/firm-specific)

Non-diversifiable

Systematic (market)

Choice "d" is correct. Non-diversifiable risk cannot be eliminated by the application of portfolio theory. Non-diversifiable risk is also referred to as systematic risk. (DUNS) Choice

"a" is incorrect. Diversifiable risk can be eliminated through effective application of portfolio theory. Diversifiable risks are also termed non-market risk.

Choice "b" is incorrect. Diversifiable risk can be eliminated through effective application of portfolio theory. Diversifiable risks are also termed unsystematic risk. Choice

"c" is incorrect. Diversifiable risk can be eliminated through effective application of portfolio theory. Diversifiable risks are also termed firm-specific risk.

#### **QUESTION 339**

Residco, Inc. expects net income of \$800,000 for the next fiscal year. Its targeted and current capital structure is 40 percent debt and 60 percent common equity. The director of capital budgeting has determined that the optimal capital spending for next year is \$1.2 million. Residco does not plan to issue any new common equity next year. If Residco follows a strict residual dividend policy, what is the expected dividend payout ratio for next year?

- A. 90.0 percent.
- B. 66.7 percent.
- C. 40.0 percent.
- D. 10.0 percent.

**Correct Answer: D**

**Section: Volume C**

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Choice "d" is correct. A strict dividend policy guides a company's management to pay no more (and no less) in dividends from net income to generate a change in equity that produces or maintains a targeted capital structure. The dividend pay out ratio is the ratio of dividends to income.

The call of the question requires the calculation of the ratio of dividends to income assuming income, capital projects and capital structure amounts as follows:

Income =	\$800,000
Capital projects planned at	\$1,200,000
Capital structure is	40/60

Capital projects, by definition, are to be funded:	
Debt (40%)	\$ 480,000
Equity (60%)	720,000
Total	<u>\$1,200,000</u>

Assuming the company is in compliance with the 40/60 Debt/Equity capital structure to begin with, 60% of the \$1,200,000 in capital projects will be financed by additions to equity the come from new earnings of \$800,000. The equity funded portion of capital projects is \$720,000 (\$1,200,000 x 60%).

Following a strict residual dividend policy, the company will pay out the difference between is additions to equity (\$800,000 in income) and the amounts reinvested in the business (\$720,000). The dividend will be \$80,000. (\$800,000 \$720,000).

The dividend payout ratio is, therefore, 10% (\$80,000 in dividends/ \$800,000 in income). Choices "a", "b", and "c" are incorrect, per the above calculation.

#### QUESTION 340

DQZ Telecom is considering a project for the coming year, which will cost \$50 million. DQZ plans to use the following combination of debt and equity to finance the investment.

- Issue \$15 million of 20-year bonds at a price of 101, with a coupon rate of 8 percent, and flotation costs of 2 percent of par.
- Use \$35 million of funds generated from earnings.

The equity market is expected to earn 12 percent. U.S. treasury bonds are currently yielding 5 percent.

The beta coefficient for DQZ is estimated to be .60. DQZ is subject to an effective corporate income tax rate of 40 percent.

The Capital Asset Pricing Model (CAPM) computes the expected return on a security by adding the riskfree rate of return to the incremental yield of the expected market return, which is adjusted by the company's beta. Compute DQZ's expected rate of return.

- A. 9.20 percent.
- B. 12.20 percent.
- C. 7.20 percent.
- D. 10.00 percent.

**Correct Answer:** A

**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

**CAPM Formula:**

**C** = Cost of equity capital

**R** = Risk free rate (treasury bond rate)

**B** = Beta coefficient of comparable publicly traded stock

**M** = Market rate of return

$$\begin{aligned} C &= R + B(M - R) \\ &= .05 + .60(.12 - .05) \\ &= .05 + .60(.07) \\ &= .05 + .042 \\ &= .092 \\ &= 9.20 \text{ percent} \end{aligned}$$

Choice "a" is correct. 9.20 percent expected rate of return.

Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 341** By using the discounted cash flow model, estimate the cost of equity capital for a firm with a stock price of \$30.00, an estimated dividend at the end of the first year of \$3.00 per share, and an expected growth rate of 10 percent.

- A. 21.1 percent.
- B. 12.2 percent.
- C. 11.0 percent.
- D. 20.0 percent.

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

$$\begin{aligned} K &= \frac{D}{P} + G = \frac{\$3 \text{ Div'd next period}}{\$30 \text{ stock price}} + 10\% \text{ Growth} \\ &= 10\% + 10\% \\ &= 20\% \text{ Cost of Equity Capital} \end{aligned}$$

Choice "d" is correct. 20.0 percent cost of equity capital by using the discounted cash flow model.

**QUESTION 342** Which one of the following factors might cause a firm to increase the debt in its financial structure?

- A. An increase in the corporate income tax rate.
- B. Increased economic uncertainty.
- C. An increase in the price/earnings ratio.
- D. A decrease in the times interest earned ratio.

**Correct Answer:** A

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. An increase in the corporate income tax rate might cause a firm to increase the debt in its financial structure because interest is tax deductible, while dividends are paid after-tax.

Choice "b" is incorrect. Increased economic uncertainty would cause a firm to decrease debt (and interest cost). Choice "c" is incorrect. An increase in the price/earnings ratio would encourage the issuance of equity rather than debt. Choice "d" is incorrect. A decrease in the times interest earned ratio indicates that earnings have declined compared with interest, and that more debt would be unwise (and more difficult to negotiate).

**QUESTION 343**

If Brewer Corporation's bonds are currently yielding 8 percent in the marketplace, why would the firm's cost of debt be lower?

- A. Market interest rates have increased.
- B. Additional debt can be issued more cheaply than the original debt.
- C. Interest is deductible for tax purposes.
- D. There is a mixture of old and new debt.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Because interest expense is a tax deduction, the cost to Brewer is lower than the market yield rate on debt.

Choice "a" is incorrect. If market interest rates increase, then Brewer's bonds would have to be offered at a discount to stay competitive with the market. This discount would increase (not lower) Brewer's cost of debt.

Choice "b" is incorrect. Issuance of cheaper additional debt will lower future cost of debt, but have no impact on current cost of debt. Choice "d" is incorrect. Presumably, the 8% yield already includes new and old debt.

**QUESTION 344** The theory underlying the cost of capital is primarily concerned with the cost of:

- A. Long-term funds and old funds.
- B. Short-term funds and new funds.
- C. Long-term funds and new funds.
- D. Any combination of old or new, short-term or long-term funds.



**Correct Answer: D**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The cost of capital considers the cost of all funds - whether they are short-term, long-term, new or old. Choices

"a", "b", and "c" are incorrect, per above.

**QUESTION 345** Which one of a firm's sources of new capital usually has the lowest after tax cost?

- A. Retained earnings.
- B. Bonds.
- C. Preferred stock.
- D. Common stock.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Because debt is a cheaper source of financing than equity, bonds will be the cheapest form of financing. In addition, the company issuing bonds receives a tax deduction for interest paid. This further reduces the cost of bond financing.  
Choices "a", "c", and "d" are incorrect, per Explanation above.

#### QUESTION 346

Youngsten Electric is contemplating new projects for the next year that will require \$30,000,000 of new financing. In keeping with its capital structure, Youngsten plans to use debt & equity financing as follows:

- Issue \$10,000,000 of 20-year bonds at a price of 101.5, with a coupon of 10%, and flotation costs of 2.5% of par value.
- Use internal funds generated from earnings of \$20,000,000.

The equity market is expected to earn 15%. U.S. treasury bonds currently are yielding 9%. The beta coefficient for Youngsten's common stock is estimated to be .8. Youngsten is subject to a 40% corporate income tax rate. Youngsten has a price/earnings ratio of 10, a constant dividend payout ratio of 40%, and an expected growth rate of 12%.

Assume Youngsten has an after-tax cost of debt of 9% and an after-tax cost of equity of 15%. Youngsten's weighted average cost of capital is:

- A. 11.0%
- B. 13.0% C. 12.0%
- D. 11.8%

**Correct Answer: B**  
**Section: Volume C**

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. The WACC is computed by multiplying the required returns on equity and debt by the percentage of equity and debt used to finance that particular project. Youngsten will use 33% debt (\$10 million of \$30 million total project cost) and 67% equity (\$20 million of \$30 million total project cost).

Therefore:

$$\begin{aligned} \text{WACC} &= 9\% (33\%) + 15\% (67\%) \\ &= 2.97\% + 10.05\% \\ &= 13.02\% \text{ or } 13.0\% \text{ (rounded)} \end{aligned}$$

Choices "a", "c", and "d" are incorrect, per the above calculation.

#### QUESTION 347

Sylvan Corporation has the following capital structure:

Debenture bonds	\$10,000,000
Preferred equity	1,000,000
Common equity	39,000,000

The financial leverage of Sylvan Corp. would increase as a result of:

- A. Issuing common stock and using the proceeds to retire preferred stock.
- B. Issuing common stock and using the proceeds to retire debenture bonds.
- C. Financing its future investments with a higher percentage of bonds.
- D. Financing its future investments with a higher percentage of equity funds.

**Correct Answer: C**  
**Section: Volume C**



## Explanation

### Explanation/Reference:

Explanation:

Choice "c" is correct. Financial leverage increases when the debt to equity ratio increases. Using a higher percentage of debt (bonds) for future investments would increase financial leverage. Choice

"a" is incorrect. This results in no change in total equity and, consequently, no change in financial leverage.

Choice "b" is incorrect. This would result in increased equity and decreased debt, which would decrease financial leverage. Choice

"d" is incorrect. This would increase equity, decrease the debt to equity ratio and decrease financial leverage.

### QUESTION 348

Colt Inc. is planning to use retained earnings to finance anticipated capital expenditures. The beta coefficient for Colt's stock is 1.15, the risk-free rate of interest is 8.5 percent, and the market return is estimated at 12.4%. If a new issue of common stock was used in this model, the flotation costs would be 7%. By using the Capital Asset Pricing Model equation  $C = R + B (M - R)$ , the cost of using retained earnings to finance the capital expenditures is:

- A. 13.96 percent.
- B. 12.99 percent.C. 14.26 percent.
- D. 13.21 percent.

**Correct Answer: B**

**Section: Volume C**

## Explanation

### Explanation/Reference:

Explanation:

Choice "b" is correct. The capital asset pricing model (CAPM) is:

$$C = R + B (M - R)$$

Where

C = Cost of Capital

R = Risk Free Rate (Usually on Treasury Bills)

M = Market Rate of Return

Substituting

$$C = .085 + 1.15 (.124 - .085) \\ = 12.99\%$$



### QUESTION 349

Listed below is selected financial information for the Western Division of the Hinzle Company for last year.

<u>Account</u>	<u>Amount</u> <u>(thousands)</u>
Average working capital	\$ 625
General and administrative expense	75
Net sales	4,000
Average plant and equipment	1,775
Cost of goods sold	3,525

If Hinzle treats the Western Division as an investment center for performance measurement purposes, what is the before-tax return on investment for last year?

- A. 26.76 percent.
- B. 22.54 percent.
- C. 19.79 percent.
- D. 16.67 percent.

**Correct Answer:** D  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "d" is correct. 16.67% return on investment.

$$\text{ROI Formula (short version)} = \frac{\$400 \text{ income}}{\$2,400 \text{ investment}} = 16.67\%$$

**Income:**

Sales	\$4,000
Cost of goods sold	(3,525)
G & A expense	( 75)
Net income	<u>\$ 400</u>



**Investment:**

Average working capital	\$ 625
Average plant & equipment	<u>1,775</u>
Investment	<u>\$2,400</u>

**QUESTION 350**

James Webb is the general manager of the Industrial Product Division, and his performance is measured using the residual income method. Webb is reviewing the following forecasted information for his division for next year.

<u>Category</u>	<u>Amount (thousands)</u>
Working capital	\$ 1,800
Revenue	30,000
Plant and equipment	17,200

If the imputed interest charge is 15 percent and Webb wants to achieve a residual income target of \$2 million, what will costs have to be in order to achieve the target?

- A. \$10,800,000
- B. \$23,620,000
- C. \$25,150,000
- D. \$25,690,000

**Correct Answer:** C  
**Section:** Volume C

### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. \$25,150,000 costs to achieve residual income target of \$2 million.

Working capital	\$ 1,800,000
Plant and equipment	<u>17,200,000</u>
Asset base	19,000,000
Times: Imputed interest rate	<u>15%</u>
Hurdle income	2,850,000
Add: Residual income target	<u>2,000,000</u>
Total target income	4,850,000
Revenue forecast	\$ 30,000,000
Less: Total target income	<u>(4,850,000)</u>
Required costs to achieve target	<u><u>\$ (25,150,000)</u></u>

Choices "a", "b", and "d" are incorrect, per the above calculation.

#### QUESTION 351

The segment margin of an investment center after deducting the imputed interest on the assets used by the investment center is known as:

- A. Return on investment.
- B. Residual income.
- C. Operating income.
- D. Return on assets.

**Correct Answer: B**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. Residual income is the segment margin of an investment center after deducting the imputed interest (hurdle rate) on the assets used by the investment center.

Choice "a" is incorrect. Return on investment is the ratio of income earned to the investment.

Choice "c" is incorrect. Operating income is not well defined, but is generally the income from operations for the entire organization, not a segment. Choice

"d" is incorrect. Return on assets is the ratio of income produced to assets employed (not the amount invested).

**QUESTION 352** Which one of the following statements pertaining to the return on investment (ROI) as a performance measurement is incorrect?

- A. When the average age of assets differs substantially across segments of a business, the use of ROI may not be appropriate.
- B. ROI relies on financial measures that are capable of being independently verified while other forms of performance measures are subject to manipulation.
- C. The use of ROI may lead managers to reject capital investment projects that can be justified by using discounted cash flow models.
- D. The use of ROI can make it undesirable for a skillful manager to take on trouble-shooting assignments such as those involving turning around unprofitable divisions.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. ROI is no more and no less capable of being independently verified or manipulated than other performance measure. Choice "a" is incorrect. Old fixed assets may be undervalued and make comparison with a segment with newer assets inappropriate.

Choice "c" is incorrect. Investment projects with positive present value may be rejected because ROI is too low.

Choice "d" is incorrect. Turning around an unprofitable division would be good for the company but would probably lower a manager's ROI.

**QUESTION 353** The basic objective of the residual income approach of performance measurement and evaluation is to have a division maximize its:

- A. Return on investment rate.
- B. Imputed interest rate charge.
- C. Cash flows in excess of a desired minimum amount.
- D. Income in excess of a desired minimum amount.

**Correct Answer: D**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Residual income is defined as income in excess of a desired minimum return.

Choices "a" and "b" are incorrect, as residual income is not a "rate" of return; it is a dollar amount. Choice

"c" is incorrect, as residual income is an accrual method.



**QUESTION 354** The imputed interest rate used in the residual income approach for performance measurement and evaluation can best be characterized as the:

- A. Historical weighted average cost of capital for the company.
- B. Average return on investment that has been earned by the company over a particular time period.
- C. Average return on assets employed over a particular time period.
- D. Average prime lending rate for the year being evaluated.

**Correct Answer: A**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Historical weighted average cost of capital is usually used as the target or hurdle rate in the residual income approach. Choices "b", "c", and "d" are incorrect, per the above definition.

**QUESTION 355**

Minon, Inc. purchased a long-term asset on the last day of the current year. What are the effects of this purchase on return on investment and residual income?

	<u>Return on Investment</u>	<u>Residual income</u>
A.	Increase	Increase
B.	Decrease	Decrease
C.	Increase	Decrease
D.	Decrease	Increase

- A. Option A  
B. Option B  
C. Option CD. Option D

**Correct**

**Answer: B**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The addition of an asset at year end serves to reduce both return on investment and residual income. The addition of an asset increases then denominator in the ROI computation and increases the threshold earnings required using the residual income approach. Both measures would suffer as a result of addition of assets. See illustration below:

#### Assumptions:

Income	\$ 100,000
Assets	\$1,000,000
Required return	10%
Additional asset	\$ 200,000



#### Return on Investment

	<u>Before</u>	<u>Purchase</u>	<u>After</u>
Income	\$ 100,000		\$ 100,000
Assets	\$1,000,000	\$200,000	\$1,200,000
Return	<u>10%</u>		<u>8%</u>

#### Residual Income

	<u>Before</u>	<u>Purchase</u>	<u>After</u>
Assets	\$1,000,000	\$200,000	\$1,200,000
Required Return	<u>10%</u>		<u>10%</u>
Required Income	\$ 100,000		\$ 120,000
Income	<u>\$ 100,000</u>		<u>\$ 100,000</u>
Difference	<u>\$ -</u>		<u>\$ (20,000)</u>

The purchase of the additional asset reduces ROI from 10% to 8% and produces negative residual income. Choices "a", "c", and "d" are incorrect, per the above illustration.

#### QUESTION 356

Vested, Inc. made some changes in operations and provided the following information:

	<u>Year 2</u>	<u>Year 3</u>
Operating revenues	\$ 900,000	\$1,100,000
Operating expenses	650,000	700,000
Operating assets	1,200,000	2,000,000

What percentage represents the return on investment for year 3?

- A. 28.57%  
B. 25%



- C. 20.31%  
D. 20%

**Correct Answer: B**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. Return on investment is the ratio of operating income to average operating assets and is computed as follows based on Year 2 and Year 3 data:

Operating revenue (Year 3)		\$1,100,000
Operating expense (Year 3)		(700,000)
Operating income		<u>400,000</u>
Operating assets (Year 2)	1,200,000	
Operating assets (Year 3)	<u>2,000,000</u>	
Total	<u>3,200,000</u>	
	31	
Average operating assets ( ÷ 2)		<u>1,600,000</u>
Return on investment		<u>25.00%</u>

Choice "a" is incorrect per the above computation.

Choice "c" is incorrect. The year 3 return on investment is not computed by combining revenues, expenses, and assets for all year's presented.

Choice "d" is incorrect. The year 3 return on investment is based on the average assets  $((\$1,200,000 + \$2,000,000)/2 = \$1,600,000)$ , not simply on the total assets at the end of year 3 (\$2,000,000).

**QUESTION 357** The capital structure of a firm includes bonds with a coupon rate of 12% and an effective interest rate is 14%. The corporate tax rate is 30%. What is the firm's net cost of debt?

- A. 8.4%  
B. 9.8%  
C. 12.0%  
D. 14.0%

**Correct Answer: B**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. The net cost of debt is computed as the effective interest rate net of tax, or  $14\% \times .70 = 9.8\%$ . The question is trying to trick the candidate into using the coupon rate of 12% rather than the effective interest rate. The coupon rate is used only if it is the same as the effective interest rate and there are no flotation costs.

Choice "a" is incorrect. The net cost of debt is computed as the effective interest rate net of tax, or  $14\% \times .70 = 9.8\%$ , not the coupon rate of  $12\% \times .70 = 8.4\%$ .

Choice "c" is incorrect. The net cost of debt is computed as the effective interest rate net of tax, or  $14\% \times .70 = 9.8\%$ , not the coupon rate of 12% by itself. The cost of debt is computed on an after-tax basis and uses the effective interest rate instead of the coupon rate.

Choice "d" is incorrect. The net cost of debt is computed as the effective interest rate net of tax, or  $14\% \times .70 = 9.8\%$ , not the effective interest rate of 14% by itself. The cost of debt is computed on an after-tax basis.

**QUESTION 358**

What is the primary disadvantage of using return on investment (ROI) rather than residual income (RI) to evaluate the performance of investment center managers?



- A. ROI is a percentage, while RI is a dollar amount.
- B. ROI may lead to rejecting projects that yield positive cash flows.
- C. ROI does not necessarily reflect the company's cost of capital.
- D. ROI does not reflect all economic gains.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The primary disadvantage of using return on investment (ROI) rather than residual income (RI) to evaluate the performance of investment center managers is that ROI may lead to rejecting projects that yield positive cash flows. Profitable investment center managers might be reluctant to invest in projects that might lower their ROI (especially if their bonuses are based only on their investment center's ROI), even though those projects might generate positive cash flows for the company as a whole.

This characteristic is often known as the "disincentive to invest."

Choice "a" is incorrect. The primary disadvantage of using return on investment (ROI) rather than residual income (RI) to evaluate the performance of investment center managers is that ROI may lead to rejecting projects that yield positive cash flows, not that ROI is a percentage and RI is a dollar amount.

The fact that one is a percentage and one is a dollar amount might make them a little harder to interpret, but this interpretation difficulty would certainly not seem to be the "primary" disadvantage.

Choice "c" is incorrect. The primary disadvantage of using return on investment (ROI) rather than residual income (RI) to evaluate the performance of investment center managers is that ROI may lead to rejecting projects that yield positive cash flows, not that ROI does not necessarily reflect the cost of capital.

Choice "d" is incorrect. The primary disadvantage of using return on investment (ROI) rather than residual income (RI) to evaluate the performance of investment center managers is that ROI may lead to rejecting projects that yield positive cash flows, not that ROI does not reflect all economic gains.

**QUESTION 359**

The benefits of debt financing over equity financing are likely to be highest in which of the following situations?

- A. High marginal tax rates and few noninterest tax benefits.
- B. Low marginal tax rates and few noninterest tax benefits.
- C. High marginal tax rates and many noninterest tax benefits.
- D. Low marginal tax rates and many noninterest tax benefits.

**Correct Answer: A**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The benefits of debt financing over equity financing are likely to be highest if marginal tax rates are high (because interest on debt is deductible for tax purposes) and if there are few noninterest tax benefits (because there is little or no reason to depart from debt financing).

Choice "b" is incorrect. The benefits of debt financing over equity financing are likely to be highest if marginal tax rates are high, not low (because interest on debt is deductible for tax purposes), and if there are few noninterest tax benefits.

Choice "c" is incorrect. The benefits of debt financing over equity financing are likely to be highest if marginal tax rates are high (because interest on debt is deductible for tax purposes) and if there are few, not many, noninterest tax benefits.

Choice "d" is incorrect. The benefits of debt financing over equity financing are likely to be highest if marginal tax rates are high, not low (because interest on debt is deductible for tax purposes), and if there are few, not many, noninterest tax benefits.

**QUESTION 360**

A company has two divisions. Division A has operating income of \$500 and total assets of \$1,000. Division B has operating income of \$400 and total assets of \$1,600. The required rate of return for the company is 10%. The company's residual income would be which of the following amounts?

- A. \$0
- B. \$260
- C. \$640
- D. \$900

**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Residual income is the difference between net income and the required return. The required return is net book value (total assets) times the hurdle rate (required rate of return). The calculations are as follows:

Division	Operating Income	Total Assets x Required Rate	= Residual income
A	\$500	\$1,000 x .10 = \$100	\$400
B	\$400	\$1,600 x .10 = \$160	\$240
Total	\$900	\$260	\$640

Choice "a" is incorrect. Residual income would certainly not be \$0 in this question because the operating income is greater than the required return for both Division A and Division B. Choice

"b" is incorrect. The \$260 is the total required return, not the total residual income.

Choice "d" is incorrect. The \$900 is the total operating income, not the total residual income.

**QUESTION 361**

At the beginning of year 1, \$10,000 is invested at 8% interest, compounded annually. What amount of interest is earned for year 2?

