

BUSINESS ENVIRONMENT & CONCEPTS

CPA2904US2-39

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ABOUT UPDATING SUPPLEMENT VERSION 39.2

Information that is only six months old is eligible to be tested on the CPA exam. Candidates with the 39th edition and corresponding software (version 13 series) will find the information in the version 39.2 updating supplement more than adequate for the October-November 2010 exam window and later exam windows.

When new information first becomes available, the examiners tend to test new or changed portions of concepts lightly. Coverage of information after that point may increase, if it is in a heavily tested area. Do not fall into the trap of attaching undue significance to new information merely because it is new.

Remember, with the information and techniques in our material, passing the exam is an attainable goal. **Adhere to a reasonable study plan—and pass the first time!**

STUDY OPTIONS AVAILABLE TO CANDIDATES

As every candidate's needs are different, Bisk Education offers a variety of CPA Review formats and packages that are guaranteed* to help you pass the CPA exam on your next sitting. Options include: our Online CPA Review with structured Internet classes and our self-study CPA Review utilizing multimedia CD-ROM software, video programs, audio lectures, and books.

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OTHER SOURCES OF INFORMATION FOR CANDIDATES

Candidates choosing to use previous editions of our books must accept responsibility for adequately updating their materials. Candidates should consider the strain that this will add to the already time-consuming process of studying for the exam. Candidates with the 38th edition and corresponding software also will want Updating Supplement Version 38.3. Material in the earlier updating supplements is incorporated within the 39th edition, and the corresponding version 13 series software, as appropriate.

Candidates with editions earlier than the 38th are strongly encouraged to purchase new materials. At a minimum, these candidates should read the supplements pertaining to the edition that they have. Each supplement has information on the appropriate supplements for the edition previous to the one it updates. Candidates choosing to use previous editions of our books must accept responsibility for adequately updating their materials. Candidates should consider the strain that this will add to the already time-consuming process of studying for the exam. Material in the related updating supplements may be reviewed to determine the nature and quantity of information that has changed from one edition to another.

NEW AICPA EXAMINATION WEB SITE

In May, 2010, the AICPA examiners changed their web site to 'http://www.aicpa.org/BecomeACPA/CPAExam/Pages/CPAExam.aspx.' Browsers set to www.cpa.exam.org are re-directed to the new address.

WRITTEN COMMUNICATIONS

There will be no simulations or written communications in the BEC section in the 2010 exam windows.

The AICPA examiners will add written communication questions to the BEC exam starting in 2011.

The AICPA plans to post on its website a tutorial and sample exam in October, 2010, which will include written communication questions and how they will be structured and graded.

CONTENT SPECIFICATION OUTLINE

The Content Specification Outline (CSO) for the Uniform CPA Examination has been updated by the Board of Examinations Team with an effective date of January 1, 2011. It has no effect on the 2010 examinations.

The new CSO is available at the AICPA exam site '<http://www.aicpa.org/BecomeACPA/CPAExam/Pages/CPAExam.aspx>,' and reflects the following changes:

1. Business Structure will be moved from the BEC section to the REG section of the examination.
2. Corporate Governance will be added to the BEC topics.
3. Planning and Measurement will be split into the two topics of Strategic Planning and Operations Management.

The following is the updated Content Specification Outline that is pertinent for the BEC portion of the CPA Examinations.

BUSINESS ENVIRONMENT & CONCEPTS

- | | |
|---|---|
| <p>I. Corporate Governance (16% - 20%)</p> <p>A. Rights, Duties, Responsibilities, and Authority of the Board of Directors, Officers, and Other Employees</p> <ol style="list-style-type: none"> 1. Financial reporting 2. Internal control (including COSO or similar framework) 3. Enterprise risk management (including COSO or similar framework) <p>B. Control Environment</p> <ol style="list-style-type: none"> 1. Tone at the top—establishing control environment 2. Monitoring control effectiveness 3. Change control process | <p>II. Economic Concepts and Analysis (16% - 20%)</p> <p>A. Changes in Economic and Business Cycles—Economic Measures/Indicators</p> <p>B. Globalization and Local Economies</p> <ol style="list-style-type: none"> 1. Impacts of globalization on companies 2. Shifts in economic balance of power (e.g., capital) to/from developed from/to emerging markets <p>C. Market Influences on Business Strategies</p> <p>D. Financial Risk Management</p> <ol style="list-style-type: none"> 1. Market, interest rate, currency, liquidity, credit, price, and other risks 2. Means for mitigating/controlling financial risks |
|---|---|

