BUSINESS-ENVIRONMENT-AND-CONCEPTS Q&As

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QUESTION 1

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-oftax contribution margin of:

A. $242,624

B. $303,280

C. $363,936

D. $454,920

Correct Answer: D

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%					80,000	
Net-of-tax contribution margin					120,000	
PV of annuity for 5 years					x 3.791	
Discounted net-of-tax contribution margin					$454,920	

Choices "a", "b", and "c" are incorrect based on the above Explanation.

QUESTION 2

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

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 3

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

Choice "d" is correct. Convertible bonds. Temporarily idle cash should be inverted 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 4

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

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.

For example:	Before Change	Change	After Change
Current assets	$500,000	120,000	620,000
Current liabilities	$300,000	(50,000)	250,000
Net working capital	$200,000		370,000

Therefore, working capital has increased $170,000.

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

QUESTION 5

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.

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- 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.

Present	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 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

Choice "c" is correct. $(13,265) overall discounted cash flow impact of working capital investment.

Period	Cash Flow		PV Interest Factor		PV of Cash Flow	
0	35,000	×	1,000	=	(35,000)	PV of cash outflow (increase in working capital) in year 1
5	35,000	×	(.621)	=	21,735	PV of cash inflow release of working capital) in year 5
					(13,265)	Overall discounted cash flow impact of working capital investment

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