- A. \$800.00
- B. \$806.40
- C. \$864.00
- D. \$933.12

**Correct Answer: C**  
**Section: Volume C**



**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. This question is a compound interest question because the interest is to be determined at the end of the second year. The calculation is as follows and uses different symbols than the SI = PIN formula in the text to show candidates the PRT formula as well (the CPA exam often uses different terminology):

Interest = PRT (for the first year)

Interest = \$1,000 x .08 x 1 = \$800 and adding the \$800 to the beginning principal

Interest = PRT (for the second year)

Interest = \$1,800 x .08 x 1 = \$864

It is obvious from the answer that the interest earned in year 2 is interest earned on the original principal (\$10,000 x .08 = \$800) plus interest on the year 1 interest (\$800 x .08 = \$64). Choice

"a" is incorrect. This answer is interest only on the original principal, and not on the year 1 interest.

Choice "b" is incorrect. This answer has a decimal point error in calculating the year 2 interest on year 1 interest.

Choice "d" is incorrect. This answer is apparently made up. It is sometimes difficult to come up with 3 decent wrong answers, especially with simple questions.

**QUESTION 362** The optimal capitalization for an organization usually can be determined by the:

- A. Maximum degree of financial leverage (DFL).
- B. Maximum degree of total leverage (DTL).
- C. Lowest total weighted-average cost of capital (WACC).
- D. Intersection of the marginal cost of capital and the marginal efficiency of investment.

**Correct Answer: C**

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The optimal capitalization for an organization usually can be determined by the lowest total weighted-average cost of capital (WACC). Capitalization at WACC serves to maximize shareholder's equity.

Choice "a" is incorrect. The degree of financial leverage relates to the risk assumed by a firm using fixed debt service costs to finance operations not comprehensively to capital structure.

Choice "b" is incorrect. The degree of total leverage relates the risk assumed by a firm using a combination of both debt services costs to finance operations and fixed costs to operate the business, not comprehensively to capital structure.

Choice "d" is incorrect. The intersection of the marginal cost of capital and the marginal efficiency of investment does not indicate optimal capitalization.

**QUESTION 363**

Bander Co. is determining how to finance some long-term projects. Bander has decided it prefers the benefits of no fixed charges, no fixed maturity date and an increase in the credit-worthiness of the company. Which of the following would best meet Bander's financing requirements?

- A. Bonds.
- B. Common stock.
- C. Long-term debt.
- D. Short-term debt.

**Correct Answer: B**

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Common stock is an equity security that conveys ownership. Common stock does not require any payment, it does not mature and, because it increases equity while having no effect on debt, it decreases the debt equity ratio and increases the credit-worthiness of the firm.

Choice "a" is incorrect. Bonds are debt instruments that require specific fixed payments, mature at a specific time and increase debt. Immediately after issue, increases in debt increase the debt equity ratio and decrease credit worthiness.

Choice "c" is incorrect. Long-term debt requires specific fixed payments, includes maturity at a specific time and (by definition), increases debt. Immediately after issue, increases in debt increase the debt equity ratio and decrease credit worthiness.

Choice "d" is incorrect. Short-term debt requires specific fixed payments, includes maturity at a specific time and, by definition, increase debt. Immediately after issue, increases in debt increase the debt equity ratio and decrease credit worthiness.

**QUESTION 364**

Which of the following formulas should be used to calculate the economic rate of return on common stock?

- A.  $(\text{Dividends} + \text{change in price}) \div \text{beginning price}$ .
- B.  $(\text{Net income} - \text{preferred dividend}) \div \text{common shares outstanding}$ .
- C.  $\text{Market price per share} \div \text{earnings per share}$ .
- D.  $\text{Dividends per share} \div \text{market price per share}$ .

**Correct Answer: A**

**Section: Volume C****Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. The economic rate of return on common stock measures the dividend income and capital growth in relation to the initial investment, the beginning price of the stock.

Choice "b" is incorrect. The proposed solution is earnings per share, a ratio generally computed as the earnings available to common shareholders (net income after payment of preferred shares) divided by the common shares outstanding.

Choice "c" is incorrect. Market price per share divided by earnings per share is the price/earnings or P/E ratio, not the economic rate of return on common stock.

Choice "d" is incorrect. The dividends per share divided by the market price per share does not represent the economic rate of return on common stock, the ratio includes change in stock value in the denominator rather than the numerator of the equation.

**QUESTION 365**

Which of the following factors is inherent in a firm's operations if it utilizes only equity financing?

- A. Financial risk.
- B. Business risk.
- C. Interest rate risk.
- D. Marginal risk.

**Correct Answer: B**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Business risk represents the risk associated with the unique circumstances of a particular company, as they might affect the shareholder value of that company. If an entity purely uses its own cumulative earnings in capitalizing its operations, it is exposed to the risks of its own unique circumstances.

Choice "a" is incorrect. Financial risk, also called default risk, relates to the exposure of lenders to the failure of borrowers to repay principal and interest on debt. An entity using its own cumulative earnings in capitalizing its operations is not exposed to default risk.

Choice "c" is incorrect. A business that exclusively uses equity capitalization would not be exposed to the risk that the value of its financial instruments will change as a result of changes in interest rates. Choice "d" is incorrect. Incremental changes in risk would be limited if a firm exclusively used its own equity financing to capitalize its operations.

**QUESTION 366**

Capital investments require balancing risk and return. Managers have a responsibility to ensure that the investments that they make in their own firms increase shareholder value. Managers have met that responsibility if the return on the capital investment:

- A. Exceeds the rate of return associated with the firm's beta factor.
- B. Is less than the rate of return associated with the firm's beta factor.
- C. Is greater than the prime rate of return.
- D. Is less than the prime rate of return.

**Correct Answer: A**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. A capital investment whose rate of return exceeds the rate of return associated with the firm's beta factor will increase the value of the firm.

Choice "b" is incorrect. A capital investment whose rate of return is less than the rate of return associated with the firm's beta factor will decrease the value of the firm.

Choice "c" is incorrect. The return on a capital investment in relation to the prime rate of return will not necessarily indicate if the investment increases or decreases the value of the company without knowing the relative risk of the firm in relation to the market and its relationship to the prime rate.

Choice "d" is incorrect. The return on a capital investment in relation to the prime rate of return will not necessarily indicate if the investment increases or decreases the value of the company without knowing the relative risk of the firm in relation to the market and its relationship to the prime rate.

**QUESTION 367**

The Frame Supply Company has just acquired a large account and needs to increase its working capital by \$100,000. The controller of the company has identified a source of funds which is given below:

Pay a factor to buy the company's receivables, which average \$125,000 per month and have an average collection period of 30 days. The factor will advance up to 80 percent of the face value of receivables at 10 percent and charge a fee of 2 percent on all receivables purchased. The controller estimates that the firm would save \$24,000 in collection expenses over the year. Assume the fee and interest are not deductible in advance.

Assume a 360-day year in all of your calculations.

The cost of factoring is:

- A. 12.0 percent.
- B. 14.8 percent.
- C. 16.0 percent.
- D. 20.0 percent.

**Correct Answer:** C  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

	AR	x Fee	x Days in yr/ days in period	Subtotals
AR Submitted	\$125,000	2%	360/30	\$30,000
Amount withheld	<u>(25,000)</u>			
Amount subject to interest	100,000	10%/12	360/30	<u>10,000</u>
Cost to company				40,000
Less: Expenses saved due to outsourcing				<u>(24,000)</u>
Net cost				<u>\$16,000</u>

Net cost/average amount invested = \$16,000/\$100,000 = 16%

**QUESTION 368**

A company uses the following formula in determining its optimal level of cash.

$$C^* = \sqrt{\frac{2bT}{i}}$$



Where:

b = Fixed cost per transaction

i = Interest rate on marketable securities T =

Total demand for cash over a period of time

This formula is a modification of the Economic Order Quantity (EOQ) formula used for inventory management. Assume that the fixed cost of selling marketable securities is \$10 per transaction, and the interest rate on marketable securities is 6 percent per year. The company estimates that it will make cash payments of \$12,000 over a one-month period. What is the average cash balance (rounded to the nearest dollar)?

- A. \$1,000
- B. \$2,000
- C. \$3,464
- D. \$6,928

**Correct Answer:** C  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Like the EOQ, this formula represents the amount of cash brought in by the sale of marketable securities. Also like the EOQ, this cash goes to zero (or the safety level) over time. The average cash (like the average inventory) is one half of the amount collected. Remember also to convert the interest rate to a per month figure of 0.5%

$$C^* = (2bT/i)^{1/2}$$

$$C^* = [2(10)12,000/.005]^{1/2}$$

$$C^* = [240,000/.005]^{1/2}$$

$$C^* = \$6,928$$

$$\text{Average cash} = \$6,928/2 = \$3,464$$

Choices "a", "b", and "d" are incorrect, per above.

#### QUESTION 369

Spotech Co.'s budgeted sales and budgeted cost of sales for the coming year are \$212,000,000 and \$132,500,000 respectively. Short-term interest rates are expected to average 5 percent. If Spotech could increase inventory turnover from its current 8 times per year to 10 times per year, its expected cost savings in the current year would be:

- A. \$165,625
- B. \$331,250
- C. \$81,812
- D. \$250,000

**Correct Answer:** A

**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. \$165,625 expected cost savings by increasing inventory turnover from its current 8 times to 10 times per year.

<u>Cost Of Sales</u>		<u>Inventory Turnover</u>		<u>Avg. Inventory</u>	
\$132,500,000	÷	8	=	\$16,562,500	
132,500,000	÷	10	=	<u>13,250,000</u>	
				3,312,500	Inventory Decrease
				× 5%	Interest Rate
				<u>\$ 165,625</u>	Cost Savings

**QUESTION 370** The amount of inventory that a company would tend to hold in stock would increase as the:

- A. Cost of carrying inventory decreases.
- B. Variability of sales decreases.
- C. Cost of running out of stock decreases.
- D. Length of time that goods are in transit decreases.

**Correct Answer:** A

**Section:** Volume C

#### Explanation



**Explanation/Reference:**

Explanation:

Choice "a" is correct. The amount of inventory that a company would tend to hold in stock would increase as the cost of carrying inventory decreases. The amount of inventory that a company would tend to hold in stock would decrease as the:

- B. Variability of sales decreases.
- C. Cost of running out of stock decreases.
- D. Length of time that goods are in transit decreases.

**QUESTION 371**

Average daily cash outflows are \$3 million for Evans Inc. A new cash management system can add two days to the disbursement schedule. Assuming Evans earns 10 percent on excess funds, how much should the firm be willing to pay per year for this cash management system?

- A. \$3,000,000
- B. \$1,500,000
- C. \$600,000
- D. \$150,000

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. \$600,000 allowed for new cash management system.

Average Daily Cash Outflows  
Days Added to Disbursement Schedule  
Excess Funds  
Earning Rate on Excess Funds  
Allowable Cost for Cash Management System

\$3,000,000  
x 2  
6,000,000  
x 10%  
\$ 600,000

**QUESTION 372**

Jackson Distributors sells to retail stores on credit terms of 2/10, net 30. Daily sales average 150 units at a price of \$300 each. Assuming that all sales are on credit and 60 percent of customers take the discount and pay on Day 10 while the rest of the customers pay on Day 30, the amount of Jackson's accounts receivable is:

- A. \$990,000
- B. \$900,000
- C. \$810,000
- D. \$450,000

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. \$810,000 accounts receivable.

	60%	40%	100%
Unit Sales Price	\$ 300	\$ 300	\$ 300
Daily Sales Average Units	× 90	× 60	× 150
Daily Sales	\$27,000	\$18,000	\$ 45,000
Days Outstanding	× 10	× 30	
	<u>270,000</u>	<u>540,000</u>	<u>\$810,000</u>

Choices "a", "b", and "d" are incorrect, per the above calculation.

**QUESTION 373** If a retailer's terms of trade are 3/10, net 45 with a particular supplier, what is the cost on an annual basis of not taking the discount? Assume a 360-day year.

- A. 37.11 percent.
- B. 36.00 percent.
- C. 24.74 percent.
- D. 31.81 percent.

**Correct Answer:** D

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

$$\frac{360}{(\text{Total pay period} - \text{Discount period})} \times \frac{\text{Discount \%}}{(100\% - \text{Discount \%})} =$$

$$\frac{360}{(45 - 10)} \times \frac{3\%}{100\% - 3\%} = 31.81\%$$



Choice "d" is correct. 31.81% annual cost of not taking the discount.  
Choices "a", "b", and "c" are incorrect, per the above calculation.

**QUESTION 374** If a firm borrows \$500,000 at 10 percent and is required to maintain \$50,000 as a minimum compensating balance at the bank, what is the effective interest rate on the loan?

- A. 11.1 percent.
- B. 9.1 percent.
- C. 12.2 percent.
- D. 11.0 percent.

**Correct Answer:** A

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. 11.1% effective interest rate on loan.

$$\frac{\text{Annual interest}}{\text{Net cash available}} = \frac{\$500,000 \times 10\%}{\$500,000 - \$50,000} = \frac{\$50,000}{\$450,000} = 11.1\%$$

This question pertains to the computation of the effective rate of interest on a \$500,000 note with a 10% stated rate that requires a \$50,000 compensating balance. The answer computes the effective rate at 11.1% by taking the ratio of the amount paid \$50,000 to the funds available \$450,000 (\$500,000 – \$50,000). Why would the \$50,000 in interest payments not also be deducted in arriving at the effective rate?

The simple answer is that the note is not discounted by the interest. It is only subject to the compensating balance.

The borrower receives \$500,000 in proceeds but must hold out \$50,000 and pay back \$550,000, principal + interest, to the lender. At the conclusion of the loan, the compensating balance requirement is removed.

#### QUESTION 375

A company has daily cash receipts of \$150,000. The treasurer of the company has investigated a lockbox service whereby the bank that offers this service will reduce the company's collection time by four days at a monthly fee of \$2,500. If money market rates average four percent during the year, the additional annual income (loss) from using the lockbox service would be:

- A. \$6,000
- B. \$(6,000)
- C. \$12,000
- D. \$(12,000)

**Correct Answer: B**

**Section: Volume C**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. \$(6,000). A company's decision to commit to a lockbox plan is an example of marginal analysis. In other words, do the marginal benefits exceed the marginal costs of the plan?

Marginal revenue equals	Increase cash	\$150,000/day
	Receipts available	× 4 days
	For investment	\$600,000
Can be invested for yr:		
	at 4%	× .04
	MR	\$ 24,000
Less: marginal costs		
Mo. Lockbox fee × 12 =		
\$2,500 × 12 =		(30,000)
Loss on plan		<u>\$ (6,000)</u>

Choices "a", "c", and "d" are incorrect, per the above calculation.

**QUESTION 376** Assume that each day a company writes and receives checks totaling \$10,000. If it takes five days for the checks to clear and be deducted from the company's account, and only four days for the deposits to clear, what is the float?

- A. \$10,000
- B. \$0
- C. \$(10,000)
- D. \$25,000

**Correct Answer: A**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. \$10,000. Float is the difference between the balance of checks outstanding, which have not cleared the bank and deposits made but which have not yet cleared the bank here.

$$\begin{array}{rcl} \$10,000/\text{day checks drawn but not cleared} & \times & 5 \text{ days} = \$50,000 \\ \text{Less } \$10,000/\text{day checks received but not cleared} & \times & 4 \text{ days} = (40,000) \\ \text{Positive "float"} & & = \underline{\underline{\$10,000}} \end{array}$$

Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 377** The optimal level of inventory would be affected by all of the following, except the: A. Cost per unit of inventory.

- B. Current level of inventory.
- C. Cost of placing an order for merchandise.
- D. Lead time to receive merchandise ordered.

**Correct Answer: B**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The current level of inventory has no impact on the optimal level of inventory.

Choices "a", "c", and "d" are incorrect. The optimal level of inventory is affected by:

1. The inventory usage rate.
2. The cost per unit of inventory - which will have a direct impact on inventory carrying costs.
3. The cost of placing on order impacts order frequency, which affects order size and optimal inventory levels.

#### QUESTION 378

During 1990, Mason Company's current assets increased by \$120, current liabilities decreased by \$50, and net working capital:

- A. Increased by \$70.
- B. Decreased by \$170.
- C. Increased by \$170.
- D. Decreased by \$70.

**Correct Answer: C**

**Section: Volume C**

### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. Net working capital is the difference between current assets and current liabilities. Because current assets went up \$120 and current liabilities down by \$50, the net effect is an increase in net working capital of \$170.

<i>For example:</i>			
Current assets	<u>\$500,000</u>	<u>120,000</u>	<u>620,000</u>
Current liabilities	<u>\$300,000</u>	<u>(50,000)</u>	<u>250,000</u>
Net working capital	<u>\$200,000</u>		<u>370,000</u>

Therefore, working capital has increased \$170,000.  
Choices "a", "b", and "d" are incorrect, per the above calculation.

#### QUESTION 379

As a company becomes more conservative with respect to working capital policy, it would tend to have a (n):

- A. Increase in the ratio of current liabilities to noncurrent liabilities.
- B. Decrease in the operating cycle.
- C. Decrease in the quick ratio.
- D. Increase in the ratio of current assets to noncurrent assets.

**Correct Answer:** D

**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

RULE: Working capital policy is deemed to be more conservative as an increasing portion of an organization's long-term assets, permanent current assets, and temporary current assets are funded by long-term financing.

Choice "d" is correct. An increase in the ratio of current assets to non-current assets would be indicative of an increasingly conservative working capital policy. With no other information, an increase in current assets would indicate that a growing percentage of current assets are financed by non current liabilities and that, nominally, the absolute amount of working capital and the current ratio is improving.

Choice "a" is incorrect. An increase in the ratio of current liabilities to noncurrent liabilities would indicate that an increasing portion of our assets are funded by current liabilities, a more aggressive approach to working capital management.

Choice "b" is incorrect. A decrease in the operating cycle implies that the time to convert inventory into sales (receivables) and receivables into cash has decreased. Assuming no change in liabilities or sales, a decreased operating cycle infers declining current asset balances, greater funding of assets by current liabilities and a more aggressive rather than conservative working capital policy.

Choice "c" is incorrect. A decrease in the quick ratio would indicate that either temporary current assets are decreasing (and are therefore increasingly funded by current liabilities, indicating a more aggressive working capital policy) or that current liabilities are increasing, signaling a decrease in the amount of noncurrent liabilities used to fund temporary current assets, a sign of an increasingly aggressive working capital policy.

**QUESTION 380** In inventory management, the safety stock will tend to increase if the:

- A. Carrying cost increases.
- B. Cost of running out of stock decreases.
- C. Variability of lead-time increases.
- D. Fixed order cost decreases.

**Correct Answer:** C

**Section:** Volume C

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. If lead times became more variable, the amount of safety stock needed to reduce the risk of stock outs will increase. Choice

"a" is incorrect. A high carrying cost would decrease safety stock.

Choice "b" is incorrect. A lower stockout cost would decrease safety stock.

Choice "d" is incorrect. If order costs decrease, then inventory will be ordered more frequently and less safety stock will be needed.



**QUESTION 381** Quantree Company is quoted credit terms of 3/15, net 60 (using a 360-day year). The effective cost of not taking this discount and paying on day 60 is (rounded to nearest hundredth):

- A. 24.74 percent.
- B. 24.00 percent.
- C. 18.56 percent.
- D. 18.00 percent.

**Correct Answer:** A  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "a" is correct. The formula for computing the cost of credit discounts is:

$$\frac{360}{(\text{Total pay period} - \text{Discount period})} \times \frac{\text{Discount \%}}{(100\% - \text{Discount \%})} =$$

$$\frac{360}{(60 - 15)} \times \frac{3\%}{100\% - 3\%} =$$

$$8 \times .0309 = 24.7\%$$



Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 382** Which of the following inventory management approaches orders at the point where carrying costs equate nearest to restocking costs in order to minimize total inventory cost?

- A. Economic order quantity.
- B. Just-in-time.
- C. Materials requirements planning.
- D. ABC.

**Correct Answer:** A  
**Section:** Volume C

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "a" is correct. The economic order quantity (EOQ) method of inventory control anticipates orders at the point where carrying costs are nearest to restocking costs. The objective of EOQ is to minimize total inventory costs. The formula for EOQ is:



$$E = \sqrt{\frac{2SO}{C}}$$

- ☒ Order size (EOQ)
- ☐ Annual Sales (in units)
- ☐ Cost per Purchase Order (primarily production set-up costs)
- ☐ Carrying cost per unit

Choice "b" is incorrect. Just in time (JIT) inventory models were developed to reduce the lag time between inventory arrival and inventory use.

Choice "c" is incorrect. Materials requirements planning (MRP) is a method of determining inventory requirements when a given number of units is needed. The method is used to create precise schedules of which items will be needed and what times they will be needed.

Choice "d" is incorrect. ABC is an acronym for Activity Based Costing, a method of cost assignment that identifies value added activities and related cost drivers. It is not an inventory management approach.

**QUESTION 383** Which of the following ratios is appropriate for the evaluation of accounts receivable?

- A. Days sales outstanding.
- B. Return on total assets.
- C. Collection to debt ratio.
- D. Current ratio.

**Correct Answer:** A  
**Section:** Volume C



#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. Among the ratios listed, the ratio that is appropriate for the evaluation of accounts receivable is the number of days sales are outstanding. Sales are related to accounts receivable, so the more days the sales are outstanding, the longer the receivables are outstanding.

Choice "b" is incorrect. Return on total assets is not appropriate for the evaluation of accounts receivable.

It is appropriate for the evaluation of return and of total assets, but not for the evaluation of account receivable specifically.

Choice "c" is incorrect. The collection to debt ratio has nothing to do with the evaluation of accounts receivable.

Choice "d" is incorrect. The current ratio is appropriate for the evaluation of liquidity (one of the ways to evaluate liquidity) but has nothing to do with the evaluation of accounts receivable, other than that accounts receivable is in the numerator of the current ratio.

#### QUESTION 384

Which of the following is not a typical characteristic of a just-in-time (JIT) production environment?

- A. Lot sizes equal to one.
- B. Insignificant setup times and costs.
- C. Push-through system.
- D. Balanced and level workloads.

**Correct Answer:** C  
**Section:** Volume C

#### Explanation

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Just-in-time has the goal to minimize the level of inventory carried. Typical characteristics include lot sizes equal to one, insignificant set-up times and costs, and balanced and level workloads. In a just-in-time environment, the flow of goods is controlled by a "pull" approach, where an item is produced only when it is needed down the line, and not a "push-through" system. Choices "a", "b", and "d" are incorrect based on the above Explanation.

**QUESTION 385**

Bell Co. changed from a traditional manufacturing philosophy to a just-in-time philosophy. What are the expected effects of this change on Bell's inventory turnover and inventory as a percentage of total assets reported on Bell's balance sheet?

	<u>Inventory turnover</u>	<u>Inventory percentage</u>
A.	Decrease	Decrease
B.	Decrease	Increase
C.	Increase	Decrease
D.	Increase	Increase

- A. Option A
- B. Option B
- C. Option C
- D. Option D

**Correct Answer:** C

**Section:** Volume C

**Explanation**



**Explanation/Reference:**

Explanation:

Choice "c" is correct. In a just-in-time system, products are produced just-in-time to be sold. Therefore, JIT systems maintain a much smaller level of inventory when compared to traditional systems. Inventory turnover (cost of goods sold divided by average inventory) increases with a switch to JIT, and inventory as a percentage of total assets decreases. Choices "a", "b", and "d" are incorrect based on the above Explanation.