III. Financial Management (19% - 23%)

- A. Financial Modeling, Projections, and Analysis
 - 1. Forecasting and trends
 - 2. Financial and risk analysis
 - 3. Impact of inflation/deflation
- B. Financial Decisions
 - 1. Debt, equity, leasing
 - 2. Asset and investment management
- C. Capital Management, including Working Capital
 - 1. Capital structure
 - 2. Short-term and long-term financing
 - 3. Asset effectiveness and/or efficiency
- D. Financial Valuations (e.g., Fair Value)
 - 1. Methods for calculating valuations
 - 2. Evaluating assumptions used in valuations
- E. Financial Transaction Processes and Controls

IV. Information Systems and Communications (15% - 19%)

- A. Organizational Needs Assessment
 - 1. Data capture
 - 2. Processing
 - 3. Reporting
 - 4. Role of information technology in business strategy
- B. Systems Design and other Elements
 - 1. Business process design (integrated systems, automated, and manual interfaces)
 - 2. Information Technology (IT) control objectives
 - 3. Role of technology systems in control monitoring
 - 4. Operational effectiveness
 - 5. Segregation of duties
 - 6. Policies
- C. Security
 - 1. Technologies and security management features
 - 2. Policies

D. Internet—Implications for Business

- 1. Electronic commerce
- 2. Opportunities for business process reengineering
- 3. Roles of internet evolution on business operations and organization cultures

E. Types of Information System and Technology Risks**F. Disaster Recovery and Business Continuity****V. Strategic Planning (10% - 14%)**

- A. Market and Risk Analysis
- B. Strategy Development, Implementation, and Monitoring
- C. Planning Techniques
 - 1. Budget and analysis
 - 2. Forecasting and projection
 - 3. Coordinating information from various sources for integrated planning

VI. Operations Management (12% - 16%)

- A. Performance Management and Impact of Measures on Behavior
 - 1. Financial and nonfinancial measures
 - 2. Impact of marketing practices on performance
 - 3. Incentive compensation
- B. Cost Measurement Methods and Techniques
- C. Process Management
 - 1. Approaches, techniques, measures, and benefits to process-management-driven businesses
 - 2. Roles of shared services, outsourcing, and off-shore operations, and their implications on business risks and controls
 - 3. Selecting and implementing improvement initiatives
 - 4. Business process reengineering
 - 5. Management philosophies and techniques for performance improvement such as Just in Time (JIT), Quality, Lean, Demand Flow, Theory of Constraints, and Six Sigma

D. Project Management

1. Project planning, implementation, and monitoring
 2. Roles of project managers, project members, and oversight or steering groups
 3. Project risks, including resource, scope, cost, and deliverables
-

ERRATA

The following errors are in the 39th edition book. If you find other items that you believe are ambiguous or in error, please contact the Bisk Education editors (editor@cpaexam.com) with details.

Chapter 50 - Economic Theory

Page 50-39, section D. 1. c. should read as follows:

Interest & Dividends Total interest and dividends received (credit) within a country on investments outside of a country, offset by total interest and dividends paid (debit) outside a country on investments by foreign entities within a country.

Chapter 51 - Financial Management

Page 51-88, Answer to question 57: The answer should read as follows:

57. (b) Since the company is required to keep \$100,000 in the checking account as a compensating balance, then it is incurring a $\$500,000 \times 8\% = \$40,000$ interest cost on \$400,000 of accessible money. Therefore, the effective interest rate is the interest cost (\$40,000) divided by the principal (\$400,000) = 10%.

Appendix E

Page E-15, Answer to question 10: The answer should read as follows:

10. (d) Jackue Co. needs to order enough wheels to produce the 180,000 pairs sold in January and another 25,000 (10% of Feb production) pairs. $180,000 + 25,000 = 205,000$ pairs of skates $\times 8$ wheels per skate = 1,640,000 wheels. Answers (a) & (b) reflect numbers of pairs of skates, not numbers of wheels. (Chapter 54-3-2, CBT Skill: Analysis, CSO: 3.1.1)

RECENTLY RELEASED AICPA QUESTIONS

In April, 2010, the AICPA released several questions labeled as "Year 2010 Disclosed Questions." Respectively, the BEC questions and the related unofficial solutions are reproduced here, along with the exclusive Bisk Education explanations. The AICPA did not state whether these questions were used on an exam. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is extremely unlikely that released questions will appear on future examinations.