**QUESTION 386** The benefits of a just-in-time system for raw materials usually include:

- A. Elimination of nonvalue adding operations.
- B. Increase in the number of suppliers, thereby ensuring competitive bidding.
- C. Maximization of the standard delivery quantity, thereby lessening the paperwork for each delivery.
- D. Decrease in the number of deliveries required to maintain production.

**Correct Answer:** A

**Section:** Volume C

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The just-in-time system focuses on expediting the production process by having materials available as needed without having to store them prior to usage. Thus, the nonvalue adding operation of storing materials is eliminated.

Choice "b" is incorrect. A just-in-time system is designed to facilitate the flow of materials whether the materials come from one or more suppliers. Competitive bidding is not a major benefit of the just-in-time system.

Choice "c" is incorrect. Maximizing the delivery quantity of materials may increase the need to store the materials prior to using them. The just-in-time system focuses on minimizing storage time and storage costs. Lessening paperwork is not a focus of the just-in-time system.

Choice "d" is incorrect. With a just-in-time system, deliveries are made as materials are needed. A decrease in deliveries may increase the delivery quantity, thus increasing the need to store the materials prior to using them. The just-in-time system focuses on minimizing storage time and storage costs.

**QUESTION 387**

Amicable Wireless, Inc. offers credit terms of 2/10, net 30 for its customers. Sixty percent of Amicable's customers take the 2% discount and pay on day 10. The remainder of Amicable's customers pay on day 30. How many days' sales are in Amicable's accounts receivable?

- A. 6
- B. 12
- C. 18
- D. 20

**Correct Answer: C**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Days' sales in accounts receivable is normally calculated as Days' sales = Ending accounts receivable / Average daily sales. However, that formula will not work in this case because the necessary information is not provided. However, enough information about payments is provided so that the total days' sales can be determined on a weighted average basis. In this question, nobody pays before the 10th day and 60% of the customers pay on the 10th day, so there are  $10 \times .60$ , or 6 day's sales there. The other 40% of the customers pay on the 30th day so there are  $30 \times .40$ , or 12 day's sales there. The total is 18 days sales.

Choice "a" is incorrect. This answer is apparently calculated from just the 60% of the customers who pay on the 10th day. The others have to be included also.

Choice "b" is incorrect. This answer is apparently calculated from just the 40% of the customers who pay on the 30th day. The others have to be included also.

Choice "d" is incorrect. This answer is apparently calculated by as the difference between the 30th day and the 10th day. The answer does not take into account how many customers pay when.

**QUESTION 388** Why would a firm generally choose to finance temporary assets with

short-term debt? A. Matching the maturities of assets and liabilities reduces risk.

B. Short-term interest rates have traditionally been more stable than long-term interest rates.

C. A firm that borrows heavily long term is more apt to be unable to repay the debt than a firm that borrows heavily short term.

D. Financing requirements remain constant.

**Correct Answer: A**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Matching the maturities of current assets with liabilities as they come due is designed to ensure liquidity and reduce risk of cash shortages. Temporary assets (such as inventories, generally, and seasonal inventories, specifically) might be financed with short term debt such that the earnings from the sales of those temporary assets could be used to liquidate the related obligations as they come due and ensure that cash is available to meet cash flow requirements.

Choice "b" is incorrect. Interest rate risks would likely motivate a firm to use longer term financing than short-term financing.

Choice "c" is incorrect. Matching cash inflows with cash outflows are more influential in determining a firm's ability to repay debt rather than the length of the obligation.

Choice "d" is incorrect. Long-term rather than short-term debt promotes consistent finance charges. The requirements for financing itself are driven by business practice, not by the maturity of financial instruments used.

**QUESTION 389**

The CFO of a company is concerned about the company's accounts receivable turnover ratio. The company currently offers customers terms of 3/10, net 30. Which of the following strategies would most likely improve the company's accounts receivable turnover ratio?

- A. Pledging the accounts receivable to a finance company.
- B. Changing customer terms to 1/10, net 30.
- C. Entering into a factoring agreement with a finance company.
- D. Changing customer terms to 3/20, net 30.

**Correct Answer: C**

**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The accounts receivable turnover ratio is expressed as  $\text{Sales} \div \text{Accounts Receivable}$ . A reduction in accounts receivable would serve to improve (increase) the turnover ratio. Factoring (selling) receivables would serve to reduce the amount of accounts receivable (indicating more rapid collections) thereby increasing (improving) the company's accounts receivable.

Choice "a" is incorrect. Pledging accounts receivable does not impact either sales or accounts receivable. There would be no improvement in the accounts receivable turnover ratio.

Choice "b" is incorrect. Changing the customer terms from 3/10, net 30 to 1/10, net 30 would actually reduce discount incentives to pay timely. Accounts receivable would likely remain the same or be higher. There would be no improvement in the company's accounts receivable turnover ratio.

Choice "d" is incorrect. Changing the customer terms from 3/10, net 30 to 3/20, net 30 would actually reduce incentives to pay timely by increasing the amount of time in which the customer could capitalize on the discount. Accounts receivable would likely remain the same or be higher. There would be no improvement in the company's accounts receivable turnover ratio.

**QUESTION 390** Which of the following effects would a lockbox most likely provide for receivables management?

- A. Minimized collection float.
- B. Maximized collection float.
- C. Minimized disbursement float.
- D. Maximized disbursement float.

**Correct Answer: A**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. A lockbox system expedites cash inflows (minimizes collection float) by having a bank receive payments from a company's customers directly, via mailboxes to which the bank has access. Payments that arrive in these mailboxes are deposited into the company's account immediately.

Choice "b" is incorrect. Lockboxes minimize rather than maximize collection float.

Choices "c" and "d" are incorrect. Lockbox systems relate to collection rather than disbursement float.



**QUESTION 391** Managers are often engaged in decision-making. There are numerous logical steps to reach a decision. The step least likely to be used by a manager for decision-making would be:

- A. Obtaining information.
- B. Establishment of a strategic vision.
- C. Selecting alternatives.
- D. Identifying alternative courses of action.

**Correct Answer: B**

**Section: Volume C**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Establishing a strategic vision is not normally included as part of the logical steps to reach a decision. Although decision-making techniques are incorporated as part of establishing a strategic vision and consideration of strategic issues is important, the process of deriving the vision is not considered part of the decision-making process.

Choice "a" is incorrect. Obtaining information as a basis for selecting between alternatives is generally viewed as a critical part of decision-making.

Choice "c" is incorrect. Selecting alternatives is a specific decision-making action that is generally included as one of the steps identified in decision-making.

Choice "d" is incorrect. Identifying alternative courses of action from which to choose is a decision-making process that is generally included as one of the steps identified in decision-making.

**QUESTION 392**

Management accountants are frequently asked to analyze various decision situations including the following.

- I. The cost of a special device that is necessary if a special order is accepted.
- II. The cost proposed annually for the plant service for the grounds at corporate headquarters.

- III. Joint production costs incurred, to be considered in a sell-at-split versus a process-further decision.
- IV. The costs associated with alternative uses of plant space, to be considered in a make/buy decision.
- V. The cost of obsolete inventory acquired several years ago, to be considered in a keep-versus disposal decision.

The costs described in situations I and IV above are:

- A. Prime costs.
- B. Sunk costs.
- C. Discretionary costs.
- D. Relevant costs.

**Correct Answer: D**

**Section: Volume C**

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Choice "d" is correct. Relevant costs.

Both I and IV are costs that are relevant to a decision.

Choice "a" is incorrect. Prime costs include direct material and direct labor.

Choice "b" is incorrect. Sunk costs are costs previously incurred and not relevant to decision-making. Choice

"c" is incorrect. Discretionary costs are discretionary. In I, the special device is necessary.

#### **QUESTION 393**

Management accountants are frequently asked to analyze various decision situations including the following.

- I. The cost of a special device that is necessary if a special order is accepted.
- II. The cost proposed annually for the plant service for the grounds at corporate headquarters.
- III. Joint production costs incurred, to be considered in a sell-at-split versus a process-further decision.
- IV. The costs associated with alternative uses of plant space, to be considered in a make/buy decision.
- V. The cost of obsolete inventory acquired several years ago, to be considered in a keep-versus disposal decision.

The cost described in situation II above is a:

- A. Prime cost.
- B. Sunk cost.
- C. Discretionary cost.
- D. Relevant cost.

**Correct Answer: C**

**Section: Volume C**

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Choice "c" is correct. Discretionary cost. The proposed cost for plant service for the grounds at corporate headquarters is an example of an avoidable cost that is discretionary. Choice

"a" is incorrect. Prime costs are direct materials and direct labor.

Choice "b" is incorrect. Sunk costs are costs previously incurred and not relevant.

Choice "d" is incorrect. Relevant costs are expected future costs that vary with the action taken.

**QUESTION 394** Companies that adopt just-in-time purchasing systems often experience:

- A. A reduction in the number of suppliers.
- B. Fewer deliveries from suppliers.

- C. A greater need for inspection of goods as the goods arrive.
- D. Less need for linkage with a vendor's computerized order entry system.

**Correct Answer: A**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. Just-in-time purchasing systems usually results in a reduction in the number of suppliers. Because a company that adopts J-I-T is very dependent on supplier performance, usually fewer suppliers are used and a very close working relationship is developed.

Choice "b" is incorrect. Just-in-time requires more deliveries from suppliers.

Choice "c" is incorrect. Usually there is more reliance on quality control by the supplier. Finding defective goods as they arrive is too late; a stock-out could cause production to shut down. Choice "d" is incorrect. There is much more need for linkage with the vendor's order entry system with JI- T because the company is dependent on timely deliveries from the vendor.

**QUESTION 395**

In a decision analysis situation, which one of the following costs is generally not relevant to the decision?

- A. Incremental cost.
- B. Avoidable cost.
- C. Historical cost.
- D. Opportunity cost.

**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Historical cost is generally not relevant in a decision analysis situation. All of the following costs are relevant in a decision analysis situation:

- A. Incremental cost
- B. Avoidable cost
- D. Opportunity cost

**QUESTION 396** The relevance of a particular cost to a decision is determined by:

- A. Riskiness of the decision.
- B. Number of decision variables.
- C. Potential effect on the decision.
- D. Accuracy of the cost.

**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. The relevance of a particular cost to a decision is determined by potential effect on the decision. Relevant costs are expected future costs that vary with the action taken. All other costs are assumed to be constant and thus have no effect on the decision.

The relevance of a particular cost to a decision is not determined by:





- A. Riskiness of the decision.
- B. Number of decision variables.
- D. Accuracy of the cost.

**QUESTION 397** Capital budgeting decisions include all but which of the following?

- A. Selecting among long-term investment alternatives.
- B. Financing short-term working capital needs.
- C. Making investments that produce returns over a long period of time.
- D. Financing large expenditures.

**Correct Answer: B**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Capital budgeting decisions do not include the financing of short-term working capital needs, which are more operational in nature. Choices "a", "c", and "d" are incorrect, as these are all types of capital budgeting decisions.

**QUESTION 398** An example of an indirect cash flow effect would be:

- A. Cash committed at inception of the project.
- B. Increased payroll expenses due to the project.
- C. A depreciation tax shield.
- D. An increase in expected future operating cash flows.



**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A depreciation tax shield is one of the most common indirect cash flow effects.

Choices "a", "b", and "d" are incorrect, as these are all directly related to the capital investment and have an immediate effect on the amount of cash available to the company. Thus, they are all direct cash flow effects.

**QUESTION 399** The annual tax depreciation expense on an asset reduces income taxes by an amount equal to:

- A. The firm's average tax rate times the depreciation amount.
- B. One minus the firm's average tax rate times the depreciation amount.
- C. The firm's marginal tax rate times the depreciation amount.
- D. One minus the firm's marginal tax rate times the depreciation amount.

**Correct Answer: C**  
**Section: Volume C**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The annual tax depreciation expense reduces income taxes by an amount equal to the firm's marginal tax rate (the tax on the next dollar of income) times the depreciation amount. Choices "a", "b", and "d" are incorrect, per above.

**QUESTION 400**

When employing the MACRS method of depreciation in a capital budgeting decision, the use of MACRS as compared to the straight-line method of depreciation will result in:

- A. Equal total depreciation for both methods.
- B. MACRS producing less total depreciation than straight line.
- C. Equal total tax payments, after discounting for the time value of money.
- D. MACRS producing more total depreciation than straight line.

**Correct Answer:** A

**Section:** Volume C

**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. MACRS and straight line depreciation will be equal in total (only the timing differs). Choices "b" and "d" are incorrect, per above.

Choice "c" is incorrect. The timing of the depreciation tax shields will differ. The discounting will result in different present values based on the differing timing.

**QUESTION 401**

Kore Industries is analyzing a capital investment proposal for new equipment to produce a product over the next eight years. The analyst is attempting to determine the appropriate "end-of-life" cash flows for the analysis. At the end of eight years, the equipment must be removed from the plant and will have a net book value of zero, a tax basis of \$75,000, a cost to remove of \$40,000, and scrap salvage value of \$10,000. Kore's effective tax rate is 40 percent. What is the appropriate "end-of-life" cash flow related to these items that should be used in the analysis?

- A. \$27,000
- B. \$12,000
- C. \$(18,000)
- D. \$(30,000)



**Correct Answer:** B

**Section:** Volume D

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. \$12,000 "end-of-life" cash flow.

The \$75,000 loss on disposal is a non-cash reduction in taxable income that will reduce taxes paid by \$30,000 ( $75,000 \times 40\%$ ).

The cost to remove the equipment is a cash expense that will reduce taxable income by \$40,000 and reduce taxes paid by \$16,000 ( $40,000 \times 40\%$ ), resulting in a net cash expense of \$24,000 (\$40,000 minus \$16,000, or  $40,000 \times 60\%$ ).

The \$10,000 salvage value will increase after-tax cash flow by \$6,000 ( $10,000 \times 60\%$ ).

<u>Items</u>	<u>Pre-Tax Bases</u>		<u>40% Tax Inflow (Outflow)</u>	<u>Net Cash Inflow (Outflow)</u>	<u>Activity</u>
	<u>Per Tax</u>	<u>Per Books</u>			
Equip Value	(75)	0	30	30	Tax disposal loss
Removal	(40)	(40)	16	(24)	Removal cost
Salvage	<u>10</u>	<u>10</u>	<u>(4)</u>	<u>6</u>	Salvage sale
Net	<u>(105)</u>	<u>30</u>	–	<u>42</u> = <u>12</u>	"End-of-life" Cash inflow

Choices "a", "c", and "d" are incorrect, per the above calculation.

**QUESTION 402** Which one of the following is most relevant to a manufacturing equipment replacement decision?

- A. Original cost of the old equipment.
- B. Disposal price of the old equipment.
- C. Gain or loss on the disposal of the old equipment.
- D. A lump-sum write-off amount from the disposal of the old equipment.

**Correct Answer: B**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Rule: Relevant costs are only those costs that will differ among many alternatives.

Choice "b" is correct. The disposal price of the old equipment is most relevant because it is an expected future inflow that will differ among alternatives. If this old equipment is replaced, there will be a cash inflow from the sale of the old equipment. If the old equipment is kept, there will be no cash inflow from the sale of the old equipment.

Choice "a" is incorrect. The original cost of the old equipment is a sunk cost and, therefore, not relevant.

Choice "c" is incorrect. The gain or loss on the disposal of the old equipment is not relevant. The gain or loss is an accounting computation that combines the book value, which is always not relevant, and the disposal value, which is relevant. The result is meaningless to future decisions and, therefore, is not relevant.

Choice "d" is incorrect. The book value is not relevant to future decisions because the undepreciated sunk cost of an asset will only reduce net income in the future as either depreciation expense or as a loss on disposal.

#### QUESTION 403

Lawson Inc. is expanding its manufacturing plant, which requires an investment of \$4 million in new equipment and plant modifications. Lawson's sales are expected to increase by \$3 million per year as a result of the expansion. Cash investment in current assets averages 30 percent of sales; accounts payable and other current liabilities are 10 percent of sales. What is the estimated total investment for this expansion?

- A. \$3.4 million.
- B. \$4.3 million.
- C. \$4.6 million.
- D. \$4.9 million.

**Correct Answer: C**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Rule: The expansion of working capital ( $WC = CA - CL$ ) is treated as an increase in investment. Choice "c" is correct. \$4.6 million estimated total investment for this expansion.

\$4,000,000	Original investment
900,000	$[(.30)(3,000,000)]$ expansion of current assets
<u>(300,000)</u>	$[(.10)(3,000,000)]$ expansion of current liabilities
<u>\$4,600,000</u>	Total investment for expansion

Choices "a", "b", and "d" are incorrect, per the above calculation.

**QUESTION 404** All of the following items are included in discounted cash flow analysis, except:

- A. Future operating cash savings.
- B. The current asset disposal price.
- C. The future asset depreciation expense.
- D. The tax effects of future asset depreciation.

**Correct Answer: C**  
**Section: Volume D**

#### Explanation

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. The future asset depreciation expense is not included in discounted cash flow analysis. Choices "a", "b", and "d" are incorrect. All of these are included in discounted cash flow analysis:

- Future operating cash savings
- Current asset disposal price
- Tax effects of future asset depreciation
- Future asset disposal price

**QUESTION 405** The method that recognizes the time value of money by discounting the after-tax cash flows over the life of a project, using the company's minimum desired rate of return is the:

- A. Accounting rate of return method.
- B. Net present value method.
- C. Internal rate of return method.
- D. Payback method.

**Correct Answer: B**  
**Section: Volume D**

#### Explanation

**Explanation/Reference:**  
 Explanation:

Choice "b" is correct. The net present value method recognizes the time value of money and discounts cash flows over the life of a project, using the minimum desired (hurdle) rate. Choice "a" is incorrect. The accounting rate of return is the accrual accounting increase compared to the initial investment. Choice "c" is incorrect. IRR is similar to NPV, but does not assume a desired rate of return. The rate is calculated that produces a NPV of zero. Choice "d" is incorrect. Payback method does not recognize the time value of money.

**QUESTION 406**

In order to increase production capacity, Gunning Industries is considering replacing an existing production machine with a new technologically improved machine effective January 1, 1997. The following information is being considered by Gunning Industries.

- The new machine would be purchased for \$160,000 in cash. Shipping, installation, and testing would cost an additional \$30,000.
- The new machine is expected to increase annual sales by 20,000 units at a sales price of \$40 per unit. Incremental operating costs are comprised of \$30 per unit in variable costs and total fixed costs of \$40,000 per year.
- The investment in the new machine will require an immediate increase in working capital of \$35,000.
- Gunning uses straight-line depreciation for financial reporting and tax reporting purposes. The new machine has an estimated useful life of five years and zero salvage value.
- Gunning is subject to a 40 percent corporate income tax rate.

Gunning uses the net present value method to analyze investments and will employ the following factors and rates.

Period	Present Value of \$1 at 10%	Present Value of an Ordinary Annuity of \$1 at 10%
1	.909	.909
2	.826	1.736
3	.751	2.487
4	.683	3.170
5	.621	3.791

Gunning Industries' net cash outflow in a capital budgeting decision would be:

- A. \$190,000
- B. \$195,000
- C. \$204,525
- D. \$225,000

**Correct Answer: D**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. \$225,000 net cash outflow.

Purchase price of new machine	\$ 160,000
Shipping, installation and testing cost	30,000
Required increase in working capital	<u>35,000</u>
Total	<u>\$ 225,000</u>

Choices "a", "b", and "c" are incorrect, per the above calculation.

Note: This question is the first from a series of questions on a prior exam. The last in the series is presented for you in the regular homework questions (not the supplemental questions) for this chapter.

#### QUESTION 407

A company has unlimited capital funds to invest. The decision rule for the company to follow in order to maximize shareholders' wealth is to invest in all projects having a (n):

- A. Present value greater than zero.
- B. Net present value greater than zero.
- C. Internal rate of return greater than zero.
- D. Accounting rate of return greater than the hurdle rate used in capital budgeting analyses.

**Correct Answer: B**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: If the net present value is positive (greater than zero), a project should be accepted, unless there is a better project. If, however, a company has unlimited funds, all projects with a net present value greater than zero should be accepted in order to maximize shareholder wealth.

Choice "a" is incorrect. Considering only present value greater than zero accounts for future net cash inflows, but it ignores cash outflows from the initial capital investment.

Choice "c" is incorrect. Considering only internal rate of return greater than zero may result in the acceptance of a project with an internal rate of return less than the company's minimum desired rate of return. Choice

"d" is incorrect. Considering only accounting rate of return greater than hurdle rate ignores the time value of money.

**QUESTION 408** When determining net present value in an inflationary environment, adjustments should be made to:

- A. Increase the discount rate, only.
- B. Increase the estimated cash inflows and increase the discount rate.
- C. Increase the estimated cash inflows but not the discount rate.
- D. Decrease the estimated cash inflows and increase the discount rate.

**Correct Answer: B**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct.

Rule: In an inflationary environment, future cash flows (except for cash flows generated from the tax effect of depreciation) should be increased to the extent of predicted inflation. For internal consistency, an inflationary factor should also be added to the discount rate.

Choices "a", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 409** All of the following are the rates used in net present value analysis, except for the:

- A. Cost of capital.
- B. Hurdle rate.
- C. Discount rate.
- D. Accounting rate of return.

**Correct Answer: D**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The accounting rate of return is a capital budgeting technique, not a rate.

Choices "a", "b", and "c" are incorrect. All of these are rates used in net present value analysis:

- Cost of capital
- Hurdle rate
- Discount rate
- Required rate of return

Cost of capital is the cost of borrowing. The hurdle rate, the discount rate, and the required rate of return are synonymous terms for an arbitrary rate set by management.



#### QUESTION 410

For capital budgeting purposes, management would select a high hurdle rate of return for certain projects because management: A.

Wants to use equity funding exclusively.

- B. Believes bank loans are riskier than capital investments.
- C. Believes capital investment proposals involve average risk.
- D. Wants to factor risk into its consideration of projects.

**Correct Answer:** D

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:


Choice "d" is correct. Management would select a high hurdle rate for certain projects to factor risk into its consideration of projects. The higher hurdle rate discounts future cash flows more, creating a smaller present value. By "devaluing" the cash flows of certain projects, risk has been compensated for.

Choices "a" and "b" are incorrect. The method and cost of funding are independent of the hurdle rate for screening investments. Choice "c" is incorrect. If capital investment proposals involve average risk, no adjustment upward is needed for risk.

#### QUESTION 411

McLean Inc. is considering the purchase of a new machine that will cost \$150,000. The machine has an estimated useful life of three years. Assume for simplicity that the equipment will be fully depreciated 30, 40, and 30 percent in each of the three years, respectively. The new machine will have a \$10,000 resale value at the end of its estimated useful life. The machine is expected to save the company \$85,000 per year in operating expenses. McLean uses a 40 percent estimated income tax rate and a 16 percent hurdle rate to evaluate capital projects.

Discount rates for a 16 percent rate are as follows.

	<u>Present Value of \$1</u>	<u>Present Value of an Ordinary Annuity of \$1</u>	
Year 1	.862	.862	
Year 2	.743	1.605	
Year 3	.641	2.246	

What is the net present value of this project?

- A. \$15,842
- B. \$13,278
- C. \$9,432
- D. \$(35,454)

**Correct Answer:** B

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. \$13,278 net present value.