Unlike some other releases, the AICPA made no reference to a difficulty rating for these questions.

Problem 1

1. Under the Revised Uniform Limited Partnership Act, which of the following is true regarding limited partnerships?
 - a. A limited partnership has no general partners.
 - b. General partnerships may not be converted to limited liability partnerships because they must be terminated first.
 - c. The limited partners may not participate in the management of the company.
 - d. Official formation is not necessary for a limited partnership other than two or more people carrying on as co-owners of a business for profit. (R/10, BEC, C03516BR1, #1, 9451)

2. Terry recently started a new business and is trying to decide what type of entity to form. Terry is part owner and is active in running the business. What type of entity would best protect Terry, as one of the owners, from personal liability?
 - a. General partnership
 - b. Limited partnership
 - c. Joint venture
 - d. Limited liability company (R/10, BEC, A0355B, #2, 9452)

3. Which of the following is a characteristic of a C corporation?
 - a. Includes most privately held businesses
 - b. Pays taxes on profits after paying dividends to shareholders
 - c. Subject to double taxation on profits if dividends are paid
 - d. Must have only one class of stock (R/10, BEC, C00382B, #3, 9453)

4. Which of the following is considered a corporate equity security?
 - a. A shareholder's preemptive right
 - b. A shareholder's appraisal right
 - c. A callable bond
 - d. A share of callable preferred stock (R/10, BEC, 0305L, #4, 9454)

5. Which of the following statements generally is correct regarding a general partner in a general partnership as compared to a general partner in a limited partnership?
 - a. A general partner in a general partnership has greater rights and powers than a general partner in a limited partnership.
 - b. A general partner in a general partnership has greater liability than a general partner in a limited partnership.
 - c. A general partner in a general partnership and a general partner in a limited partnership have the same rights and powers.
 - d. A general partner in a general partnership has rights and powers provided by articles of partnership, while a general partner in a limited partnership has rights and powers provided by statute. (R/10, BEC, 5043L, #5, 9455)

6. Which of the following economic terms describes a general decline in prices for goods and services and in the level of interest rates?
- Expansion
 - Inflation
 - Deflation
 - Recession
- (R/10, BEC, A1929B, #6, 9456)
7. The primary purpose of the consumer price index (CPI) is to
- Establish a cost-of-living index
 - Identify the strength of an economic recovery
 - Help determine the Federal Reserve Bank's discount rate
 - Compare relative price changes over time
- (R/10, BEC, A0522B, #7, 9457)
8. Carter Co. paid \$1,000,000 for land three years ago. Carter estimates it can sell the land for \$1,200,000, net of selling costs. If the land is not sold, Carter plans to develop the land at a cost of \$1,500,000. Carter estimates net cash flow from the development in the first year of operations would be \$500,000. What is Carter's opportunity cost of the development?
- \$1,500,000
 - \$1,200,000
 - \$1,000,000
 - \$ 500,000
- (R/10, BEC, A1607B, #8, 9458)
9. What is the formula for calculating the profitability index of a project?
- Subtract actual after-tax net income from the minimum required return in dollars
 - Divide the present value of the annual after-tax cash flows by the original cash invested in the project
 - Divide the initial investment for the project by the net annual cash inflow
 - Multiply net profit margin by asset turnover
- (R/10, BEC, A2323B, #9, 9459)
10. Which of the following statements is correct regarding the weighted-average cost of capital (WACC)?
- One of a company's objectives is to minimize the WACC.
 - A company with a high WACC is attractive to potential shareholders.
 - An increase in the WACC increases the value of the company.
 - WACC is always equal to the company's borrowing rate.
- (R/10, BEC, A1795B, #10, 9460)
11. An increase in which of the following should cause management to reduce the average inventory?
- The cost of placing an order
 - The cost of carrying inventory
 - The annual demand for the product
 - The lead time needed to acquire inventory
- (R/10, BEC, 0103M, #11, 9461)
12. Which of the following ratios would most likely be used by management to evaluate short-term liquidity?
- Return on total assets
 - Sales to cash
 - Accounts receivable turnover
 - Acid test ratio
- (R/10, BEC, C00482B, #12, 9462)
13. Which of the following ratios would be used to evaluate a company's profitability?
- Current ratio
 - Inventory turnover ratio
 - Debt to total assets ratio
 - Gross margin ratio
- (R/10, BEC, A2794B, #13, 9463)

14. When a client's accounts payable computer system was relocated, the administrator provided support through a dial-up connection to a server. Subsequently, the administrator left the company. No changes were made to the accounts payable system at that time. Which of the following situations represents the greatest security risk?
- User passwords are not required to be in alpha-numeric format.
 - Management procedures for user accounts are not documented.
 - User accounts are not removed upon termination of employees.
 - Security logs are not periodically reviewed for violations.
- (R/10, BEC, ZA0516B, #14, 9464)
15. An entity doing business on the Internet most likely could use any of the following methods to prevent unauthorized intruders from accessing proprietary information except
- Password management
 - Data encryption
 - Digital certificates
 - Batch processing
- (R/10, BEC, 1330A, #15, 9465)
16. Which of the following information technology (IT) departmental responsibilities should be delegated to separate individuals?
- Network maintenance and wireless access
 - Data entry and antivirus management
 - Data entry and application programming
 - Data entry and quality assurance
- (R/10, BEC, A3666B, #16, 9466)
17. Which of the following transaction processing modes provides the most accurate and complete information for decision making?
- Batch
 - Distributed
 - Online
 - Application
- (R/10, BEC, A2471B, #17, 9467)
18. Which of the following is considered an application input control?
- Run control total
 - Edit check
 - Report distribution log
 - Exception report
- (R/10, BEC, A3943B, #18, 9468)
19. Which of the following terms refers to a site that has been identified and maintained by the organization as a data processing disaster recovery site but has not been stocked with equipment?
- Hot
 - Cold
 - Warm
 - Flying start
- (R/10, BEC, A2342B, #19, 9469)
20. Relevant information for material A follows:
- | | |
|---------------------------|------------|
| Actual quantity purchased | 6,500 lbs. |
| Standard quantity allowed | 6,000 lbs. |
| Actual price | \$3.80 |
| Standard price | \$4.00 |
- What was the direct material quantity variance for material A?
- \$2,000 favorable
 - \$1,900 favorable
 - \$1,900 unfavorable
 - \$2,000 unfavorable
- (R/10, BEC, C05098B, #20, 9470)

21. Smart Co. uses a static budget. When actual sales are less than budget, Smart would report favorable variances on which of the following expense categories?

	<u>Sales commissions</u>	<u>Building rent</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

(R/10, BEC, A0410B, #21, 9471)

22. An increase in production levels within a relevant range most likely would result in

- a. Increasing the total cost
- b. Increasing the variable cost per unit
- c. Decreasing the total fixed cost
- d. Decreasing the variable cost per unit

(R/10, BEC, A1574B, #22, 9472)

23. A CPA would recommend implementing an activity-based costing system under which of the following circumstances?

- a. The client is a single-product manufacturer.
- b. Most of the client's costs currently are classified as direct costs.
- c. The client produced products that heterogeneously consume resources.
- d. The client produced many different products that homogeneously consume resources.

(R/10, BEC, C03886B, #23, 9473)

24. A company that produces 10,000 units has fixed costs of \$300,000, variable costs of \$50 per unit, and a sales price of \$85 per unit. After learning that its variable costs will increase by 20%, the company is considering an increase in production to 12,000 units. Which of the following statements is correct regarding the company's next steps?

- a. If production is increased to 12,000 units, profits will increase by \$50,000.
- b. If production is increased to 12,000 units, profits will increase by \$100,000.
- c. If production remains at 10,000 units, profits will decrease by \$50,000.
- d. If production remains at 10,000 units, profits will decrease by \$100,000.