	<u>"Zero"</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Equipment cost	(150,000)			
Depreciation tax shield		18,000	24,000	18,000
Annual savings		51,000	51,000	51,000
Salvage				6,000
After tax cash flow	(150,000)	69,000	75,000	75,000
Discount rate	$\times 1.00$	$\times .862$	$\times .743$	$\times .641$
Present value	(150,000)	59,478	55,725	48,075
Net present value	<u>13,278</u>			

Calculation of depreciation tax shield:

$$\begin{array}{l} \text{Years 1 \& 3 } 150,000(.30) = 45,000(.40) = 18,000 \\ \text{Year 2 } 150,000(.40) = 60,000(.40) = 24,000 \end{array}$$

Calculation of annual savings:

$$85,000 \text{ each year} \times .60 = 51,000$$

Calculation of salvage value inflow:

$$10,000(.60) = 6,000$$



#### QUESTION 412

Barker Inc. has no capital rationing constraint and is analyzing many independent investment alternatives. Barker should accept all investment proposals:

- A. If debt financing is available for them.
- B. That have positive cash flows.
- C. That provide returns greater than the after-tax cost of debt.
- D. That have a positive net present value.

**Correct Answer: D**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Accept all investment alternatives that have a positive net present value (NPV). A positive NPV means the return on the investment exceeds the hurdle rate (the minimum acceptable rate of return). Choice

"a" is incorrect. The cost of debt financing is a factor in determining the hurdle rate.

Choice "b" is incorrect. The cash flow may be positive but the return on investment may be unacceptable. Choice

"c" is incorrect. The cost of debt financing is a factor in determining the hurdle rate.

#### QUESTION 413

The net present value (NPV) of a project has been calculated to be \$215,000. Which one of the following changes in assumptions would decrease the NPV?

- A. Decrease the estimated effective income tax rate.
- B. Extend the project life and associated cash inflows.
- C. Increase the estimated salvage value.
- D. Increase the discount rate.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. An increase in the discount rate will decrease the present value of future cash inflows and, therefore, decrease the net present value of the project. Each of the other options would increase the NPV:

Choice "a" is incorrect. A decrease in the estimated effective income tax rate will reduce the depreciation tax shield and therefore increase the cash inflow. A larger cash inflow in the future will increase the present value of the cash inflows and therefore increase the net present value of the project.

Choice "b" is incorrect. Increasing the project life and associated cash inflows will increase the present value of the cash inflows and therefore increase the net present value. Choice "c" is incorrect. An increase in the estimated salvage value will decrease the present value of the cash outflow and therefore increase the net present value.

**QUESTION 414** The net present value method of capital budgeting assumes that cash flows are reinvested at:

- A. The risk-free rate.
- B. The cost of debt.
- C. The rate of return of the project.
- D. The discount rate used in the analysis.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The net present value method of capital budgeting assumes that cash flows are reinvested at the discount rate used in the analysis. Choices "a", "b", and "c" are incorrect, per the above Explanation.

**QUESTION 415**

Willis, Inc. has a cost of capital of 15 percent and is considering the acquisition of a new machine, which costs \$400,000 and has a useful life of five years. Willis projects that earnings and cash flow will increase as follows.

<u>Year</u>	<u>Net Earnings</u>	<u>After-Tax Cash Flow</u>
1	\$100,000	\$160,000
2	100,000	140,000
3	100,000	100,000
4	100,000	100,000
5	200,000	100,000

<u>Period</u>	15% interest rate factors	
	<u>Present value of \$1</u>	<u>Present value of an annuity of \$1</u>
1	0.87	0.87
2	0.76	1.63
3	0.66	2.29
4	0.57	2.86
5	0.50	3.36

The net present value of this investment is:

- A. Negative, \$64,000
- B. Negative, \$14,000
- C. Positive, \$18,600
- D. Positive, \$200,000

**Correct Answer:** C  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Positive NPV, \$18,600.

Present Value Of Cash Inflows (Outflows)		Present Value Interest Factor (15%)		Initial Investment (Outflow)	After-Tax Cash Inflows
(400,000)	=	1.00	×	(400,000)	
139,200	=	0.87	×		160,000 (Year 1)
106,400	=	0.76	×		140,000 (Year 2)
66,000	=	0.66	×		100,000 (Year 3)
57,000	=	0.57	×		100,000 (Year 4)
<u>50,000</u>	=	<u>0.50</u>	×		100,000 (Year 5)
<u>18,600</u>	NPV				



**QUESTION 416** The net present value of a proposed investment is negative; therefore, the discount rate used must be:

- A. Greater than the project's internal rate of return.
- B. Less than the project's internal rate of return.
- C. Greater than the firm's cost of equity.
- D. Less than the incremental borrowing rate.

**Correct Answer:** A  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. If the NPV of a proposed investment is negative, the discount rate used must be greater than the project's internal rate of return (IRR). The IRR is the discount rate that results in a NPV of zero. If a discount rate used is greater than the project's IRR, the present value of future cash inflows will be lower resulting in a negative net present value. If a discount rate used is less than the project's IRR, the present value of future cash inflows will be higher resulting in a positive net present value. Choices "b", "c", and "d" are incorrect, per the above discussion.

**QUESTION 417** A disadvantage of the net present value method of capital expenditure evaluation is that it:

- A. Is calculated using sensitivity analysis.
- B. Does not provide the true rate of return on investment.
- C. Is difficult to apply because it uses a trial and error approach.
- D. Is difficult to adapt for risk.

**Correct Answer: B**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The net present value (NPV) method of capital expenditure evaluation does not provide the true rate of return on investment. The NPV indicates whether or not an investment will earn the "hurdle rate" used in the NPV calculation. If the NPV is positive, the return on investment will exceed the hurdle rate. If the NPV is negative, the return on investment will be less than the hurdle rate. If the NPV is zero, the return on investment will be exactly equal to the hurdle rate.

Choice "a" is incorrect. Sensitivity analysis is a "what if" technique that asks how a given organization will change if the original estimates used in the capital budgeting model are changed.

Choice "c" is incorrect. NPV calculations do not use a trial and error approach.

Choice "d" is incorrect. NPV method is not difficult to adapt for risk. To adapt for increased risk, a higher hurdle rate is used. To adapt for less risk, a lower hurdle rate is used.

#### QUESTION 418

Andrew Corporation is evaluating a capital investment that would result in a \$30,000 higher contribution margin benefit and increased annual personnel costs of \$20,000. The effects of income taxes on the net present value computation on these benefits and costs for the project are to:

- A. Decrease both benefits and costs.
- B. Decrease benefits but increase costs.
- C. Increase benefits but decrease costs.
- D. Increase both benefits and costs.

**Correct Answer: A**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. The effects of income taxes on the net present value computations will decrease both benefits and costs for the project. Net present value computations focus of the present value of cash flows. Income taxes decrease both the benefit and the cost of cash flows.

Choices "b", "c", and "d" are incorrect, per the above Explanation.

#### QUESTION 419

The Keego Company is planning a \$200,000 equipment investment, which has an estimated five-year life with no estimated salvage value. The company has projected the following annual cash flows for the investment.

<u>Year</u>	<u>Projected Cash Inflows</u>	<u>Present Value of \$1</u>
1	\$120,000	.91
2	60,000	.76
3	40,000	.63
4	40,000	.53
5	40,000	.44
<b>Totals</b>	<b><u>\$300,000</u></b>	<b><u>3.27</u></b>

The net present value for the investment is:



- A. \$18,800
- B. \$196,200
- C. \$(3,800)
- D. \$91,743

**Correct Answer: A**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. \$18,800 net present value. The net present value of an investment is calculated as the present value of the cash inflows minus the present value of the cash outflows. In this case, there is only one cash outflow (at the purchase date), and that amount (\$200,000) is already at present value (or, is multiplied by a present value factor of 1.0).

<u>Present Value of Cash Inflows:</u>			
\$120,000	×	.91	\$109,200
60,000	×	.76	45,600
40,000	×	.63	25,200
40,000	×	.53	21,200
40,000	×	.44	17,600
Total			\$218,800
<u>Less: Present Value of Cash Outflows:</u>			
\$200,000	×	1.00	(200,000)
Net present value			<u>\$18,800</u>



#### QUESTION 420

The use of an accelerated method instead of the straight-line method of depreciation in computing the net present value of a project has the effect of:

- A. Raising the hurdle rate necessary to justify the project.
- B. Lowering the net present value of the project.
- C. Increasing the present value of the depreciation tax shield.
- D. Increasing the cash outflows at the initial point of the project.

**Correct Answer: C**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Rule: The greater the depreciation expense, the greater the depreciation tax shield.

Deprecation Tax Shield =  
 Depreciation Expense × Marginal Tax Rate

Choice "c" is correct. Use of an accelerated method instead of the straight-line method of depreciation in computing the NPV of a project has the effect of increasing the PV of the depreciation tax shield.

Choice "a" is incorrect. Depreciation method does not affect the hurdle rate. The hurdle rate is independently selected by management.

Choice "b" is incorrect. Using an accelerated method instead of the straight-line method of depreciation will increase the present value of the depreciation tax shield and therefore increase the net present value of the project. Choice "d" is incorrect. Depreciation method does not affect cash outflows at the initial point of the project.



**QUESTION 421** The internal rate of return for a project can be determined:

- A. Only if the project cash flows are constant.
- B. By finding the discount rate that yields a net present value of zero for the project.
- C. By subtracting the firm's cost of capital from the project's profitability index.
- D. Only if the project's profitability index is greater than one.

**Correct Answer:** B

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The internal rate of return (IRR) is the discount rate that produces a NPV of zero.

Choice "a" is incorrect. IRR valuation does not require cash flows that are constant.

Choice "c" is incorrect. Cost of capital is a percentage, profitability index is a ratio; this won't work.

Choice "d" is incorrect. IRR can be determined even if the profitability index is less than 1.0. A profitability index of less than 1.0 means a negative NPV, which means the IRR is less than the discount rate being used.

**QUESTION 422** The internal rate of return is the:

- A. Rate of interest that equates the present value of cash outflows and the present value of cash inflows.
- B. Risk-adjusted rate of return.
- C. Required rate of return.
- D. Weighted average rate of return generated by internal funds.

**Correct Answer:** A

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The internal rate of return is defined as the technique that determines the present value factor such that the present value of the after-tax cash flows equals the initial investment on the project. Alternately, the internal rate of return (IRR) is the discount rate that produces a NPV of zero. Choices "b", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 423** The internal rate of return (IRR) is the:

- A. Hurdle rate.
- B. Rate of interest where the net present value is greater than 1.0.
- C. Rate of interest where the net present value is equal to zero.
- D. Rate of return generated from the operational cash flows.

**Correct Answer:** C

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. IRR is the rate of interest where the NPV is zero.

Choice "a" is incorrect. The hurdle rate is a desired or minimum rate of return, set by management, to evaluate investments.

Choice "b" is incorrect. NPV will be greater than zero when the IRR is higher than the hurdle rate. Choice "d" is incorrect. IRR is the rate of return of all cash flows produced by the investment.

**QUESTION 424**

The method that divides a project's annual after-tax net income by the average investment cost to measure the estimated performance of a capital investment is the:

- A. Internal rate of return method.
- B. Accounting rate of return method.
- C. Payback method.
- D. Net present value method.

**Correct Answer: B**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Accounting rate of return divides annual after-tax net income by average investment amount. Choices "a", "c", and "d" are incorrect. IRR, NPV and payback all use cash flows, not net income.

**QUESTION 425**

The length of time required to recover the initial cash outlay of a capital project is determined by using the:

- A. Discounted cash flow method.
- B. Payback method.
- C. Net present value method.
- D. Accounting rate of return method.

**Correct Answer: B**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. The payback method measures the time required to recover the initial investment.  
Choice "a" is incorrect. Discounted cash flows are used for several methods of capital budgeting; this is a generic term.  
Choice "c" is incorrect. The NPV method does not measure the length of time required to recover the initial cash outlay. Choice "d" is incorrect. The accounting rate of return does not measure the time to recover the initial investment.

**QUESTION 426** A characteristic of the payback method (before taxes) is that it:

- A. Incorporates the time value of money.
- B. Neglects total project profitability.
- C. Uses accrual accounting inflows in the numerator of the calculation.
- D. Uses the estimated expected life of the asset in the denominator of the calculation.

**Correct Answer: B**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:



Choice "b" is correct. The payback method neglects total project profitability. It simply looks at the time required to recover the initial investment; subsequent receipts are ignored. Choice "a" is incorrect. Payback does not incorporate the time value of money. Choice "c" is incorrect. Payback uses cash flow, not accrual accounting income. Choice "d" is incorrect. The denominator is the annual cash inflows.

#### QUESTION 427

McLean Inc. is considering the purchase of a new machine that will cost \$150,000. The machine has an estimated useful life of three years. Assume for simplicity that the equipment will be fully depreciated 30, 40, and 30 percent in each of the three years, respectively. The new machine will have a \$10,000 resale value at the end of its estimated useful life. The machine is expected to save the company \$85,000 per year in operating expenses. McLean uses a 40 percent estimated income tax rate and a 16 percent hurdle rate to evaluate capital projects. Discount rates for a 16 percent rate are as follows:

	<u>Present Value of \$1</u>	<u>Present Value of an Ordinary Annuity of \$1</u>
Year 1	.862	.862
Year 2	.743	1.605
Year 3	.641	2.246

The payback period for this investment would be:

- A. 2.95 years
- B. 1.76 years
- C. 2.09 years
- D. 2.94 years

**Correct Answer: C**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. 2.09 years payback period.

	<u>19X0</u>	<u>19X1</u>	<u>19X2</u>	<u>19X3</u>	
Initial cash outflow	\$(150,000)				
<u>After tax cash inflows:</u>					
Depreciation tax shield		\$18,000	\$24,000	\$18,000	[Note A]
Annual savings		51,000	51,000	51,000	[Note B]
Salvage (realized at end of year)					Not Applicable
After tax cash flow	(150,000) – Ø	69,000 – Ø	75,000	69,000	
Unrecovered cost	(150,000)	(81,000)	(6,000)		

**Note A** The tax shields are calculated as follows:

<u>Depr. Basis</u>		<u>Depr %</u>		<u>Tax Rate</u>		
				63		
Year 1:	\$150,000	x	.30	x	.40	= \$18,000
Year 2:	150,000	x	.40	x	.40	= 24,000
Year 3:	150,000	x	.30	x	.40	= 18,000

**Note B** The annual savings is calculated as follows:

Operating expenses saved	\$85,000
Times: 1 - tax rate (1 - .40)	x .60
Annual savings	<u>\$51,000</u>

At the beginning of year 3, \$6,000 is needed to recover the investment. Because an inflow of \$69,000 is expected throughout the year, only  $6,000 \div 69,000 = .09$  years is needed to recover the \$6,000. Thus, the payback is 2.09 years. The \$6,000 in salvage is excluded from the totals for year 3. Amounts are not realized until the end of the year while savings and depreciation tax shield occur throughout the year and are relevant to the partial year payback.

#### QUESTION 428

Which one of the following statements about the payback method of investment analysis is correct? The payback method:

- A. Does not consider the time value of money.
- B. Uses discounted cash flow techniques.
- C. Generally leads to the same decision as other methods for long-term projects.
- D. Is rarely used in practice.



**Correct Answer:** A

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. The payback method does not consider the time value of money.

Choice "b" is incorrect. The payback method does not use discounted cash flow techniques. The time value of money is ignored.

Choice "c" is incorrect. The payback method may or may not lead to the same decision as other methods for long-term projects. Choice

"d" is incorrect. The payback method is frequently used in practice because of its simplicity.

#### QUESTION 429

Willis, Inc. has a cost of capital of 15 percent and is considering the acquisition of a new machine, which costs \$400,000 and has a useful life of five years. Willis projects that earnings and cash flow will increase as follows.

<u>Year</u>	<u>Net Earnings</u>	<u>After-Tax Cash Flow</u>
1	\$100,000	\$160,000
2	100,000	140,000
3	100,000	100,000
4	100,000	100,000
5	200,000	100,000

15% interest rate factors		
<u>Period</u>	<u>Present value of \$1</u>	<u>Present value of an annuity of \$1</u>
1	0.87	0.87
2	0.76	1.63
3	0.66	2.29
4	0.57	2.86
5	0.50	3.36

What is the payback period of this investment?

- A. 1.50 years
- B. 3.00 years
- C. 3.33 years
- D. 4.00 years



**Correct Answer:** B  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. 3.00 year payback period.

<u>Cash Inflows</u>	<u>Year</u>	<u>Amount</u>	<u>Cumulative</u>
	1	\$160,000	\$160,000
	2	140,000	300,000
	3	100,000	400,000

Note: After 3 years, the initial investment is recovered, as the cumulative cash inflows equal \$400,000. The cash flows are not discounted when the payback method is used.

**QUESTION 430**

Whatney Co. is considering the acquisition of a new, more efficient press. The cost of the press is \$360,000, and the press has an estimated six-year life with zero salvage value. Whatney uses straightline depreciation for both financial reporting and income tax reporting purposes and has a 40 percent corporate income tax rate. In evaluating equipment acquisitions of this type, Whatney uses a goal of a four-year payback period. To meet Whatney's desired payback period, the press must produce a minimum annual before-tax, operating cash savings of:

- A. \$90,000
- B. \$110,000C. \$114,000



D. \$150,000

**Correct Answer:** B

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. \$110,000 minimum annual before-tax operating cash savings.

Step 1: Determine the after-tax annual cash savings. The question provides the cash outflow and the desired payback period (which is calculated using after-tax cash flows). The \$90,000 annual after-tax cash flows is calculated as follows:

$$\frac{\text{Cost of equipment}}{\text{Expected payback period}} = \frac{360,000}{4 \text{ yrs}} = 90,000 \text{ annual after tax cash saving}$$

Step 2: Determine the amount of the annual depreciation expense. Because the question asks for annual before-tax cash savings, we will need to convert the \$90,000 after-tax cash savings we calculated in Step 1, above, to a before-tax amount. The depreciation tax shield plays a role in the after-tax cash flows, so the annual depreciation of \$60,000 must be calculated, as follows:

$$\frac{\text{Cost of equipment}}{\text{Estimated useful life}} = \frac{360,000}{6 \text{ yrs}} = 60,000 \text{ annual depreciation expense}$$

Step 3: Use algebra to determine the before-tax cash savings. Before-tax cash savings is equal to the after-tax cash savings plus the taxes paid. So:

Let B = annual before-tax operating cash savings

$$\$90,000 \text{ after tax cash savings} + [(B - \$60,000 \text{ depreciation expense}) (.40 \text{ tax rate})] = B$$

$$\$90,000 + [(B - \$60,000) (.40)] = B$$

$$\$90,000 + [.40B - \$24,000] = B$$

$$\$90,000 - \$24,000 = .60B$$

$$\$66,000 = .60B$$

$$\$110,000 = B = \text{annual before-tax operating cash savings}$$

**Proof:**

Annual before-tax cash savings	\$110,000
Less depreciation expense	(60,000)
Taxable income	50,000
× tax rate	× .40
Taxes paid	<u>\$ 20,000</u>

**Therefore:**

Annual before tax cash saving	\$110,000
Less: Taxes paid	(20,000)
Annual after tax cash saving	<u>\$ 90,000</u>



**QUESTION 431** When evaluating capital budgeting analysis techniques, the payback period emphasizes:

- A. Liquidity.
- B. Profitability.
- C. Net income.
- D. The accounting period.

**Correct Answer:** A  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. The payback period is the time period required for cash inflows to recover the initial investment. The emphasis of the technique is on liquidity (i.e., cash flow). Choices "b", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 432** The term underwriting spread refers to the:

- A. Commission percentage an investment banker receives for underwriting a security lease.
- B. Discount investment bankers receive on securities they purchase from the issuing company.
- C. Difference between the price the investment banker pays for a new security issue and the price at which the securities are resold.
- D. Commission a broker receives for either buying or selling a security on behalf of an investor.

**Correct Answer:** C  
**Section:** Volume D



**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. Investment bankers are paid their fees partly by being allowed to purchase the new securities they are underwriting for a discount and then reselling those securities on the market. This is known as the underwriting spread.

Choices "a" and "d" are incorrect, as both of these describe either fees or commissions and not an underwriting spread.

Choice "b" is incorrect. The underwriting spread is the difference between the discount price paid and the resale price.

**QUESTION 433**

The principle measure of non-diversifiable risk included in the CAPM formula is the beta coefficient. The beta coefficient measures the volatility or risk inherent in an investment by:

- A. Computing the ratio of changes in earnings per share to changes in sales.
- B. Computing the ratio of stock price to earnings per share.
- C. Computing the ratio of percentage changes in a stock's price to percentage changes in overall market values during the same period.
- D. Computing the ratio of percentage changes in the expected value of alpha equivalents to derivative fluctuations.

**Correct Answer:** C  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "c" is correct. The beta coefficient represents the measure of a particular stock's percentage change compared to the percentage change in the market over the same period. The equation for the beta coefficient is as follows:

%  $\Delta$  in Stock Price

% Δ in Market price

Choice "a" is incorrect. The percentage change in earnings per share related to a percentage change in sales represents the degree of combined leverage.

Choice "b" is incorrect. The ratio of stock price to earnings per share is the price earnings ratio. Choice

"d" is incorrect. Choice "d" represents a word salad distracter of nonsense terms.

#### QUESTION 434

Carlisle Company presently sells 400,000 bottles of perfume each year. Each bottle costs \$.84 to produce and sells for \$1.00. Fixed costs are \$28,000 per year. The firm has annual interest expense of \$6,000, preferred stock dividends of \$2,000 per year, and a 40 percent tax rate. Carlisle uses the following formulas to determine the company's leverage.

$$\text{Operating leverage} = \frac{Q (S - VC)}{Q (S - VC) - FC}$$

$$\text{Financial leverage} = \frac{\text{EBIT}}{\text{EBIT} - I - [P + (1 - t)]}$$

$$\text{Total leverage} = \frac{Q (S - VC)}{Q(S - VC) - FC - I - [P + (1 - t)]}$$

Where:	Q	=	Quantity
	FC	=	Fixed cost
	VC	=	Variable cost
	S	=	Selling price
	I	=	Interest expense
	P	=	Preferred dividends
	t	=	Tax rate
	EBIT	=	Earnings before interest and taxes



The degree of operating leverage for Carlisle Company is:

- A. 2.4
- B. 1.78
- C. 1.35
- D. 2.3

**Correct Answer: B**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. Calculation of operating leverage is:

$$\begin{aligned} \text{Operating leverage} &= \frac{400,000 (\$1.00 - .84)}{400,000 (\$1.00 - .84) - \$28,000} \\ &= 1.78 \text{ B} \end{aligned}$$

Choices "a", "c", and "d" are incorrect, per the above calculation.

#### QUESTION 435

Carlisle Company presently sells 400,000 bottles of perfume each year. Each bottle costs \$.84 to produce and sells for \$1.00. Fixed costs are \$28,000 per year. The firm has annual interest expense of \$6,000, preferred stock dividends of \$2,000 per year, and a 40 percent tax rate. Carlisle uses the following formulas to determine the company's leverage.

$$\text{Operating leverage} = \frac{Q(S - VC)}{Q(S - VC) - FC}$$

$$\text{Financial leverage} = \frac{\text{EBIT}}{\text{EBIT} - I - [P + (1 - t)]}$$

$$\text{Total leverage} = \frac{Q(S - VC)}{Q(S - VC) - FC - I - [P + (1 - t)]}$$

Where:	Q	=	Quantity
	FC	=	Fixed cost
	VC	=	Variable cost
	S	=	Selling price
	I	=	Interest expense
	P	=	Preferred dividends
	t	=	Tax rate
	EBIT	=	Earnings before interest and taxes

The degree of financial leverage for Carlisle Company is:

- A. 2.4
- B. 1.78
- C. 1.35
- D. 2.3

**Correct Answer: C**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. To calculate financial leverage, EBIT must first be calculated:

$$\begin{aligned} \text{Sales } (400,000 \times \$1) &= \$400,000 \\ \text{Variable Expenses } (400,000 \times .84) &= (336,000) \\ \text{Fixed Expenses} &= (28,000) \\ \text{EBIT} &= 36,000 \end{aligned}$$

$$\begin{aligned} \text{Financial leverage} &= \frac{36,000}{36,000 - 6,000 - (2,000 + [1 - .40])} \\ &= 1.35 \end{aligned}$$

Choices "a", "b", and "d" are incorrect, per the above calculation.