(R/10, BEC, A4111B, #24, 9474)

25. A delivery company is implementing a system to compare the costs of purchasing and operating different vehicles in its fleet. Truck 415 is driven 125,000 miles per year at a variable cost of \$0.13 per mile. Truck 415 has a capacity of 28,000 pounds and delivers 250 full loads per year. What amount is the truck's delivery cost per pound?

- a. \$0.00163 per pound
- b. \$0.00232 per pound
- c. \$0.58036 per pound
- d. \$1.72000 per pound

(R/10, BEC, A3968B, #25, 9475)

Problem 2

26. Which of the following disqualifies an entity from an S corporation election?
- Seventy-seven individual shareholders (including four married couples)
 - An estate shareholder
 - A 501(c)(3) exempt organization shareholder
 - A nonresident alien shareholder
- (R/10, BEC, A0052T, #26, 9576)
27. Davis, an inventor, developed a new product, but lacked money to get the product to the marketplace. Before creating a corporation to raise capital, Davis leased office space and equipment, entered into contracts with third parties, and identified investors. Who has liability for pre-incorporation debts?
- Davis is liable until the corporation assumed the debts in novation.
 - Davis is liable until the articles of incorporation were filed.
 - If this corporation is never formed, Davis is not liable.
 - If this corporation is never formed, the unpaid third parties must write off the debt because no corporate entity existed at the time debt was incurred.
- (R/10, BEC, A0352B, #27, 9477)
28. Frey Corp. has 1,000 shares of issued and outstanding common stock. Frey's articles of incorporation permit a stockholder who owns 5% or more of the outstanding stock or who has owned the stock for longer than six months to inspect Frey's books and records. Ace, who has owned 25 shares of Frey stock for four months, wants to inspect the books and records. Under the Revised Model Business Corporation Act, which of the following statements is correct regarding Ace's right to inspect the books and records?
- Ace must wait two months before being allowed to inspect the books and records.
 - Ace must purchase an additional 25 shares of Frey stock before being allowed to inspect the books and records.
 - Ace may, after giving five days' written notice, inspect the books and records to determine the value of Frey stock.
 - Ace may, after giving five days' written notice, inspect the books and records to provide a list of Frey stockholders to Ace's broker.
- (R/10, BEC, 0514L, #28, 9478)
29. Which of the following corporate shareholder rights is enforceable by means of a derivative suit?
- Compelling payment of properly declared dividends
 - Enforcing access to corporate records
 - Recovering damages from a third party
 - Protecting preemptive rights
- (R/10, BEC, 5222L, #29, 9479)
30. Toby invested \$25,000 in a limited partnership with Connor and Blair. Toby was a general partner in the limited partnership. The partnership failed to pay Kelly \$45,000 for services on behalf of the partnership. Which of the following statements is generally correct regarding Toby's liability under the Revised Uniform Limited Partnership Act?
- Toby was liable for \$25,000 because this was a limited partnership.
 - Toby was liable for zero because this was a partnership debt, not a personal debt.
 - Toby was liable for \$45,000 because Toby was a general partner.
 - Toby was liable for \$15,000 because this was a limited partnership.
- (R/10, BEC, 5433L, #30, 9480)
31. Which of the following is an assumption in a perfectly competitive financial market?
- No single trader or traders can have a significant impact on market prices.
 - Some traders can impact market prices more than others.
 - Trading prices vary based on supply only.
 - Information about borrowing/lending activities is only available to those willing to pay market prices.
- (R/10, BEC, C00962B, #31, 9481)

32. A country's currency conversion value has recently changed from 1.5 to the U.S. dollar to 1.7 to the U.S. dollar. Which of the following statements about the country is correct?
- Its exports are less expensive for the United States.
 - Its currency has appreciated.
 - Its imports of U.S. goods are more affordable.
 - Its purchases of the U.S. dollar will cost less.

(R/10, BEC, C01853B, #32, 9482)

33. Salem Co. is considering a project that yields annual net cash inflows of \$420,000 for years 1 through 5, and a net cash inflow of \$100,000 in year 6. The project will require an initial investment of \$1,800,000. Salem's cost of capital is 10%. Present value information is presented below:

Present value of \$1 for 5 years at 10% is .62.

Present value of \$1 for 6 years at 10% is .56.

Present value of an annuity of \$1 for 5 years at 10% is 3.79.

What was Salem's expected net present value for this project?