#### QUESTION 436

Carlisle Company presently sells 400,000 bottles of perfume each year. Each bottle costs \$.84 to produce and sells for \$1.00. Fixed costs are \$28,000 per year. The firm has annual interest expense of \$6,000, preferred stock dividends of \$2,000 per year, and a 40 percent tax rate. Carlisle uses the following formulas to determine the company's leverage.

$$\text{Operating leverage} = \frac{Q(S - VC)}{Q(S - VC) - FC}$$

$$\text{Financial leverage} = \frac{\text{EBIT}}{\text{EBIT} - I - [P + (1 - t)]}$$

$$\text{Total leverage} = \frac{Q(S - VC)}{Q(S - VC) - FC - I - [P + (1 - t)]}$$

Where:	Q	=	Quantity
	FC	=	Fixed cost
	VC	=	Variable cost
	S	=	Selling price
	I	=	Interest expense
	P	=	Preferred dividends
	t	=	Tax rate
	EBIT	=	Earnings before interest and taxes



If Carlisle Company did not have preferred stock, the degree of total leverage would:

- A. Decrease in proportion to a decrease in financial leverage.
- B. Increase in proportion to an increase in financial leverage.
- C. Decrease but not be proportional to the decrease in financial leverage.
- D. Decrease but not have an effect on financial leverage.

**Correct Answer:** A

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. Without preferred stock, the denominator in the total leverage calculation would be larger (because preferred stock is subtracted to arrive at the denominator). The same holds true for financial leverage. Therefore, both financial and total leverage would decrease in proportion. Choices "b", "c", and "d" are incorrect, per above Explanation.

#### QUESTION 437

A firm with a higher degree of operating leverage when compared to the industry average implies that the:

- A. Firm has higher variable costs.
- B. Firm's profits are more sensitive to changes in sales volume.
- C. Firm is more profitable.
- D. Firm uses a significant amount of debt financing.

**Correct Answer:** B

**Section:** Volume D

## Explanation

### Explanation/Reference:

Explanation:

Rule: Operating leverage is the presence of fixed costs in operations, which allows a small change in sales to produce a larger relative change in profits.

Choice "b" is correct. A firm with a higher degree of operating leverage when compared to the industry average implies that the firm's profits are more sensitive to changes in sales volume. Choice

"a" is incorrect. Higher variable costs imply a lower degree of operating leverage.

Choice "c" is incorrect. Profits will depend upon sales.

Choice "d" is incorrect. A firm using a significant amount of debt financing has a higher degree of "financial leverage."

### QUESTION 438

Datacomp Industries, which has no current debt, has a beta of .95 for its common stock. Management is considering a change in the capital structure to 30% debt and 70% equity. This change would increase the beta on the stock to 1.05, and the after-tax cost of debt will be 7.5%. The expected return on equity is 16%, and the risk-free rate is 6%. Should Datacomp's management proceed with the capital structure change?

- A. No, because the cost of equity capital will increase.
- B. Yes, because the cost of equity capital will decrease.
- C. Yes, because the weighted average cost of capital will decrease.
- D. No, because the weighted average cost of capital will increase.

**Correct Answer: C**

**Section: Volume D**

## Explanation

### Explanation/Reference:

Explanation:

Choice "c" is correct. First, compute Datacomp's current weighted average cost of capital by using the capital asset pricing model (CAPM):

$$R = RF + B(RM - RF)$$

Substituting:

$$R = .06 + .95(.16 - .06)$$

$$= 15.5\%$$

Because there is no debt, the WACC is equal to the CAPM formula for equity or 15.5%. When debt is introduced, the WACC is calculated by first using the CAPM to determine the required return on equity:

$$R = .06 + 1.05(.16 - .06)$$

$$= 16.5\%$$

Assuming an after tax cost of debt is equal to 7.5%, the WACC becomes:

$$(.165 \times (.70)) + (.075 \times (.3)) = 13.8\%$$

Therefore, Datacomp should change its capital structure because its WACC will decrease (Choice "c"). Choices

"a", "b", and "d" are incorrect, per above.

### QUESTION 439

The three elements needed to estimate the cost of equity capital for use in determining a firm's weighted average cost of capital are:

- A. Current dividends per share, expected growth rate in earnings per share, and current market price per share of common stock.
- B. Current earnings per share, expected growth rate in dividends per share, and current market price per share of common stock.
- C. Current earnings per share, expected growth rate in earnings per share, and current book value per share of common stock.
- D. Current dividends per share, expected growth rate in dividends per share, and current market price per share of common stock.

**Correct Answer: D**



**Section: Volume D****Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. The three elements needed to estimate the cost of equity capital are:

1. Current dividends per share (D)
2. Expected growth rate in dividends (g) and
3. Current market price per share of common stock (P)

The question asks the candidate to identify the three elements needed to estimate the cost of equity capital for use in determining a firm's weighted average cost of capital. The cost of equity capital is defined by the following mathematical expression where the cost of capital or return (R) is:  $R = D/P + g$

Choice "d" is consistent with our text, the Explanation and the Gordon Growth Model.

Use of earnings per share, as suggested by choice "a" is sometimes referred to as the constant growth model and assumes that all earnings per share are either ultimately distributed or reinvested for the benefit of the shareholder. Earnings are anticipated to grow to infinity.

**QUESTION 440** A firm's target or optimal capital structure is consistent with which one of the following?

- A. Minimum cost of debt.
- B. Minimum risk.
- C. Minimum cost of equity.
- D. Minimum weighted average cost of capital.

**Correct Answer: D**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Minimum weighted average cost of capital is consistent with a firm's target or optimal capital structure.

Choice "a" is incorrect. Minimum cost of debt is a component of minimum weighted average cost of capital.

Choice "b" is incorrect. Minimum risk results in a cost of capital heavily weighted in equity.

Choice "c" is incorrect. Minimum cost of equity results in a cost of capital heavily weighted in debt.

**QUESTION 441**

Williams, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

- Williams can raise cash by selling \$1,000, 8 percent, 20-year bonds with annual interest payments.

In selling the issue, an average premium of \$30 per bond would be received, and the firm must pay flotation costs of \$30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.

- Williams can sell 8 percent preferred stock at par value, \$105 per share. The cost of issuing and selling the preferred stock is expected to be \$5 per share.

- Williams' common stock is currently selling for \$100 per share. The firm expects to pay cash dividends of \$7 per share next year, and the dividends are expected to remain constant. The stock will have to be underpriced by \$3 per share, and flotation costs are expected to amount to \$5 per share.

- Williams expects to have available \$100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.

- Williams' preferred capital structure is:

Long-term debt 30%

Preferred stock 20

Common stock 50

The cost of funds from the sale of common stock for Williams, Inc. is:

- A. 7.0 percent.
- B. 7.6 percent.
- C. 7.4 percent.



D. 7.8 percent.

**Correct Answer:** B  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. 7.6%. Williams would receive \$92 per share (\$100 less \$5 flotation cost and \$3 underpricing) and pay an annual dividend of \$7/share. The annual cost is:

$$\frac{\$7}{\$92} = 7.6\%$$

This question purely asks the cost of new common shares issued. The problem gives you the expected dividend to be paid annually (\$7) and the net proceeds after issue costs and market adjustments \$92 (current selling price of \$100 minus the \$3 market adjustment and the \$5 flotation costs). The cost of common shares issued is the finance charge (dividend) divided by the net proceeds of the issue \$92 or 7.6%. Choices "a", "c", and "d" are incorrect, per above.

#### QUESTION 442

Williams, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

- Williams can raise cash by selling \$1,000, 8 percent, 20-year bonds with annual interest payments. In selling the issue, an average premium of \$30 per bond would be received, and the firm must pay flotation costs of \$30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.
- Williams can sell 8 percent preferred stock at par value, \$105 per share. The cost of issuing and selling the preferred stock is expected to be \$5 per share.
- Williams' common stock is currently selling for \$100 per share. The firm expects to pay cash dividends of \$7 per share next year, and the dividends are expected to remain constant. The stock will have to be underpriced by \$3 per share, and flotation costs are expected to amount to \$5 per share.
- Williams expects to have available \$100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.
- Williams' preferred capital structure is:  
Long-term debt 30%  
Preferred stock 20  
Common stock 50

If Williams, Inc. needs a total of \$200,000, the firm's weighted-average cost of capital would be closest to:

- A. 4.8 percent.
- B. 6.6 percent.
- C. 6.8 percent.
- D. 7.3 percent.

**Correct Answer:** B  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. 6.6%. Williams' after tax cost of debt is 4.8% and cost of preferred stock is 8.4% (\$105/share less issue costs of \$5/share). The cost of equity (as calculated in a prior question) is 7.0%.

This question pertains to the manner in which changes in the required amount of capital will impact the weighted average cost of capital governed by the target capital structure. The rates are given, and you must derive the weights. The company needs a total of \$200,000. The question gives you the amount of Retained Earnings at \$100,000, the source of 7% dividend payments on common shares. If all that is needed is \$200,000, then, by definition, the target capital structure is "priced out" as shown with 7% common equity of \$100,000 being equal to 50% of the target capital structure totaling \$200,000 without any modification:

Type of financing	Cost	Target Structure	Extension
Long-term debt	4.8%	30%	1.44%
Preferred shares	8.4%	20%	1.68%
Common equity (Retained earnings)	7.0%	50%	3.50%
<b>Total</b>		<b>100%</b>	<b>6.62%</b>

Choices "a", "c", and "d" are incorrect, per the above Explanation.

#### QUESTION 443

Williams, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

- Williams can raise cash by selling \$1,000, 8 percent, 20-year bonds with annual interest payments. In selling the issue, an average premium of \$30 per bond would be received, and the firm must pay floatation costs of \$30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.
- Williams can sell 8 percent preferred stock at par value, \$105 per share. The cost of issuing and selling the preferred stock is expected to be \$5 per share.
- Williams' common stock is currently selling for \$100 per share. The firm expects to pay cash dividends of \$7 per share next year, and the dividends are expected to remain constant. The stock will have to be underpriced by \$3 per share, and floatation costs are expected to amount to \$5 per share.
- Williams expects to have available \$100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.
- Williams' preferred capital structure is:  
Long-term debt 30%  
Preferred stock 20  
Common stock 50

If Williams, Inc. needs a total of \$1,000,000, the firm's weighted-average cost of capital would be:

- A. 6.8 percent.
- B. 4.8 percent.
- C. 6.5 percent.
- D. 9.1 percent.



**Correct Answer:** A  
**Section:** Volume D

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. 6.8%.

This question pertains to the manner in which changes in the required amount of capital will impact the weighted average cost of capital governed by the target capital structure. The rates are given, and you must derive the weights. The company needs a total of \$1,000,000. The total Retained Earnings is \$100,000, which will only represent 10% of the total amount needed. In J92-1.01, we computed the cost of new common share issues at 7.6%, and we know that we can issue unlimited amounts of each security. Based on these assumptions, we know that the target capital structure will remain unchanged but that the components of common equity will be priced differently because Retained Earnings only equals \$100/\$1,000 (or 10%).

If the target capital structure calls for 50% common stock and only 10% is available from retained earnings, then 40% must come from the issuance of new common shares. The weighted average is computed as follows:

Type of financing	Cost	Target Structure	Extension
Long-term debt	4.8%	30%	1.44%
Preferred shares	8.4%	20%	1.68%
Common equity (retained earnings)	7.0%	10%	0.70%
<b>New common shares</b>	<b>7.6%</b>	<b>40%</b>	<b>3.04%</b>
<b>Total</b>		<b>100%</b>	<b>6.78%</b>

Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 444** Osgood Products has announced that it plans to finance future investments so that the firm will achieve an optimum capital structure. Which one of the following corporate objectives is consistent with the announcement?

- A. Maximize earnings per share.
- B. Minimize the cost of debt.
- C. Maximize the net worth of the firm.
- D. Minimize the cost of equity.

**Correct Answer: C**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. The optimal capital structure is the financial structure that would theoretically maximize shareholder wealth by maximizing the net worth of the company. Choices "a", "b", and "d" are incorrect. Strategies (not objectives) for creating an optimal capital structure to maximize net worth include:

1. Maximizing earnings per share (choice "a").
2. Minimizing the cost of debt (choice "b").
3. Minimizing the cost of equity (choice "d").
4. Maximizing cash flow (choice not given).

#### QUESTION 445

Youngsten Electric is contemplating new projects for the next year that will require \$30,000,000 of new financing. In keeping with its capital structure, Youngsten plans to use debt & equity financing as follows:

\* Issue \$10,000,000 of 20-year bonds at a price of 101.5, with a coupon of 10%, and flotation costs of 2.5% of par value. \*  
Use internal funds generated from earnings of \$20,000,000.

The equity market is expected to earn 15%. U.S. treasury bonds currently are yielding 9%. The beta coefficient for Youngsten's common stock is estimated to be .8. Youngsten is subject to a 40% corporate income tax rate. Youngsten has a price/earnings ratio of 10, a constant dividend payout ratio of 40%, and an expected growth rate of 12%.

An analysis of Youngsten's planned equity financing using Capital Asset Pricing Model (or Security Market Line) would incorporate only the:

- A. Expected market earnings, the current U.S. Treasury bond yield, and the beta coefficient.
- B. Expected market earnings and the price' earnings ratio.
- C. Current U.S. Treasury bond yield, the price/earnings ratio, and the beta coefficient.
- D. Current U.S. Treasury bond yield and the dividend payout ratio.

**Correct Answer: A**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. The capital asset pricing model formula is:

$$R = RF + B (RM - RF)$$

Where:

R = Required return rate on equity

RF = Risk free rate earned on U.S. treasury bonds.

B = Beta coefficient

RM = Expected market return (earnings).

Choices "b", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 446** A preferred stock is sold for \$101 per share, has a face value of \$100 per share, underwriting fees of \$5 per share, and annual dividends of \$10 per share. If the tax rate is 40 percent, the cost of funds (capital) for the preferred stock is:

- A. 4.2 percent.
- B. 6.2 percent.
- C. 10.0 percent.
- D. 10.4 percent.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. The stock is issued for a net of \$96 per share (\$101 less \$5 underwriting fee). Because preferred stock dividends are not tax deductible, the cost to the company is \$10/share (the tax rate is a distractor). Therefore, the cost of the preferred stock is:

$$\frac{\$10}{\$96} = 10.4\% \text{ D}$$

Choices "a", "b", and "c" are incorrect, per the above Explanation calculation.

**QUESTION 447**

**Martin Corporation**  
**Statement of Financial Position**  
**December 31, 1994**  
(Dollars in millions)



<b>Assets</b>	
Current assets	\$ 75
Plant and equipment	250
Total assets	<u>\$325</u>
<b>Liabilities and shareholders' equity</b>	
Current liabilities	\$ 46
Long-term debt (12%)	64
Common equity:	
Common stock, \$1 par	10
Additional paid-in capital	100
Retained earnings	105
Total liabilities and shareholders' equity	<u>\$325</u>

**Additional Data**

- The long-term debt was originally issued at par (\$1,000/bond) and is currently trading at \$1,250 per bond.

- Martin Corporation can now issue debt at 150 basis points over U.S. treasury bonds.
- The current risk-free rate (U.S. treasury bonds) is 7 percent.
- Martin's common stock is currently selling at \$32 per share.
- The expected market return is currently 15 percent.
- The beta value for Martin is 1.25.
- Martin's effective corporate income tax rate is 40 percent.

Using the Capital Asset Pricing Model (CAPM), Corporation's current cost of common equity is:

- A. 10.00 percent.
- B. 15.00 percent.
- C. 17.00 percent.
- D. 18.75 percent.

**Correct Answer: C**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. 17.00 percent. Using the CAPM model, Martin's current cost of common equity would be:

Cost of equity = Capital risk free rate + Beta (market rate – risk free rate)

Cost of equity = 7% + 1.25 (15% – 7%)

Cost of equity = 7% + 1.25 (8%)

Cost of equity = 7% + 10%

Cost of equity = 17%



#### QUESTION 448

DQZ Telecom is considering a project for the coming year, which will cost \$50 million. DQZ plans to use the following combination of debt and equity to finance the investment.

- Issue \$15 million of 20-year bonds at a price of 101, with a coupon rate of 8 percent, and flotation costs of 2 percent of par.
- Use \$35 million of funds generated from earnings.

The equity market is expected to earn 12 percent. U.S. treasury bonds are currently yielding 5 percent.

The beta coefficient for DQZ is estimated to be .60. DQZ is subject to an effective corporate income tax rate of 40 percent.

The before-tax cost of DQZ's planned debt financing, net of flotation costs, in the first year is:

- A. 11.80 percent.
- B. 8.08 percent.
- C. 10.00 percent.
- D. 7.92 percent.

**Correct Answer: B**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. 8.08 percent before-tax cost of debt financing, net of flotation costs.



$$k_{dt} = \frac{1 + (PV - Nd)/n}{(Nd + PV)/2}$$

$$k_{dt} = \frac{\$1,200,000 + [(\$15,000,000 - \$14,850,000)/20]}{(\$14,850,000 + \$15,000,000)/2}$$

$$k_{dt} = \frac{\$1,200,000 + \$7,500}{\$14,925,000}$$

$$k_{dt} = 8.09\% \text{ (and with rounding, is 8.08\%)}$$

#### Alternate Computation

$$\frac{8\% \text{ Interest rate}}{101\% \text{ Sales price} - 2\% \text{ Flotation costs}} = \frac{8}{99} = 8.08\% \text{ Before-tax cost}$$

**QUESTION 449** Assume the following facts about Martin Corporation:

- The long-term debt was originally issued at par (\$1,000/bond) and is currently trading at \$1,250 per bond.
- Martin Corporation can now issue debt at 150 basis points over U.S. treasury bonds.
- The current risk-free rate (U.S. treasury bonds) is 7 percent.
- Martin's common stock is currently selling at \$32 per share.
- The expected market return is currently 15 percent.
- The beta value for Martin is 1.25.
- Martin's effective corporate income tax rate is 40 percent.



Based on these assumptions, what is the current net after-tax cost of debt for Martin Corporation? A.

5.5 percent.

B. 7.0 percent. C.

5.1 percent.

D. 8.5 percent.

**Correct Answer: C**

**Section: Volume D**

#### **Explanation**

#### **Explanation/Reference:**

Explanation:

Choice "c" is correct. 5.1 percent current net cost of debt.

The fact pattern states that debt can be currently secured at 150 basis points above the Treasury bond rate. A basis point is equal to 1/100 of 1% (1% of 1%). Applying the decimals, it's:

150 basis points x 1/100 of 1% (or .0001)

this yields .015 or 1.5%

Add the additional basis points converted to percentage (1.5%) to the Treasury bond rate of 7% to arrive at the pre-tax debt cost of 8.5%. Apply 1 - tax rate to arrive at the current net cost of debt as follows:



	<u>Decimal</u>	<u>%</u>
Basis points over U.S. Treasury bond rate	150	150
One basis point = 1/100 of 1%	<u>x .0001</u>	<u>.01%</u>
	.015	1.5%
Current risk-free rate (U.S. Treasury bonds = baseline)	<u>.070</u>	<u>7.0</u>
Pretax cost	.085	8.5
Income tax at 40%	<u>.034</u>	<u>3.4</u>
Net (after-tax) cost of debt (60%)	<u>.051</u>	<u>5.1%</u>

#### QUESTION 450

When a firm finances each asset with a financial instrument of the same approximate maturity as the life of the asset, it is applying:

- A. Working capital management.
- B. Return maximization.
- C. Financial leverage.
- D. Operating leverage.

**Correct Answer:** A

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. Appropriate working capital management matches the maturity life of each asset with the length of the financial instrument used to finance that asset.

Choice "b" is incorrect. Return maximization seeks to obtain the optimal return rate by asset utilization. It is not necessarily related to the maturity of the asset.

Choice "c" is incorrect. Financial leverage is the amount of debt used to finance an asset. Higher leverage equals more debt. It is unrelated to the maturity life of an asset.

Choice "d" is incorrect. Operating leverage is the degree that fixed costs are used in the production process. Operating leverage is unrelated to the methods used to finance assets.

**QUESTION 451** Net working capital is the difference between:

- A. Current assets and current liabilities.
- B. Fixed assets and fixed liabilities.
- C. Total assets and total liabilities.
- D. Total assets and current liabilities.

**Correct Answer:** A

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. Current assets minus current liabilities equals net working capital.

Choices "b", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 452** Which one of the following would increase the working capital of a firm?

- A. Purchase of a new plant financed by a 20-year mortgage.
- B. Cash collection of accounts receivable.
- C. Payment of a 20-year mortgage payable with cash.

D. Refinancing a short-term note payable with a two-year note payable.

**Correct Answer:** D

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Refinancing a short-term note payable with a two-year note payable would increase the working capital of a firm.

<u>Journal Entry</u>	<u>Dr</u>	<u>Cr</u>
Short-term N/P (working capital)	xx	
Long-term note payable		xx

Choice "a" is incorrect. The purchase of a new plant (fixed asset) financed by a 20-year mortgage (longterm debt with a one-year current portion) would reduce working capital because current liabilities would be increased.

Choice "b" is incorrect. The cash collection of accounts receivable has no effect on working capital-cash increases by the amount that A/R decreases.

Choice "c" is incorrect. The payment of a 20-year mortgage payable (long-term debt) would reduce cash and have no effect on current liabilities, thereby reducing working capital.

**QUESTION 453** If a firm increases its cash balance by issuing additional shares of common stock, working capital:

- A. Remains unchanged and the current ratio remains unchanged.
- B. Increases and the current ratio remains unchanged.
- C. Increases and the current ratio decreases.
- D. Increases and the current ratio increases.



**Correct Answer:** D

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. If a firm increases its cash balance by issuing additional shares of common stock, working capital increases and the current ratio increases.

<u>Illustration</u>	<u>Before</u>		<u>Stock Sale</u>		<u>After</u>
Current Assets	300	+	100	=	400
Current Liabilities	<u>100</u>				<u>100</u>
Working Capital	<u>200</u>	+	<u>100</u>	=	<u>300</u>
Current Ratio	3 To 1				4 To 1
Equity	<u>100</u>	+	<u>100</u>	=	<u>200</u>

#### QUESTION 454

A firm has daily cash receipts of \$100,000. A bank has offered to reduce the collection time on the firm's deposits by two days for a monthly fee of \$500. If money market rates are expected to average 6 percent during the year, the net annual benefit (loss) from having this service is:

- A. \$3,000

- B. \$12,000
- C. \$6,000
- D. \$(6,000)

**Correct Answer: C**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. \$6,000 net annual benefit from using a lockbox system.