- \$ 83,000
- \$(108,200)
- \$(152,200)
- \$(442,000)

(R/10, BEC, 0356M, #33, 9483)

34. SkBound Airlines provided the following information about its two operating divisions:

	<u>Passenger</u>	<u>Cargo</u>
Operating profit	\$ 40,000	\$ 50,000
Investment	\$250,000	500,000
External borrowing rate	6%	8%

Measuring performance using return on investment (ROI), which division performed better?

- The Cargo division, with an ROI of 10%
- The Passenger division, with an ROI of 16%
- The Cargo division, with an ROI of 18%
- The Passenger division, with an ROI of 22%

(R/10, BEC, C00991B, #34, 9484)

35. Egan Co. owns land that could be developed in the future. Egan estimates it can sell the land for \$1,200,000, net of all selling costs. If it is not sold, Egan will continue with its plans to develop the land. As Egan evaluates its options for development or sale of the property, what type of cost would the potential selling price represent in Egan's decision?

- Sunk
- Opportunity
- Future
- Variable

(R/10, BEC, A1606B, #35, 9485)

36. Which of the following statements is correct regarding the payback method as a capital budgeting technique?

- The payback method considers the time value of money.
- An advantage of the payback method is that it indicates if an investment will be profitable.
- The payback method provides the years needed to recoup the investment in a project.
- Payback is calculated by dividing the annual cash inflows by the net investment.

(R/10, BEC, A1001B, #36, 9486)

37. Larson Corp. issued \$20 million of long-term debt in the current year. What is a major advantage to Larson with the debt issuance?

- The reduced earnings per share possible through financial leverage
- The relatively low after-tax cost due to the interest deduction
- The increased financial risk resulting from the use of the debt
- The reduction of Larson's control over the company

(R/10, BEC, A1195B, #37, 9487)

38. Green, Inc., a financial investment-consulting firm, was engaged by Maple Corp. to provide technical support for making investment decisions. Maple, a manufacturer of ceramic tiles, was in the process of buying Bay, Inc., its prime competitor. Green's financial analyst made an independent detailed analysis of Bay's average collection period to determine which of the following?
- Financing
 - Return on equity
 - Liquidity
 - Operating profitability
- (R/10, BEC, C03695B, #38, 9488)
39. Which of the following items would be most critical to include in a systems specification document for a financial report?
- Cost-benefit analysis
 - Data elements needed
 - Training requirements
 - Communication change management considerations
- (R/10, BEC, A3137B, #39, 9489)
40. An enterprise resource planning (ERP) system has which of the following advantages over multiple independent functional systems?
- Modifications can be made to each module without affecting other modules
 - Increased responsiveness and flexibility while aiding in the decision-making process
 - Increased amount of data redundancy since more than one module contains the same information
 - Reduction in costs for implementation and training
- (R/10, BEC, A3134B, #40, 9490)
41. Which of the following structures refers to the collection of data for all vendors in a relational data base?
- Record
 - Field
 - File
 - Byte
- (R/10, BEC, A2649B, #41, 9491)
42. During the annual audit, it was learned from an interview with the controller that the accounting system was programmed to use a batch processing method and a detailed posting type. This would mean that individual transactions were
- Posted upon entry, and each transaction had its own line entry in the appropriate ledger
 - Assigned to groups before posting, and each transaction had its own line entry in the appropriate ledger
 - Posted upon entry, and each transaction group had a cumulative entry total in the appropriate ledger
 - Assigned to groups before posting, and each transaction group had a cumulative entry total in the appropriate ledger
- (R/10, BEC, C03447B, #42, 9492)
43. A company has a significant e-commerce presence and self-hosts its web site. To assure continuity in the event of a natural disaster, the firm should adopt which of the following strategies?
- Backup the server database daily
 - Store records off-site
 - Purchase and implement RAID technology
 - Establish off-site mirrored web server
- (R/10, BEC, A2028B, #43, 9493)
44. Which of the following is the primary advantage of using a value-added network (VAN)?
- It provides confidentiality for data transmitted over the Internet.
 - It provides increased security for data transmissions.
 - It is more cost effective for the company than transmitting data over the Internet.
 - It enables the company to obtain trend information on data transmissions.
- (R/10, BEC, A3882B, #44, 9494)

45. Wexford Co. has a subunit that reported the following data for year 1:

Asset (investment) turnover	1.5 times
Sales	\$750,000
Return on sales	8%

The imputed interest rate is 12%. What is the division residual income for year 1?

- a. \$60,000
- b. \$30,000
- c. \$20,000
- d. \$0

(R/10, BEC, A4850B, #45, 9495)

46. The target capital structure of Traggle Co. is 50% debt, 10% preferred equity, and 40% common equity. The interest rate on debt is 6%, the yield on the preferred is 7%, the cost of common equity is 11.5%, and the tax rate is 40%. Traggle does not anticipate issuing any new stock. What is Traggle's weighted-average cost of capital?

- a. 6.50%
- b. 6.77%
- c. 7.10%
- d. 8.30%

(R/10, BEC, A4749B, #46, 9496)

47. Galax, Inc. had operating income of \$5,000,000 before interest and taxes. Galax's net book value of plant assets at January 1 and December 31 were \$22,000,000 and \$18,000,000, respectively. Galax achieved a 25 percent return on investment for the year, with an investment turnover of 2.5. What were Galax's sales for the year?

- a. \$55,000,000
- b. \$50,000,000
- c. \$45,000,000
- d. \$20,000,000

(R/10, BEC, 0258M, #47, 9497)

48. Management has reviewed the standard cost variance analysis and is trying to explain an unfavorable labor efficiency variance of \$8,000. Which of the following is the most likely cause of the variance?

- a. The new labor contract increased wages.
- b. The maintenance of machinery has been inadequate for the last few months.
- c. The department manager has chosen to use highly skilled workers.
- d. The quality of raw materials has improved greatly.

(R/10, BEC, 0202M, #48, 9498)

49. Boyle, Inc. makes two products, X and Y, that require allocation of indirect manufacturing costs. The following data was compiled by the accountant before making any allocations:

	<u>Product X</u>	<u>Product Y</u>
Quantity produced	10,000	20,000
Direct manufacturing labor hours	15,000	5,000
Setup hours	500	1,500

The total cost of setting up manufacturing processes and equipment is \$400,000. The company uses a job-costing system with a single indirect cost rate. Under this system, allocated costs were \$300,000 and \$100,000 for X and Y, respectively. If an activity-based system is used, what would be the allocated costs for each product?

- | | <u>Product X</u> | <u>Product Y</u> |
|----|------------------|------------------|
| a. | \$100,000 | \$300,000 |
| b. | \$150,000 | \$250,000 |
| c. | \$200,000 | \$200,000 |
| d. | \$250,000 | \$150,000 |

(R/10, BEC, C01105B, #49, 9499)

50. A company is offered a one-time special order for its product and has the capacity to take this order without losing current business. Variable costs per unit and fixed costs in total will be the same. The gross profit for the special order will be 10%, which is 15% less than the usual gross profit. What impact will this order have on total fixed costs and operating income?
- Total fixed costs increase, and operating income increases.
 - Total fixed costs do not change, and operating income increases.
 - Total fixed costs do not change, and operating income does not change.
 - Total fixed costs increase, and operating income decreases. (R/10, BEC, A4076B, #50, 9500)
-

Problem 3

The following two questions on corporate governance were released by the AICPA examiners. They do not represent previous exam questions and will not be on any 2010 examinations. This subject matter does not appear in the 39th edition textbook as it is not tested under the current CSO, but will be included in the 40th edition textbook.

51. According to Sarbanes-Oxley Act of 2002, which of the following statements is correct regarding an issuer's audit committee financial expert?
- The issuer's current outside CPA firm's audit partner must be the audit committee financial expert.
 - If an issuer does not have an audit committee financial expert, the issuer must disclose the reason why the role is not filled.
 - The issuer must fill the role with an individual who has experience in the issuer's industry.
 - The audit committee financial expert must be the issuer's audit committee chairperson to enhance internal control. (R/10, BEC, A6288B, #51, 9449)
52. According to COSO, which of the following components of enterprise risk management addresses an entity's integrity and ethical values?
- Information and communication
 - Internal environment
 - Risk assessment
 - Control activities (R/10, BEC, A6303B, #52, 9450)
-