Daily Cash Receipts	\$100,000/Day
Days Accelerated	× 2 Days
Increased Cash Receipts	\$200,000
Annual Interest Rate	× 6%
Marginal Revenue	12,000
Monthly Lockbox Fee \$500 × 12 =	(6,000)
Net Annual Benefit From Using Lockbox System	\$ 6,000



**QUESTION 455** Determining the appropriate level of working capital for a firm requires:

- A. Changing the capital structure and dividend policy of the firm.
- B. Maintaining short-term debt at the lowest possible level because it is generally more expensive than long-term debt.
- C. Offsetting the benefit of current assets and current liabilities against the probability of technical insolvency.
- D. Maintaining a high proportion of liquid assets to total assets in order to maximize the return on total investments.

**Correct Answer: C**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. Determining the appropriate level of working capital for a firm requires offsetting the benefit of current assets and current liabilities against the probability of technical insolvency.

Choice "a" is incorrect. Changing the capital structure (common stock vs. preferred stock vs. long-term debt) and dividend policy has nothing to do with the level of working capital required for day-to-day operations of the business.

Choice "b" is incorrect. The relative interest cost of short-term vs. long-term debt does not determine the appropriate level of working capital.

Choice "d" is incorrect. Because profitability varies inversely with liquidity, maximizing the return on total investments would require a low (not high) level of liquid assets and a high level of liquid assets does nothing to determine the required level of working capital.

**QUESTION 456** As a company becomes more conservative in its working capital policy, it would tend to have a (n):

- A. Decrease in its acid-test ratio.
- B. Increase in the ratio of current assets to units of output.

- C. Increase in funds invested in common stock and a decrease in funds invested in marketable securities.
- D. Decrease in its level of permanent working capital.

**Correct Answer: B**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. As a company becomes more conservative in its working capital policy, it would tend to have an increase in the ratio of current assets to units of output.  
Choice "a" is incorrect. Acid-test ratio would tend to increase with conservatism.  
Choice "c" is incorrect. Marketable securities investments would tend to increase while common stock investments would tend to decrease. Choice "d" is incorrect. Permanent working capital would tend to increase.

**QUESTION 457**

Which of the following transactions does not change the current ratio and does not change the total current assets?

- A. A cash advance is made to a divisional office.
- B. A cash dividend is declared.
- C. Short-term notes payable are retired with cash.
- D. Equipment is purchased with a three-year note and a 10 percent cash down payment.

**Correct Answer: A**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. This does not change the current ratio because the reduction of cash is offset by an increase in accounts receivable.  
Choice "b" is incorrect. A cash dividend increases current liabilities without increasing current assets. Although current assets remain unchanged (until the payment happens), the current ratio will change.  
Choice "c" is incorrect. Cash is reduced and current liabilities are reduced. Total current assets will change (they will be reduced).  
Choice "d" is incorrect. The payment of cash reduces current assets. Long-term assets are increased, as well as long-term and short-term liabilities. The current ratio is reduced.

**QUESTION 458**

The working capital financing policy that subjects the firm to the greatest risk of being unable to meet the firm's maturing obligations is the policy that finances:

- A. Fluctuating current assets with long-term debt. B. Permanent current assets with long-term debt.
- C. Permanent current assets with short-term debt.
- D. Fluctuating current assets with short-term debt.

**Correct Answer: C**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The working capital financing policy that finances permanent current assets with short-term debt subjects the firm to the greatest risk of being unable to meet the firm's maturing obligations.  
Choices "a" and "b" are incorrect because the use of long-term debt financing produces the smallest risk of being unable to meet maturing obligations.  
Choice "d" is incorrect because, although financing fluctuating current assets with short-term debt exposes the firm to some risk, it is not the greatest or the smallest.

**QUESTION 459** When managing cash and short-term investments, a corporate treasurer is primarily concerned with:

- A. Maximizing rate of return.
- B. Minimizing taxes.
- C. Investing in common stock due to the dividend exclusion for federal income tax purposes.
- D. Liquidity and safety.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. When managing cash and short-term investments, a corporate treasurer is primarily concerned with liquidity and safety.

Choice "a" is incorrect. The board of directors and general management would be interested in maximizing rate of return on company operations.

Choices "b" and "c" are incorrect. The tax manager would be interested in minimizing taxes, and investing in common stock due to the dividend exclusion for federal income tax purposes.

**QUESTION 460**

An increase in sales collections resulting from an increased cash discount for prompt payment would be expected to cause a (n):

- A. Increase in the operating cycle.
- B. Increase in the average collection period.
- C. Decrease in the cash conversion cycle.
- D. Increase in bad debt losses.

**Correct Answer:** C  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. An increase in sales collections would decrease the cash conversion cycle.

Choice "a" is incorrect because the operating cycle (as well as the cash conversion cycle) would decrease.

Choice "b" is incorrect, as the average collection period would decrease.

Choice "d" is incorrect. Bad debt losses would decrease from an increase in sales collections.

**QUESTION 461** Wyley Inc. purchases an item on credit with terms of 3/10, net 45. Based on a 360-day year, Wyley's annual interest cost of foregoing the cash discount and making payment on the last day of the credit period is:

- A. 24.00% B. 30.86%
- C. 31.81% D. 37.11%

**Correct Answer:** C  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The formula for computing the cost of credit discounts is:



$$\frac{360}{(\text{Total pay period} - \text{Discount period})} \times \frac{\text{Discount \%}}{(100\% - \text{Discount \%})} =$$

$$\frac{360}{(45 - 10)} \times \frac{3\%}{100\% - 3\%} =$$

$$10.28 \times .0309 = 31.8\%$$

Choices "a", "b", and "d" are incorrect, per the above calculation.

**QUESTION 462** A firm can best delay disbursements through the use of:

- A. A centralized disbursement function.
- B. Drafts.
- C. Factoring.
- D. Trade discounts.

**Correct Answer:** B  
**Section:** Volume D

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "b" is correct. Paying by means of a draft (or check) allows the firm to take advantage of the float period. These delays cash disbursements.  
Choice "a" is incorrect. A centralized disbursement function will not necessarily delay cash disbursements.  
Choice "c" is incorrect. Factoring is the sale of accounts receivable to a factor. This has no effect on cash disbursements. Choice "d" is incorrect. Trade discounts are discounts on account receivable and do not impact cash disbursements.

#### QUESTION 463

The following information applies to Brandon Company.

	<u>Purchases</u>	<u>Sales</u>
January	\$160,000	\$100,000
February	160,000	200,000
March	160,000	240,000
April	140,000	300,000
May	140,000	260,000
June	120,000	240,000

Forty percent of purchases are paid for in cash at the time of purchase, and 30 percent is paid for in each of the next two months. Purchases for the previous November and December were \$150,000 per month. Payroll is 10 percent of sales in the month it occurs, and operating expenses are 20 percent of the following months sales (July sales were \$220,000). Interest payments were \$20,000 paid quarterly in January and April. Brandon's cash disbursements for the month of April were:

- A. \$152,000
- B. \$200,000
- C. \$248,000



D. \$254,000

**Correct Answer:** D

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Cash disbursements in April would include paying for purchases made in February and March. It would also include payroll expense and operating expenses. The calculation would be:

<b>Purchases:</b>		
February	$160,000 \times 30\% =$	\$ 48,000
March	$160,000 \times 30\% =$	\$ 48,000
April	$140,000 \times 40\% =$	\$ 56,000
<b>Payroll:</b>		
April Sales	$= 300,000 \times 10\% =$	\$ 30,000
<b>Operating Expenses:</b>		
May Sales	$= 260,000 \times 20\% =$	\$ 52,000
Interest Expenses		<u>\$ 20,000</u>
April Cash Disbursements		<u>\$254,000</u>

Choices "a", "b", and "c" are incorrect, per above calculations.

#### QUESTION 464

Newman Products has received proposals from several banks to establish a lockbox system to speed up receipts. Newman receives an average of 700 checks per day averaging \$1,800 each, and its cost of short-term funds is 7 percent per year. Assuming that all proposals will produce equivalent processing results and using a 360-day year, which one of the following proposals is optimal for Newman?

- A. A flat fee of \$125,000 per year.
- B. A fee of 0.03 percent of the amount collected.
- C. A compensating balance of \$1,750,000.
- D. A fee of \$0.35 per check plus 0.01 percent of the amount collected.

**Correct Answer:** C

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The optimal proposal is that which has the lowest cost for Newman.

(A) Costs		\$125,000
(B) Costs $0.03 (1,800) (700) (360) =$		\$136,080
(C) Costs $0.07 (\$1,750,000) =$		\$122,500
(D) Costs $0.35 (700) (360) =$	\$ 88,200	
$+0.01(1,800)(700)(360) =$	<u>45,360</u>	
		\$133,560

Thus, the lowest cost is "c" at \$122,500.

Choices "a", "b", and "d" are incorrect, per the above calculations/Explanation.

#### QUESTION 465

The treasury analyst for Garth Manufacturing has estimated the cash flows for the first half of next year (ignoring any short-term borrowings) as follows:

	Cash (millions)	
	Inflows	Outflows
January	\$2	\$1
February	2	4
March	2	5
April	2	3
May	4	2
June	5	3

Garth has a line of credit of up to \$4 million on which it pays interest monthly at a rate of 1 percent of the amount utilized. Garth is expected to have a cash balance of \$2 million on January 1 and no amount utilized on its line of credit. Assuming all cash flows occur at the end of the month, approximately how much will Garth pay in interest during the first half of the year?

- A. \$61,000
- B. \$80,000
- C. \$132,000
- D. \$240,000

**Correct Answer:** A  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. First, determine the amount and timing of cash needs:

	Borrow	Inflows	Cash Outflows	Balance	
Beg. bal				\$2,000,000	<sup>1</sup>
January		2,000,000	(1,000,000)	\$3,000,000	<sup>2</sup>
February		2,000,000	(4,000,000)	\$1,000,000	<sup>2</sup>
March		2,000,000	(5,000,000)	(\$2,000,000)	<sup>3</sup>
Borrow	2,000,000			-	<sup>4</sup>
April		2,000,000	(3,000,000)	(\$1,000,000)	<sup>3</sup>
Interest paid on \$2 mil			(20,000)	(\$1,020,000)	<sup>5</sup>
Borrow	1,020,000			-	<sup>4</sup>
Total debt	3,020,000				<sup>6</sup>
May		4,000,000	(2,000,000)	\$2,000,000	<sup>7</sup>
Interest paid on \$3.02 mil			(30,200.00)	\$1,969,800	<sup>8</sup>
Pay LOC	(1,969,800)		(1,969,800)	-	<sup>9</sup>
Total debt	1,050,200				<sup>6</sup>
June		5,000,000	(3,000,000)	\$2,000,000	<sup>7</sup>
Interest on \$1,050,200			(10,502)	\$1,989,498	<sup>8</sup>
Total interest paid is sum of three interest payments					
			(20,000)		

Comments

- 1 Given
  - 2 Computed balance, positive cash flows
  - 3 Computed balance, negative cash flows
  - 4 Borrow from LOC
  - 5 Computed balance, negative cash flows + interest
  - 6 Cumulative LOC Balance
  - 7 Computed positive cash flows
  - 8 Computed balance, positive cash flows - interest
  - 9 Immediate pay down of LOC
- Choices "b", "c", and "d" are incorrect, per the above calculation.

#### QUESTION 466

MFC Corporation has 100,000 shares of stock outstanding. Below is part of MFC's Statement of Financial Position for the last fiscal year.

**MFC Corporation**  
**Statement of Financial Position - Selected Items**  
 December 31, 1996

Cash	\$455,000
Accounts receivable	900,000
Inventory	650,000
Prepaid assets	45,000
Accrued liabilities	285,000
Accounts payable	550,000
Current portion, long-term notes payable	65,000

What is the maximum amount MFC can pay in cash dividends per share and maintain a minimum current ratio of 2 to 1? Assume that all accounts other than cash remain unchanged.

- A. \$2.05 B. \$2.50  
 C. \$3.35 D. \$3.80

**Correct Answer: B**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. The current ratio is found by dividing current assets by current liabilities. Presently current assets are:

Cash	\$ 455,000
Accounts receivable	900,000
Inventory	650,000
Prepaid assets	<u>45,000</u>
Total current assets	\$2,050,000

Current liabilities total	
Accrued liabilities	\$ 285,000
Accounts payable	550,000
Current portion of LT debt	<u>65,000</u>
Total	\$ 900,000

Because current liabilities must be two times current liabilities, the current assets cannot go below \$1,800,000. Thus current assets can go down:

$$\begin{array}{r} \$2,050,000 \\ - 1,800,000 \\ \hline \text{or } \$ 250,000 \end{array}$$

On a per share basis this is \$250,000 / 100,000 shares or \$2.50 per share.  
Choices "a", "c", and "d" are incorrect, per the above calculation.

#### QUESTION 467

Kemple Cleaning Services is a newly established janitorial firm, and the owner is deciding which type of checking account to open. Kemple is planning to keep a \$500 minimum balance in the account for emergencies and plans to write an average of 80 checks per month. The bank charges \$10 per month plus a \$0.10 per check charge for a standard business checking account with no minimum balance. Kemple also has the option of a premium business checking account, which requires a \$2,500 minimum balance but has no monthly fees or per check charges. If Kemple's cost of funds is 10 percent, which account should Kemple choose?

- A. Standard account, since the savings is \$34 per year.
- B. Premium account, since the savings is \$34 per year.
- C. Standard account, since the savings is \$16 per year.
- D. Premium account, since the savings is \$16 per year.

**Correct Answer:** D

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. The total cost for a standard account is:

Monthly charge	\$ 10
Per check charge (\$ .10 × 80 checks)	<u>8</u>
Total per month	\$ 18
Total per year standard (\$18 × 12)	\$216

Cost per year for premium is cost of the extra amount (\$2,000) that Kemple must maintain in the account.  
Total per year premium (10% × \$2,000) = \$200 The premium account will save \$16.



Choices "a", "b", and "c" are incorrect, per the above calculation.

**QUESTION 468** The collection of accounts receivable can be accelerated by the use of:

- A. Turnaround documents.
- B. A lockbox system.
- C. Bank drafts.
- D. Remittance advices.

**Correct Answer: B**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Lockboxes are systems of mailboxes, usually in many locations, where customers send payments. The company's bank checks these mailboxes frequently and immediately deposits checks received. This accelerates the collection of accounts receivable.

Choice "a" is incorrect. A turnaround document is a computer output that can later be used as a source document. No relevance to A/R collections.

Choice "c" is incorrect. A bank draft is a document issued by a bank to indicate that payment has been made.

Choice "d" is incorrect. A bank remittance advice is a document generated by a bank to indicate that payment has been made by a customer.

**QUESTION 469**

A working capital technique that increases the payable float and, therefore, delays the outflow of cash is:

- A. Concentration banking.
- B. A draft.
- C. A lock-box system.
- D. The use of a local post office box.



**Correct Answer: B**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. A draft is a working capital technique that increases the payable float and, therefore, delays the outflow of cash. Each of the three following choices accelerate the flow of cash and/or data:

Choice "a" is incorrect. Concentration banking automatically channels funds from every source of the business into a single usable account, thus quickly identifying available funds each day, and moving them to accounts that have funding requirements that day, and investing the remainder in short-term, interest-bearing instruments until needed.

Choice "c" is incorrect. A lock-box system is simply a central collection location that receives payment checks (generally, the bank where a central checking account is maintained by the firm). Choice "d" is incorrect. The use of a local post office box allows more rapid access to mail than actual delivery to a street address.

**QUESTION 470**

Hagar Company's bank requires a compensating balance of 20 percent on a \$100,000 loan. If the stated interest on the loan is 7 percent, what is the effective cost of the loan?

- A. 7.00 percent.
- B. 8.18 percent.
- C. 8.40 percent.
- D. 8.75 percent.

**Correct Answer: D**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Total interest for the loan is \$100,000 × 7% or \$7,000. The effective amount received is \$80,000 after the 20% compensating balance. The effective interest is \$7,000 / \$80,000 = 8.75%

Choices "a", "b", and "c" are incorrect, per the above calculation.

**QUESTION 471** Which one of the following represents methods for converting accounts receivable to cash?

- A. Trade discounts, collection agencies, and credit approval.
- B. Factoring, pledging, and electronic funds transfers.
- C. Cash discounts, collection agencies, and electronic funds transfers.
- D. Trade discounts, cash discounts, and electronic funds transfers.

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The following are methods of converting accounts receivable (AR) into cash:

1. Collection agencies - used to collect overdue AR.
2. Factoring AR - selling AR to a factor for cash.
3. Cash discounts - offering cash discounts to customers for paying AR quickly (or paying at all). For example: 2/10, net 30.
4. Electronic fund transfers - a method of payment, which electronically transfers funds between banks.

Therefore, only choice "c" matches the above list.

Choice "a" is incorrect. Trade discounts offer discounts on future merchandise purchases offered to trade customers. These discounts do not turn AR into cash.

Choice "b" is incorrect. Pledging AR as collateral on a loan does not convert AR into cash. Choice "d" is incorrect, per choice for "a" above.

**QUESTION 472**

Foster Inc. is considering implementing a lock-box collection system at a cost of \$80,000 per year. Annual sales are \$90 million, and the lock-box system will reduce collection time by 3 days. If Foster can invest funds at 8 percent, should it use the lock-box system? Assume a 360-day year.

- A. Yes, producing savings of \$60,000 per year.
- B. No, producing a loss of \$20,000 per year.
- C. No, producing a loss of \$60,000 per year.
- D. No, producing a loss of \$140,000 per year.

**Correct Answer: B**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. No, do not use the lock-box system, which produces a loss of \$20,000 per year.

$$\frac{3 \text{ days}}{360 \text{ days}} \times \$90,000,000 \times \frac{8}{10} = \begin{array}{l} \$80,000 \text{ Lock-box cost} \\ \underline{60,000 \text{ Investment income}} \\ \underline{\underline{\$20,000 \text{ Loss per year}}} \end{array}$$



**QUESTION 473** When a company offers credit terms of 2/10, net 30, the annual interest cost, based on a 360-day year, is:

- A. 24.0 percent.
- B. 35.3 percent.
- C. 36.0 percent.
- D. 36.7 percent.

**Correct Answer: D**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "d" is correct. The formula for calculating the cost of a credit policy is:

$$\frac{360}{\left(\frac{\text{Total pay}}{\text{period}} - \frac{\text{Discount}}{\text{period}}\right)} \times \frac{\text{Discount \%}}{(100\% - \text{Discount \%})} =$$

$$\frac{360}{(30 - 10)} \times \frac{2\%}{100\% - 2\%} = 36.7\%$$

Therefore, the cost of customers taking this discount is 36.7% of the invoice price of the sale. Choices "a", "b", and "c" are incorrect, per the above answer.



**QUESTION 474** If a firm's credit terms require payment within 45 days but allow a discount of 2 percent if paid within 15 days (using a 360 day year), the approximate cost/benefit of the trade credit terms is:

- A. 16 percent.
- B. 48 percent.
- C. 24 percent.
- D. 36 percent.

**Correct Answer: C**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. The formula for computing the cost/benefit for trade discounts is:

$$\frac{360}{(\text{Total pay period} - \text{Discount period})} \times \frac{\text{Discount \%}}{(100\% - \text{Discount \%})} =$$

$$\frac{360}{(45 - 15)} \times \frac{2\%}{100\% - 2\%} = 24\%$$

Choice is 24% ("c").

Choices "a", "b", and "d" are incorrect, per the above calculations.

**QUESTION 475** Using a 360-day year, what is the opportunity cost to a buyer of not accepting terms 3/10, net 45?

- A. 55.67 percent.
- B. 31.81 percent.
- C. 15.43 percent.
- D. 24.00 percent.

**Correct Answer:** B

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. 31.81%

Formula:



$$\frac{360}{\text{Pay period} - \text{Discount period}} \times \frac{\text{Discount \%}}{(100\% - \text{Discount \%})} =$$

Therefore:

$$\frac{360}{45 - 10} \times \frac{3\%}{100\% - 3\%} = \frac{360}{35} \times \frac{3\%}{97\%}$$

$$= \underline{\underline{31.81\%}}$$

**QUESTION 476** Which one of the following statements concerning cash discounts is correct?

- A. The cost of not taking a 2/10, net 30 cash discount is usually less than the prime rate.
- B. With trade terms of 2/15, net 60, if the discount is not taken, the buyer receives 45 days of free credit.
- C. The cost of not taking the discount is higher for terms of 2/10, net 60 than for 2/10, net 30.
- D. The cost of not taking a cash discount is generally higher than the cost of a bank loan.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. The cost of not taking a cash discount is generally higher than the cost of a bank loan.

Choice "a" is incorrect. The cost of not taking a 2/10, net 30 cash discount is usually more than the prime rate.

Choice "b" is incorrect. With trade terms of 2/15, net 60, if the discount is not taken, the buyer receives 60 (not 45) days of free credit. Choice

"c" is incorrect. The cost of not taking the discount is lower (not higher) for terms of 2/10, net 60 than for 2/10, net 30.

**QUESTION 477**

Commercial paper:

- A. Has a maturity date greater than one year.
- B. Is generally sold only through investment banking dealers.
- C. Generally does not have an active secondary market.
- D. Has an interest rate lower than treasury bills.

**Correct Answer:** C  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Although commercial paper has a secondary market available, it is generally not an active secondary market. Commercial paper is usually sold to the money markets by highly creditworthy companies.

Choice "a" is incorrect. The maturity dates are generally less than 270 days.

Choice "b" is incorrect. Commercial paper can be sold to the money markets through a variety of intermediaries including brokers, dealers, investment brokers, etc. It can also be sold direct from one company to another. Choice

"d" is incorrect. The interest rate on commercial paper is below the prime rate, but generally above the Treasury bill rate.

**QUESTION 478**

Which one of the following is not a characteristic of a negotiable certificate of deposit? Negotiable certificates of deposit:

- A. Have a secondary market for investors.
- B. Are regulated by the Federal Reserve System.
- C. Are usually sold in denominations of a minimum of \$100,000.
- D. Have yields considerably greater than bankers' acceptances and commercial paper.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Negotiable CDs generally carry interest rates slightly lower than bankers' acceptances (which are drafts drawn on deposits at a bank) or commercial paper (which is unsecured debt issued by credit worthy customers).

Choice "a" is incorrect. Negotiable CDs have a formal secondary market.

Choice "b" is incorrect. Negotiable CDs are a product of the banking industry, which is regulated by the Federal Reserve Board. Choice

"c" is incorrect. Negotiable CDs are usually sold in denominations of a minimum of \$100,000.

**QUESTION 479** All of the following are alternative marketable securities suitable for investment, except:

- A. Eurodollars.

- B. Commercial paper.
- C. Bankers' acceptances.
- D. Convertible bonds.

**Correct Answer: D**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Convertible bonds. Temporarily idle cash should be invested in very liquid, low risk short-term investments only. U.S. T-bills are basically risk-free. Banker's acceptances and Eurodollars are only slightly more risky. Commercial paper, the short-term unsecured notes of the most credit-worthy large U.S. corporations is a little riskier, but still relatively low risk. However, convertible bonds are subject to default risk, liquidity risk, and maturity (interest rate) risk, and as such are inappropriate securities for short-term marketable security investment.

#### QUESTION 480

Which one of the following responses is not an advantage to a corporation that uses the commercial paper market for short-term financing?

- A. The borrower avoids the expense of maintaining a compensating balance with a commercial bank.
- B. There are no restrictions as to the type of corporation that can enter into this market.
- C. This market provides a broad distribution for borrowing.
- D. A benefit accrues to the borrower because its name becomes more widely known.

**Correct Answer: B**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. There are restrictions as to the type of corporation that can enter into the commercial paper market for short-term financing, since the use of the open market is restricted to a comparatively small number of the most credit-worthy large corporations. The commercial paper market:

- A. Avoids the expense of maintaining a compensating balance with a commercial bank.
- C. Provides a broad distribution for borrowing.
- D. Accrues a benefit to the borrower because its name becomes more widely known.

**QUESTION 481** Corbin Inc. can issue three-month commercial paper with a face value of \$1,000,000 for \$980,000. Transaction costs would be \$1,200. The effective annualized percentage cost of the financing, based on a 360-day year, would be:

- A. 2.16%
- B. 8.48%
- C. 8.65%
- D. 8.00%

**Correct Answer: C**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. The cost to issue the commercial paper is the \$20,000 original issue discount (\$1 million - \$980,000), plus transaction costs of \$1,200 for a total of \$21,200. Therefore, it costs \$21,200 to borrow \$980,000 for 3 months. The 3-month interest cost is 2.16% (\$21,200 / \$980,000). The annual interest cost is 8.65%. Choices "a", "b", and "d" are incorrect, per the above calculation.

**QUESTION 482**

All of the following are valid reasons for a business to hold cash and marketable securities, except to:

- A. Satisfy compensating balance requirements.
- B. Maintain adequate cash needed for transactions.
- C. Maintain a precautionary balance.
- D. Earn maximum returns on investment assets.

**Correct Answer:** D

**Section:** Volume D

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. There are three primary motives for holding cash:

1. Transactions demand
2. Precautionary demand
3. Speculative demand

However, cash is generally held in very short-term liquid investments which are low risk, low return.

**QUESTION 483** The marketable securities with the least amount of default risk are:

- A. Federal government agency securities.
- B. U.S. treasury securities.
- C. Repurchase agreements.
- D. Bankers' acceptances.

**Correct Answer:** B

**Section:** Volume D

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Default risk is the risk that the security will not be repaid because the issuing entity is insolvent or illiquid. U.S. Treasury securities are issued by the Treasury Department, which has virtually no risk of being insolvent or illiquid.

Choice "a" is incorrect. Securities issued by certain federal government agencies carry slightly more default risk than U.S. treasuries because these agencies are (usually) not as large or liquid as the U.S. Treasury.

Choice "c" is incorrect. Repurchase agreements are sales by dealers in government securities who agree to repurchase these securities at a specific time and price. The risk of default is high because it is based upon the ability of the dealer to repurchase the securities.

Choice "d" is incorrect. Bankers' acceptances are drafts drawn on a bank, which guarantees payment at maturity. The default risk is higher because the execution of the acceptance is based upon the solvency of the bank.

**QUESTION 484** When purchasing temporary investments, which one of the following best describes the risk associated with the ability to sell the investment in a short period of time without significant price concessions?

- A. Interest rate risk.
- B. Purchasing power risk.
- C. Financial risk.
- D. Liquidity risk.

**Correct Answer:** D

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Liquidity risk is associated with the ability to sell the temporary investment in a short period of time without significant price concessions.

Choice "a" is incorrect. Interest rate risk is the fluctuation in the value of a "financial asset" when interest rates change.

Choice "b" is incorrect. Purchasing power risk is the risk that price levels will change and affect asset values (mostly real estate). Choice

"c" is incorrect. Financial risk is a general category of risk that includes:

- Interest rate risk
- Market risk
- Purchasing power risk
- Liquidity risk
- Default risk

**QUESTION 485**

A firm averages \$4,000 in sales per day and is paid, on an average, within 30 days of the sale. After they receive their invoice, 55 percent of the customers pay by check, while the remaining 45 percent pay by credit card. Approximately how much would the company show in accounts receivable on its balance sheet on any given date?

- A. \$120,000
- B. \$48,000C. \$54,000
- D. \$21,600

**Correct Answer: A**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Sales Per Day	\$ 4,000/Day
A/R Days Outstanding on Average	× 30 Days
Accounts Receivable on Balance Sheet	<u>\$120,000</u>



Choice "a" is correct. \$120,000 accounts receivable approximation. There is no effect on total A/R based on how (i.e., check or credit card) the customers actually pay their A/R.

**QUESTION 486**

A company plans to tighten its credit policy. The new policy will decrease the average number of days in collection from 75 to 50 days and will reduce the ratio of credit sales to total revenue from 70 to 60 percent. The company estimates that projected sales would be five percent less if the proposed new credit policy is implemented. If projected sales for the coming year are \$50 million, calculate the dollar impact on accounts receivable of this proposed change in credit policy.

Assume a 360-day year.

- A. \$3,817,445 decrease. B.
- \$6,500,000 decrease.
- C. \$3,333,334 decrease.
- D. \$18,749,778 increase.

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:



	<u>Credit Policy Change</u>	
	<u>No</u>	<u>Yes</u>
Sales Projections	\$50,000,000	$\times 95\% = \$47,500,000$
Credit Sales Ratio	$\times 70\%$	$\times 60\%$
Sales on Credit	35,000,000	28,500,000
Collection Day Ratio	$\times 75/360$	$\times 50/360$
Accounts Receivable	\$ 7,291,667	\$ 3,958,333
Decrease in A/R		<u>3,333,334</u>

Choice "c" is correct. \$3,333,334 decrease in accounts receivable.

#### QUESTION 487

A company enters into an agreement with a firm who will factor the company's accounts receivable. The factor agrees to buy the company's receivables, which average \$100,000 per month and have an average collection period of 30 days. The factor will advance up to 80 percent of the face value of receivables at an annual rate of 10 percent and charge a fee of 2 percent on all receivables purchased. The controller of the company estimates that the company would save \$18,000 in collection expenses over the year. Fees and interest are not deducted in advance. Assuming a 360-day year, what is the annual cost of financing?

- A. 12.0 percent.
- B. 14.0 percent.
- C. 16.0 percent.
- D. 17.5 percent.

**Correct Answer:** D  
**Section:** Volume D

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. 17.5% annual cost of financing.

	<u>A/R</u>	<u>Cost to Company</u>
Amount of A/R Submitted	$\$100,000 \times 2\% \times 360/30 =$	\$24,000
Amount Not Advanced	<u>(20,000)</u>	
Amount to Calculate Interest Exp	$80,000 \times 10\% =$	<u>8,000</u>
Cost to Company		32,000
Less Collection Expense Saved		<u>(18,000)</u>
Net Cost		<u>\$14,000</u>
$\frac{\text{Net cost}}{\text{Amt advance}} = \frac{\$14,000}{\$80,000} = 17.5\% \text{ Annual cost of financing}$		

#### QUESTION 488

Gartshore Inc. is a mail-order book company. The Company recently changed its credit policy in an attempt to increase sales. Gartshore's variable cost ratio is 70 percent and its required rate of return is 12 percent. The company projects that annual sales will increase from the current level of \$360,000 to \$432,000, but the average collection period on receivables will go from 30 days to 40 days. Ignoring any tax implications, what is the cost of carrying the additional investment in accounts receivable, using a 360-day year?

- A. \$1,512 B. \$2,000
- C. \$2,160
- D. \$12,600

**Correct Answer:** A

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The cost of carrying accounts receivable now is the variable cost of creating the account receivable times the cost of that capital during the collection period. The cost of the investment in accounts receivable is now:

\$360,000 Sales (70%) (12%) (30 Days/360 Days)	= \$2,520
The cost of the investment under the new proposal is \$432,000 Sales (70%) (12%) (40 Days/360 Days)	= \$4,032
The difference in the two alternatives is	<u>\$1,512</u>

Choice "c" is incorrect. This considers the entire account receivable as a cost.

Choices "b" and "d" are incorrect, per the above calculation.

**QUESTION 489** Which of the following represents a firm's average gross receivable balance?

- I. Days' sales in receivables x accounts receivable turnover.
- II. Average daily sales x average collection period.
- III. Net sales ÷ average gross receivables.



- A. I only.
- B. I and II only.
- C. II only.
- D. II and III only.

**Correct Answer:** C

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. II only - Average daily sales (\$27,397) × Average collection period (36.5) = \$1,000,000 Avg gross A/R Not

I – Days' sales in receivables (36.5) × AR turnover 10 = 365 days in year.

Not III – Net sales (\$10,000,000) ÷ Avg gross receivables (\$1,000,000) = 10 AR turnover.

**QUESTION 490**

Clauson Inc. grants credit terms of 1/15, net 30 and projects gross sales for next year of \$2,000,000. The credit manager estimates that 40 percent of their customers pay on the discount date, 40 percent on the net due date, and 20 percent pay 15 days after the net due date. Assuming uniform sales and a 360-day year, what is the projected days sales outstanding (rounded to the nearest whole day)?

- A. 20 days.
- B. 24 days.
- C. 27 days.
- D. 30 days.

**Correct Answer:** C

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. 27 days projected days sales outstanding.

				<u>Avg.</u>
40%	×	15 Days	=	6 Days
40%	×	30 Days	=	12
20%	×	45 Days	=	9
				<u>27 Days</u>

**QUESTION 491** A change in credit policy has caused an increase in sales, an increase in discounts taken, a reduction in the investment in accounts receivable, and a reduction in the number of doubtful accounts. Based upon this information, we know that:

- A. Net profit has increased.
- B. The average collection period has decreased.
- C. Gross profit has declined.
- D. The size of the discount offered has decreased.

**Correct Answer: B**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Whenever accounts receivable (AR) are decreasing when sales are increasing (and the decrease in AR is not due to an increase in bad debt write offs), this would indicate that the average collection period for AR has decreased.

Choices "a", "c", and "d" are incorrect. There is insufficient information in the question to draw conclusions about these items.

**QUESTION 492**

The following information regarding a change in credit policy was assembled by the Wilson Wax Company. The company has a required rate of return of 10 percent and a variable cost ratio of 60 percent.

	<u>Old Credit Policy</u>	<u>New Credit Policy</u>
Sales	\$3,600,000	\$3,960,000
Average collection period	30 days	36 days

The pretax cost of carrying the additional investment in receivables, using a 360-day year, would be:

- A. \$5,760 B. \$9,600
- C. \$8,160
- D. \$960

**Correct Answer: A**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct.

Step 1 Determine the average accounts receivable balance and the additional accounts receivable as follows:

	Old Credit Policy	New Credit Policy
Accounts Receivable	\$300,000	\$396,000
New credit policy		\$396,000
Old credit policy		(300,000)
Additional A/R		\$ 96,000

Therefore, the accounts receivable balance is \$96,000 higher under the new credit policy.

Step 2 Determine the additional INVESTMENT in the additional accounts receivable.

Although Wilson has an additional \$96,000 in accounts receivable, Wilson's actual investment in the additional accounts receivable is only 60% of \$96,000 (because variable costs are 60% of sales). Wilson's investment in the additional accounts receivable is calculated as follows:  $\$96,000 \times 60\% = \$57,600$

Step 3 Calculate the cost of carrying the additional accounts receivable.

Wilson's additional investment in accounts receivable is \$57,600 and we are given a 10% required rate of return. This means that Wilson's carrying cost of \$5,760 is calculated as follows:

$\$57,600 \times 10\% = \$5,760$

Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 493** An organization would usually offer credit terms of 2/10, net 30 when:

- A. The organization can borrow funds at a rate less than the annual interest cost.
- B. The cost of capital approaches the prime rate.
- C. Most competitors are not offering discounts, and the organization has a surplus of cash.
- D. Most competitors are offering the same terms, and the organization has a shortage of cash.



**Correct Answer: D**  
**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Offering favorable credit terms is usually a response to either competitive forces in the market or to improve cash flow.

Choice "a" is incorrect, although the payment terms of AR is a form of borrowing (or lending) to customers, companies are more likely to extend credit terms because of competitive pressures rather than because it represents a cheaper form of borrowing.

Choice "b" is incorrect. The cost of capital at (or approaching) the prime rate is irrelevant without additional information.

Choice "c" is incorrect. If most competitors are not offering discounts or credit terms, there is no reason to offer them. Also, if there is a surplus of cash, there is no reason to accelerate accounts receivable collection by offering credit terms.

**QUESTION 494** The average collection period for a firm measures the number of days:

- A. After a typical credit sale is made until the firm receives the payment.
- B. It takes a typical check to "clear" through the banking system.
- C. Before a typical account becomes delinquent.
- D. In the inventory cycle.

**Correct Answer: A**  
**Section: Volume D**

#### Explanation

**Explanation/Reference:**

Explanation:

Choice "a" is correct. The average collection period for a firm measures the number of days after a typical credit sale is made until the firm receives the payment.

Choice "b" is incorrect. "Float" measures the number of days it takes a typical check to "clear" through the banking system.

Choice "c" is incorrect. "Credit period (term)" measures the number of days before a typical account becomes delinquent. Choice

"d" is incorrect. "Average days sales in inventory" measures the number of days in the inventory cycle.

**QUESTION 495**

A company with \$4.8 million in credit sales per year plans to relax its credit standards, projecting that this will increase credit sales by \$720,000. The company's average collection period for new customers is expected to be 75 days; and the payment behavior of the existing customers is not expected to change.

Variable costs are 80 percent of sales. The firm's opportunity cost is 20 percent before taxes. Assuming a 360-day year, what is the company's benefit (loss) on the planned change in credit terms?

- A. \$28,800
- B. \$144,000C. \$120,000
- D. \$126,000

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. \$120,000 benefit on the planned change in credit standards.

		Opportunity Cost	
Sales	\$720,000		
Variable Costs (80%)	$\frac{576,000}{360} \times 75 =$	\$120,000 =	75 Days' Costs O/S
Variable Margin	144,000	$\times 20\%$	Opportunity Cost Rate
Less Opportunity Cost	<u>(24,000)</u>	<u>\$ 24,000</u>	
Benefit	<u>\$120,000</u>		

This question pertains to the economic benefit associated with a change in credit terms.

The question tells us that the credit sales will increase by \$720,000 if we relax our credit terms. We know variable costs are 80%, so we will earn \$144,000 as a result of the expanded sales. The 20% contribution margin is equal to the 20% opportunity cost so there is no better investment of our resources for the expanded credit sales relative to its margin. What about the variable costs, though?

We have \$576,000 in variable costs that will be outstanding, pro rata, 75 days of the year. So the resources we will use to produce our sales is 75/360ths of \$576,000, or \$120,000 at any given time during the year. These \$120,000 in resources could earn 20% annual return or \$24,000. The \$24,000 opportunity cost, compared to the \$144,000 margin results in a \$120,000 benefit in relaxing credit terms. Choices "a", "b", and "d" are incorrect, per the above calculation/discussion.

**QUESTION 496** A change in credit policy has caused an increase in sales, an increase in discounts taken, a decrease in the amount of bad debts, and a decrease in the investment in accounts receivable. Based upon this information, the company's:

- A. Average collection period has decreased.



- B. Percentage discount offered has decreased.
- C. Accounts receivable turnover has decreased.
- D. Working capital has increased.

**Correct Answer:** A  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. Average collection period has decreased due to a change in credit policy that has caused:

1. Increase in sales,
2. Increase in discounts taken,
3. Decrease in the amount of bad debt; and
4. Decrease in the investment in accounts receivable

Choice "b" is incorrect. Percentage discount offered has probably increased, as discounts taken has increased.

Choice "c" is incorrect. Accounts receivable turnover has increased, as sales are up and accounts receivable are down. Choice "d" is incorrect. Change in gross profit and working capital is not determinable from these facts.

#### QUESTION 497

Which one of the following statements is most correct if a seller extends credit to a purchaser for a period of time longer than the purchaser's operating cycle? The seller:

- A. Will have a lower level of accounts receivable than those companies whose credit period is shorter than the purchaser's operating cycle.
- B. Is, in effect, financing more than just the purchaser's inventory needs.
- C. Is, in effect, financing the purchaser's long-term assets.
- D. Has no need for a stated discount rate or credit period.



**Correct Answer:** B  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. If a seller extends credit to a purchaser for a period of time longer than the purchaser's operating cycle, the seller is, in effect, financing more than just the purchaser's inventory needs. Choice

"a" is incorrect. Accounts receivable would be higher than those companies whose credit period is shorter than the purchaser's operating cycle.

Choice "c" is incorrect. Seller is financing the purchaser, but not necessarily long-term assets.

Choice "d" is incorrect. It is appropriate for the seller to have stated policies for discount rate and credit periods.

#### QUESTION 498

The sales manager at Ryan Company feels confident that if the credit policy at Ryan's was changed, sales would increase and, consequently, the company would utilize excess capacity. The two credit proposals being considered are as follows:

	<u>Proposal A</u>	<u>Proposal B</u>
Increase in sales	\$500,000	\$600,000
Contribution margin	20%	20%
Bad debt percentage	5%	5%
Increase in operating profits	\$75,000	\$90,000
Desired return on sales	15%	15%



Currently, payment terms are net 30. The proposal payment terms for Proposal A and Proposal B are net 45 and net 90, respectively. An analysis to compare these two proposals for the change in credit policy would include all of the following factors, except the:

- A. Cost of funds for Ryan.
- B. Current bad debt experience.
- C. Impact on the current customer base of extending terms to only certain customers.
- D. Bank loan covenants on days sales outstanding.

**Correct Answer:** B

**Section:** Volume D

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "b" is correct. Because the bad debt percentage is the same under either of the two proposals, there is no differential cost associated with bad debt. Because it is not a differential cost, it is not considered in comparing the two alternatives.

Choice "a" is incorrect. Because Proposal A and B have different net collection dates, Proposal B will cause a greater amount of accounts receivable with a corresponding increase in working capital. The cost to fund this will be greater for Proposal B, so this is a legitimate concern.

Choice "c" is incorrect. Customers may feel they should be given the extended terms. If this is granted, the additional working capital need will be even greater.

Choice "d" is incorrect. Banks may require that days sales outstanding cannot exceed a certain number of days. If so, it will be harder to meet this covenant with Proposal B.

**QUESTION 499** The amount of inventory that a company would tend to hold in safety stock would increase as the:

- A. Cost of carrying inventory decreases.
- B. Variability of sales decreases.
- C. Costs of running out of stock decreases.
- D. Length of time that goods are in transit decreases.



**Correct Answer:** A

**Section:** Volume D

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "a" is correct. As the cost of carrying inventory decreases, safety stock would tend to increase to reduce the risk of stock outs.

Choice "b" is incorrect. As sales become more predictable (sales variability decreases), less (not more) safety stock would be needed because the risk of stock outs would have decreased.

Choice "c" is incorrect. If the cost of stock outs decrease, safety stock would decrease. Choice "d" is incorrect. If lead-time decreases, safety stock would decrease.

**QUESTION 500** The level of safety stock in inventory management depends on all of the following, except the:

- A. Level of uncertainty of the sales forecast.
- B. Level of customer dissatisfaction for back orders.
- C. Level of uncertainty in lead-time for stock shipments.
- D. Cost to reorder stock.

**Correct Answer:** D

**Section:** Volume D

#### Explanation

##### Explanation/Reference:

Explanation:

Choice "d" is correct. Reorder costs do not impact the level of safety stock.

Choices "a", "b", and "c" are incorrect. Safety stock levels are affected by:

1. Uncertain sales forecasts - greater uncertainty means a higher level of safety stock should be carried.
2. Dissatisfaction of customers - if customers are dissatisfied with back orders (which occur when there are stock outs), then more safety stock should be carried to prevent stock outs.
3. Uncertain lead times - greater uncertainty means a higher level of safety stock is needed.

#### QUESTION 501

The following information regarding inventory policy was assembled by the JRJ Corporation. The company uses a 50-week year in all calculations.

Sales	10,000 units per year
Order quantity	2,000 units
Safety stock	1,300 units
Lead-time	4 weeks

The reorder point is:

- A. 3,300 units.
- B. 2,100 units.
- C. 1,300 units.
- D. 5,200 units.

**Correct Answer:** B

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "b" is correct. A 50-week year would mean that 200 units are sold per week (10,000 units per year over 50 weeks). Therefore, 800 units are sold during the lead-time (4 weeks  $\times$  200 units per week). Required safety stock is 1,300 units, which means that no less than 1,300 units must be on hand at any time. The reorder point is then 2,100 units (1,300 safety stock plus the 800 units used during lead time). Choices "a", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 502** All of the following are inventory carrying costs, except:

- A. Insurance.
- B. Opportunity cost on inventory investment.
- C. Obsolescence and spoilage.
- D. Inspections.

**Correct Answer:** D

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Inspections. Inspections are part of order costs, not carrying costs.

Choices "a" and "c" are incorrect. Inventory carrying costs include all costs associated with warehousing (storing) inventory (e.g., storage, insurance, obsolescence, and spoilage associated with holding inventory). Choice "b" is incorrect. The economic cost of holding inventory includes the implicit (opportunity) cost of foregoing a return on the money invested in inventory.

**QUESTION 503** Which one of the following would not be considered a carrying cost associated with inventory?

- A. Insurance costs.

- B. Cost of capital invested in the inventory.
- C. Cost of obsolescence.
- D. Shipping costs.

**Correct Answer:** D  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Shipping costs (which are selling costs) would not be considered a carrying cost associated with inventory.

Choices "a", "b", and "c" are incorrect. Each of the following would be considered a carrying cost associated with inventory. A.

Insurance costs.

B. Cost of capital invested in the inventory.

C. Cost of obsolescence.

#### QUESTION 504

Handyman Inc. operates a chain of hardware stores across New England. The controller wants to determine the optimum safety stock levels for an air purifier unit. The inventory manager has compiled the following data.

- The annual carrying cost of inventory approximates 20 percent of the investment in inventory.
- The inventory investment per unit averages \$50.
- The stockout cost is estimated to be \$5 per unit.
- The company orders inventory on the average of ten times per year.
- Total cost = carrying cost + expected stockout cost.
- The probabilities of a stockout per order cycle with varying levels of safety stock are as follows.

Units		
Safety Stock	Stockout	Probability
200	0	0%
100	100	15
0	100	15
0	200	12



The total cost of safety stock on an annual basis with a safety stock level of 100 units is:

- A. \$1,750 B.
- \$1,950
- C. \$2,000
- D. \$650

**Correct Answer:** A  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. \$1,750 total annual cost of safety stock of 100 units.

### Stockout Cost

Stockout Units	100
Stockout Cost Per Units	$\times \$5$
	<u>\$500</u>
Probability at 100 Safety Stock Level	$\times .15$
	<u>\$ 75</u>
Orders Per Year	$\times 10$
Expected Stockout Cost	<u>\$750</u>

### Carrying Cost

Inventory Investment	
Per Unit	\$ 50
Carrying Cost Percentage	$\times 20\%$
Carrying Cost Per Unit	<u>\$10</u>
Stockout Units	$\times 100$
Carrying Cost	<u>1,000</u>
Total Annual Cost of Safety Stock of 100 Units	<u>\$1,750</u>



Choices "b", "c", and "d" are incorrect, per the above calculation.

**QUESTION 505** An example of a carrying cost is:

- A. Disruption of production schedules.
- B. Quantity discounts lost.
- C. Handling costs.
- D. Obsolescence.

**Correct Answer:** D  
**Section:** Volume D

#### Explanation

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. Obsolescence is an example of a carrying cost.  
Choices "a", "b", and "c" are incorrect. Carrying cost is not:  
A. Disruption of production schedules.  
B. Quantity discounts lost.  
C. Handling costs.

**QUESTION 506** When the Economic Order Quantity (EOQ) model is used for a firm, which manufactures its inventory, ordering costs consist primarily of:

- A. Insurance and taxes.
- B. Storage and handling.

- C. Production set-up.
- D. Cost of funds.

**Correct Answer: C**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "c" is correct. When the economic order quantity (EOQ) model is used for a firm that manufactures its own inventory, ordering costs consist primarily of production set-up. Choices "a", "b", and "d" are incorrect, per the above Explanation.

**QUESTION 507** Edwards Manufacturing Corporation uses the standard Economic Order Quantity (EOQ) model. If the EOQ for Product A is 200 units and Edwards maintains a 50-unit safety stock for the item, what is the average inventory of Product A?

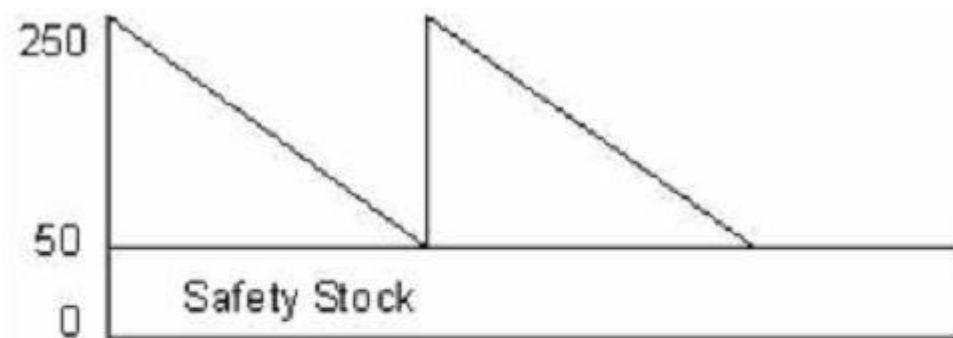
- A. 250 units.
- B. 150 units.
- C. 125 units.
- D. 100 units.

**Correct Answer: B**  
**Section: Volume D**

**Explanation**

**Explanation/Reference:**  
 Explanation:

Choice "b" is correct. 150 units is the average inventory including a 50-unit safety stock.



Reorder Quantity	200
Divide By 2 to Calculate Avg Inventory	$\div 2$
Average Inventory <b>Excluding</b> Safety Stock	100
Add Safety Stock	50
Average Inventory <b>Including</b> Safety Stock	<u>150</u>

Choices "a", "c", and "d" are incorrect, per the above calculation.

**QUESTION 508**

A company obtained a short-term bank loan of \$250,000 at an annual interest rate of 6 percent. As a condition of the loan, the company is required to maintain a compensating balance of \$50,000 in its checking account. The company's checking account earns interest at an annual rate of 2 percent.

Ordinarily, the company maintains a balance of \$25,000 in its checking account for transaction purposes. What is the effective interest rate of the loan?

- A. 6.44 percent. B.  
7.11 percent.  
C. 5.80 percent. D.  
6.66 percent.

**Correct Answer:** A  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "a" is correct. 6.44%. To calculate the effective interest rate:

	<u>Useable Loan</u>	<u>Rate</u>	<u>Interest</u>
Step 1 - Calculate the Actual Finance Charge: Actual Interest (Principal × Rate × Time)	250,000	× 6%	= \$15,000
Step 2 - Subtract any Interest Earned (if any) on <b>Additional</b> Required Compensating Balance \$50,000 – 25,000 =	(25,000)	× 2%	= (500)
Net Interest Cost	<u>225,000</u>		<u>14,500</u>
Step 3 - $\frac{\text{Divide net interest cost}}{\text{By net loan proceeds useable}} = \frac{14,500}{(225,000)} = 6.44\%$			

**QUESTION 509**

A company obtained a short-term bank loan of \$500,000 at an annual interest rate of eight percent. As a condition of the loan, the company is required to maintain a compensating balance of \$100,000 in its checking account. The checking account earns interest at an annual rate of three percent. Ordinarily, the company maintains a balance of \$50,000 in its account for transaction purposes. What is the effective interest rate of the loan?

- A. 7.77 percent.  
B. 8.50 percent.  
C. 9.44 percent.  
D. 8.56 percent.

**Correct Answer:** D  
**Section:** Volume D

**Explanation**

**Explanation/Reference:**  
Explanation:

Choice "d" is correct. 8.56%. To calculate the effective annualized percentage cost of financing:



Step 1 Calculate the actual finance charge:

$$\text{Actual interest} = (P \times \text{Rate} \times \text{Time})$$

$$\$500,000 \times 8\% = \$40,000$$

Step 2 Subtract any interest earned (if any) on additional required compensating balance:

$$\text{Additional interest earned: } \$50,000 \times .03 = \$1,500$$

$$\text{Net interest cost} = \$40,000 \text{ [from Step 1]} - \$1,500 = \$38,500$$

Step 3 Divide the difference (net interest) by the loan proceeds the company has use of:

$$\text{Loan proceeds company has use of: } \$500,000 - \$50,000 \text{ (additional balance)} = \$450,000$$

$$\frac{\$38,500}{\$450,000} = 8.555\% = \mathbf{8.56\%} \text{ (Periodic Rates)}$$

Choices "a", "b", and "c" are incorrect, per the above calculation.

**QUESTION 510** Which one of the following financial instruments generally provides the largest source of short-term credit for small firms?

- A. Installment loans.
- B. Commercial paper.
- C. Trade credit.
- D. Bankers' acceptances.



**Correct Answer:** C

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Trade credit generally provides the largest source of short-term credit for small firms. Choices "a", "b", and "d" are incorrect, per the above Explanation.

**QUESTION 511** Which one of the following provides a spontaneous source of financing for a firm?

- A. Accounts payable.
- B. Accounts receivable.
- C. Debentures.
- D. Preferred stock.

**Correct Answer:** A

**Section:** Volume D

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "a" is correct. Accounts payable provide a spontaneous source of financing for a firm. Choice

"b" is incorrect. Accounts receivable take time to factor.

Choices "c" and "d" are incorrect.

Each of the following take time to issue:

C. Debentures.

D. Preferred stock.

**QUESTION 512** Which one of the following statements about trade credit is correct? Trade credit is:

A. Not an important source of financing for small firms.

B. A source of long-term financing to the seller.

C. Subject to risk of buyer default.

D. Usually an inexpensive source of external financing.

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. Trade credit is subject to risk of buyer default.

Choice "a" is incorrect. Trade credit is an important source of financing for small firms. Choice

"b" is incorrect. Trade credit is not a source of long-term financing to the seller.

Choice "d" is incorrect. Trade credit is usually an expensive source of external financing.

**QUESTION 513**

CyberAge outlet, a relatively new store, is a cafe that offers customers the opportunity to browse the Internet or play computer games at their tables while they drink coffee. The customer pays a fee based on the amount of time spent signed on to the computer. The store also sells books, tee shirts, and computer accessories. CyberAge has been paying all of its bills on the last day of the payment period, thus forfeiting all supplier discounts. Shown below are data on CyberAge's two major vendors, including average monthly purchases and credit terms.

<u>Vendor</u>	<u>Average Monthly Purchases</u>	<u>Credit Terms</u>
Web Master	\$25,000	2/10, net 30
Softidee	50,000	5/10, net 90

Assuming a 360-day year and that CyberAge continues paying on the last day of the credit period, the company's weighted annual interest rate for trade credit (ignoring the effects of compounding) for these two vendors is:

A. 27.0 percent.

B. 28.0 percent.

C. 29.3 percent.

D. 30.2 percent.

**Correct Answer: B**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. 28% weighted annual interest rate.

This question pertains to a complex computation of effective rates on lost discounts for multiple terms and multiple balances. The computation of the annual percentage cost of the lost discount is equal to the effective rate of interest for the period (for example 2/10, net 30 is 2% interest charge/ 98% proceeds) times the number of times this period occurs in a year (for example 2/10, net 20 is 360 days per year divided by 20 day period during which the lost discount is used or 18 times). Extension of this logic to the referenced question involves allocating the computed annual rates to the relative balances of the outstanding payables as follows:

Vendor	Terms	Amount	Ratio	Effective Rate	Times/Year	Extension
Web	2/10, net 30	\$ 25,000	33%	2.04%	18	12.12
Soft	5/10, net 90	50,000	67%	5.26%	4.5	15.86
Total		<u>\$ 75,000</u>	100%			<u>27.98</u>
						[rounds to 28%]

#### QUESTION 514

CyberAge outlet, a relatively new store, is a cafe that offers customers the opportunity to browse the Internet or play computer games at their tables while they drink coffee. The customer pays a fee based on the amount of time spent signed on to the computer. The store also sells books, tee shirts, and computer accessories. CyberAge has been paying all of its bills on the last day of the payment period, thus forfeiting all supplier discounts. Shown below are data on CyberAge's two major vendors, including average monthly purchases and credit terms.

Vendor	Average Monthly Purchases	Credit Terms
Web Master	\$25,000	2/10, net 30
Softidee	50,000	5/10, net 90

Should CyberAge use trade credit and continue paying at the end of the credit period?

- A. No, if the cost of alternative short-term financing is more.
- B. Yes, if the firm's weighted average cost of capital is equal to its weighted average trade credit.
- C. No, if the cost of alternative long-term financing is more.
- D. Yes, if the cost of alternative short-term financing is more.



**Correct Answer: D**

**Section: Volume D**

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Yes, CyberAge should use trade credit and continue paying at the end of the credit period, if the cost of alternative short-term financing is more. Choices "a", "b", and "c" are incorrect, per the above Explanation.

#### QUESTION 515

The Frame Supply Company has just acquired a large account and needs to increase its working capital by \$100,000. The controller of the company has identified four alternative sources of funds, which are given below.

- A. Pay a factor to buy the company's receivables, which average \$125,000 per month and have an average collection period of 30 days. The factor will advance up to 80 percent of the face value of receivables at 10 percent and charge a fee of 2 percent of all receivables purchased. The controller estimates that the firm would save \$24,000 in collection expenses over the year. Assume the fee and interest are not deductible in advance.
- B. Borrow \$110,000 from a bank at 12 percent interest. A 9 percent compensating balance would be required.
- C. Issue \$110,000 of six-month commercial paper to net \$100,000. (New paper would be issued every 6 months.)
- D. Borrow \$125,000 from a bank on a discount basis at 20 percent. No compensating balance would be required. Assume a 360-day year in all of your calculations.

The cost of Alternative B is:

- A. 10.5 percent.
- B. 12.0 percent.
- C. 13.2 percent.

D. 21.0 percent.

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

$$13.2 \text{ Percent} = \frac{\$13,200 \text{ interest}}{\$100,100 \text{ net usable cash}}$$

Bank Loan	\$110,000	× 12% = \$13,200 Interest
9% Compensating Balance	<u>9,900</u>	
Net Usuable Cash	<u>\$100,100</u>	

Choices "a", "b", and "d" are incorrect, per the above calculation.

#### QUESTION 516

The Frame Supply Company has just acquired a large account and needs to increase its working capital by \$100,000. The controller of the company has identified four alternative sources of funds, which are given below.

A. Pay a factor to buy the company's receivables, which average \$125,000 per month and have an average collection period of 30 days. The factor will advance up to 80 percent of the face value of receivables at 10 percent and charge a fee of 2 percent of all receivables purchased. The controller estimates that the firm would save \$24,000 in collection expenses over the year. Assume the fee and interest are not deductible in advance. B. Borrow \$110,000 from a bank at 12 percent interest. A 9 percent compensating balance would be required.

C. Issue \$110,000 of six-month commercial paper to net \$100,000. (New paper would be issued every 6 months.)

D. Borrow \$125,000 from a bank on a discount basis at 20 percent. No compensating balance would be required. Assume a 360-day year in all of your calculations.

The cost of Alternative D is:

A. 10.0 percent.

B. 20.0 percent.

C. 25.0 percent.

D. 40.0 percent.

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct.

$$25.0 \text{ Percent} = \frac{\$25,000 \text{ Interest}}{\$125,000 - \$25,000 \text{ Discount}}$$

Bank Loan	\$125,000
20% Discount	<u>(25,000)</u>
Net Cash Proceeds	<u>\$100,000</u>

Choices "a", "b", and "d" are incorrect, per the above calculation.

**QUESTION 517**

A company has total costs of \$100,000, of which 40% is variable costs. What is the operating leverage?

- A. .40
- B. .60
- C. 1.5
- D. 2.5

**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. A shortcut computation for operating leverage is the ratio of fixed costs to variable costs. If total cost is \$100,000 and variable cost is 40% of total costs (or \$40,000), then fixed costs must be 60% (or \$60,000). Operating leverage is then calculated as follows:  $\$60,000/\$40,000 = 1.5$

Choice "a" is incorrect. .4 is obtained by dividing \$100,000 into the variable cost of \$40,000.

Choice "b" is incorrect. .6 is obtained by dividing total costs into fixed costs.

Choice "d" is incorrect. 2.5 is obtained by dividing total costs by variable costs.

**QUESTION 518** In planning and controlling capital expenditures, the most logical sequence is to begin with:

- A. Analyzing capital addition proposals.
- B. Analyzing and evaluating all promising alternatives.
- C. Identifying capital addition projects and other capital needs.
- D. Developing capital budgets.



**Correct Answer: C**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "c" is correct. The most logical sequence in planning and controlling capital expenditures is to begin with identifying capital addition projects and other capital needs.

Choice "a" is incorrect. Analyzing capital addition proposals omits other capital needs.

Choice "b" is incorrect. Analyzing and evaluating all promising alternatives is beyond the scope of planning and controlling capital expenditures. Choice

"d" is incorrect. Developing capital budgets is the same as planning and controlling capital expenditures.

**QUESTION 519**

Return on assets:

- A. Is a measure of profitability and indicates how much is left of each sales dollar to cover operating expenses and profit.
- B. Is a profitability measure and can be used to evaluate the efficiency of asset usage and management, and the effectiveness of business strategies to create profits.
- C. Measures the amount of operating income earned above the imputed cost of capital for the operating unit. If the measure is positive, returns exceed the cost of financing the operating unit.
- D. Measures asset activity and the ability of the firm to generate sales through the use of assets. Generally, the more sales dollars generated per dollar of assets used, the better the net income of an entity.

**Correct Answer: B**

**Section: Volume D**

**Explanation**



**Explanation/Reference:**

Explanation:

Choice "b" is correct. Return on assets is a profitability measure and can be used to evaluate the efficiency of asset usage and management, and the effectiveness of business strategies to create profits. Choice "a" is incorrect. This option defines gross profit margin.

Choice "c" is incorrect. This option defines residual income.

Choice "d" is incorrect. This option defines total asset turnover.

**QUESTION 520**

Limitations of the information provided by total asset turnover include:

- A. A good measure for trend analysis of a particular company, but variable ways of calculating cost of goods sold limit its usefulness for comparative analysis.
- B. The calculation can be affected by varying accounting assumptions, which affect the calculation of net income.
- C. Because of differing costs of capital, the measure cannot be effectively used for comparative analysis.
- D. When making the calculation, total assets may need to be refined by the elimination of assets that do not relate to sales as the inclusion of these items could distort the measure.

**Correct Answer: D**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. When calculating the turnover, total assets may need to be refined by the elimination of assets that do not relate to sales as the inclusion of these items could distort the measure. Choice "a" is incorrect. This option pertains to gross profit margin.

Choice "b" is incorrect. This option pertains to return on the investment in assets. Choice

"c" is incorrect. This option pertains to residual income.

**QUESTION 521**

Of the following items, the one item that would not be considered in evaluating the adequacy of the budgeted annual operating income for a company is:

- A. Return on assets.
- B. Long-range profit objectives.
- C. Industry average for earnings on sales.
- D. Internal rate of return.

**Correct Answer: D**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. In evaluating the adequacy of the budgeted annual operating income, you would not use the internal rate of return calculation. The internal rate of return is used for capital budgeting.

Choices "a", "b", and "c" are incorrect. Return on assets, long range profit objectives, industry average for earnings on sales, and earnings per share [not mentioned as an option] are all measures for evaluating the adequacy of the budgeted annual operating income.

**QUESTION 522**

The selection of the denominator in the return on investment (ROI) formula is critical to the measure's effectiveness. Which denominator is criticized because it combines the effects of operating decisions made at one level of the organization with financing decisions made at another organization level?

- A. Total assets available.
- B. Total assets employed.
- C. Working capital plus other assets.
- D. Shareholder's equity.

**Correct Answer: D**



**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Shareholders' equity is the ROI denominator that has been criticized because it combines the effects of operating decisions made at another organization level. Choices "a", "b", and "c" are incorrect, per the above Explanation.

**QUESTION 523**

Micro Manufacturers uses a performance reporting system that combines both financial and nonfinancial measures to evaluate division performance. All of the following measure operational efficiency, except:

- A. Operating leverage.
- B. Days' sales in accounts receivables.
- C. Inventory turnover.
- D. Residual income.

**Correct Answer: D**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "d" is correct. Residual income measures profitability in excess of a target rate of return. Operational efficiency is not considered.

Choices "a", "b", and "c" are incorrect. Operating leverage, days' sales in accounts receivable, and inventory are all measures of operational efficiency, specifically, efficiency in managing working capital.

**QUESTION 524**

Managerial performance can be measured in many different ways including return on investment (ROI) and residual income (RI). A good reason for using RI instead of ROI is that:

- A. RI can be computed without regard to identifying an investment base.
- B. Goal congruence is more likely to be promoted by using RI.
- C. RI is well understood and often used in the financial press.
- D. ROI does not take into consideration both the investment turnover ratio and return-on-sales percentage.

**Correct Answer: B**

**Section: Volume D**

**Explanation**

**Explanation/Reference:**

Explanation:

Choice "b" is correct. Goal congruence is promoted through the use of the residual income approach. The ROI approach may cause segments that achieve high returns to reject investments that may benefit the company but lower the segment's rate of return.

Choices "a", "c", and "d" are incorrect, per the above Explanation.

**QUESTION 525**

The imputed interest rate used in the residual income approach to performance evaluation can best be described as the:

- A. Historical weighted average cost of capital for the company.
- B. Target return on investment set by the company's management.
- C. Average return on investments for the company over the last several years.
- D. Marginal after-tax cost of capital on new equity capital.

**Correct Answer: B**

**Section: Volume D**

**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. The imputed interest rate used in the residual income approach can best be described as the target return on investment set by the company's management.

Choice "a" is incorrect, but it is a close second. The historical weighted average cost of capital may be how management sets the target return on investment.

Choice "c" is incorrect. The average return on investments for past years may not be a good indication of management's future intentions. Choice

"d" is incorrect. Marginal after-tax cost of capital on new equity may be how management sets its targets, but it may not be, too.

**QUESTION 526**

One approach to measuring divisional performance is return on investment. Return on investment is expressed as operating income:

- A. Divided by the current year's capital expenditures plus cost of capital.
- B. Divided by fixed assets.
- C. Divided by current assets.
- D. Divided by total assets.

**Correct Answer: D****Section: Volume D****Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Return on investment is operating income divided by total assets.

Choice "a" is incorrect. Current year's capital expenditures plus cost of capital would be a meaningless denominator.

Choice "b" is incorrect. This omits the current assets employed by the division. Choice "c" is incorrect. This omits fixed assets.

**QUESTION 527**

The following selected data pertain to the Darwin Division of Beagle Co. for 1994:

Sales	\$400,000
Operating income	40,000
Capital turnover	4
Imputed interest rate	10%

What was Darwin's 1994 residual income?

- A. \$0
- B. \$4,000
- C. \$10,000
- D. \$30,000

**Correct Answer: D****Section: Volume D****Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Residual income is income less the imputed interest rate times average invested capital. Capital turnover is equal to sales / average invested capital.

$$\begin{aligned}
 \text{Average invested capital} &= (\$400,000 \div 4) \\
 &= \$100,000 \\
 \text{Residual income} &= \$40,000 - (10\% \times \$100,000) \\
 &= \underline{\underline{\$30,000}}
 \end{aligned}$$

Choice "a" is incorrect. Residual income is greater than zero. The imputed interest rate times average invested capital needs to be compared with operating income.

Choice "b" is incorrect. Residual income is not simply the imputed interest rate times operating income.

The imputed interest rate times average invested capital needs to be compared with operating income.

Choice "c" is incorrect. Residual income is not simply imputed interest rate times average invested capital. The operating income must be considered.

#### QUESTION 528

Select Co. had the following 1994 financial statement relationships:

Asset turnover 5

Profit margin on sales 0.02

What was Select's 1994 percentage return on assets?

- A. 0.1 percent.
- B. 0.4 percent.
- C. 2.5 percent.
- D. 10.0 percent.

**Correct Answer:** D

**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "d" is correct. Return on assets equals income divided by average assets. This formula can be further divided into the components of profit margin times asset turnover (referred to as the Dupont formula):

$$\frac{\text{Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Average Assets}}$$

$$\text{Return on assets} = 0.02 \times 5 = 10\%$$

Choices "a", "b", and "c" are incorrect, per the above calculation.

#### QUESTION 529

The following information pertains to Quest Co.'s Gold Division for 1993:

Sales	\$311,000
Variable cost	250,000
Traceable fixed costs	50,000
Average invested capital	40,000
Imputed interest rate	10%

Quest's return on investment was:

- A. 10.00 percent.
- B. 13.33 percent.
- C. 27.50 percent.
- D. 30.00 percent.

**Correct Answer:** C  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "c" is correct. Return on investment equals net income divided by average invested capital:

$$\begin{aligned}
 \text{ROI} &= \text{Net income} / \text{Average invested capital} \\
 &= (\$311,000 - \$250,000 - \$50,000) / \$40,000 \\
 &= \$11,000 / \$40,000 \\
 &= 27.5\%
 \end{aligned}$$

Choices "a", "b", and "d" are incorrect, per the above calculation.

#### QUESTION 530

Williams, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

- Williams can raise cash by selling \$1,000, 8 percent, 20-year bonds with annual interest payments.

In selling the issue, an average premium of \$30 per bond would be received, and the firm must pay flotation costs of \$30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.

- Williams can sell 8 percent preferred stock at par value, \$105 per share. The cost of issuing and selling the preferred stock is expected to be \$5 per share.
- Williams' common stock is currently selling for \$100 per share. The firm expects to pay cash dividends of \$7 per share next year, and the dividends are expected to remain constant. The stock will have to be underpriced by \$3 per share, and flotation costs are expected to amount to \$5 per share.
- Williams expects to have available \$100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.
- Williams' preferred capital structure is:

Long-term debt 30%

Preferred stock 20

Common stock 50

The cost of funds from retained earnings for Williams, Inc. is:

- A. 7.0 percent.
- B. 7.4 percent.
- C. 8.1 percent.
- D. 7.8 percent.

**Correct Answer:** A  
**Section:** Volume D

#### Explanation

#### Explanation/Reference:

Explanation:

Choice "a" is correct. 7.0 percent cost of funds from retained earnings.

The cost of retained earnings is equal to the rate of return required by the firm's common shareholders (or, in effect, the return "lost" by them when the firm chooses to fund with retained earnings). While oftentimes this rate is somewhat subjective, we are given the facts to exactly answer the question in this case. The stock is currently selling for \$100/share, and the dividend is given at \$7/share.  $\$7 / \$100 = 7\%$

Choices "b", "c", and "d" are incorrect, per the above Explanation/calculation.