Solution 1

1. (c) Under the Revised Uniform Limited Partnership Act (RULPA), a limited partner may not participate in the management of the company. If limited partners participate in the management of the company, they are subject to the unlimited liability a general partner. RULPA also dictates that a limited partnership must have one or more general partners who have unlimited liability. A general partnership may convert to a limited partnership without terminating first, but formation of a limited partnership must be done in accordance with strict statutory requirements, including having a written certificate filed with the Secretary of State. (Bisk 48-6-1, CSO: 1.2.0)

2. (d) A limited liability company would provide Terry with limited liability (limited to the amount of his investment in the company) and still allow him to be a part owner and actively participate in running the business. A general partnership, a joint venture, or a limited partnership (since Terry is actively running the business and, therefore, has the same liability as a general partner) would not protect Terry as he would be subject to unlimited liability. (Bisk 48-7-1, CSO: 1.1.2)

3. (c) C corporations pay taxes on profits before paying dividends to shareholders. Then the shareholders often must also pay taxes on those dividends. This is known as double taxation. C corporation may have several classes of stock, including common stock, voting stock, non-voting stock, preferred stock. A great many privately held businesses are sole proprietorships, S corporations, general partnerships, limited partnerships, and limited liability companies. (Bisk 6-1-2, CSO: 49.3.0)

4. (d) Callable preferred stock is a corporate equity security in that it confers certain ownership rights to the owner. A shareholder's preemptive right is the right of first refusal to subscribe to a new issue of stock, but it is not a corporate equity security. A shareholder's appraisal right is the right for a shareholder to have her/his equity shares valued and, if s/he wishes, to receive that appraised value from the company in the event of a merger or sale. A callable bond represents a debt owed to the bondholder by the company; it is not an ownership asset. (Bisk 51-3-3, CSO: 3.2.0)

5. (c) Both a general partner in a general partnership and a general partner in a limited partnership have the same rights and powers as well as the same unlimited liability. A general partner in a general partnership can have rights and powers merely through an oral agreement. There is no common law requirement for an articles of partnership for a general partnership. (Bisk 48-6-1, CSO: 6.1.1)

6. (c) By definition, deflation describes a general decline in prices for goods and services. Expansion is characterized by increasing levels of economic activity. By definition, inflation describes a general increase in prices for goods and services. Recession is characterized by decreasing levels of economic activity. (Bisk 50-2-7, CSO: 1.2.0)

7. (d) By definition, the consumer price index (CPI) is a comparison of the price of items to a base value over time. A consumer price index is not limited to just cost of living items. An economic recovery is measured by the strength of increasing levels of economic activity. The consumer price index is one of many factors that may influence the Federal Reserve Bank's discount rate, but that is not its primary purpose. (Bisk 50-2-7, CSO: 2.2.0)

8. (b) Opportunity cost is the cost of not engaging in an alternative activity. In this case, the alternative activity is to sell the land and the opportunity cost is \$1,200,000. Answers "a," "c," and "d" are associated with the planned activity of developing the land. (Bisk 52-3-1, CSO: 3.2.1)

9. (b) The profitability index is calculated by dividing the present value of the annual after-tax cash flows by the original cash invested in the project. Residual income is the subtraction of actual after-tax net income from the minimum required return in dollars. Payback period is the initial investment for a project divided by the net annual cash inflow. Asset turnover is not an integral component in calculating the profitability index of a project. (Bisk 51-5-2, CSO: 3.1.1)

10. (a) Since the weighted-average cost of capital (WACC) is the true cost to the company, the objective is to minimize the WACC in combination with meeting other objectives. A high WACC would be unattractive to potential shareholders as a high cost would decrease the return for shareholders. An increase in the WACC

decreases the value of the company. The company's borrowing rate is just one component included in calculating the WACC. (Bisk 51-5-3, CSO: 3.1.2)

11. (b) High costs of carrying inventory tend to cause management to reduce the average inventory. High costs of placing an order tend to cause management to increase average inventory. Annual demand will influence total inventory, but is not a component in calculating the most advantageous average inventory. Lead time is a timing issue that does not influence the desired average inventory. (Bisk 51-4-3, CSO: 3.2.0)

12. (d) Short-term liquidity is measured by the acid test ratio ((current assets – investments) / current liabilities). Return on total assets is used for long-term evaluation. The sales to cash ratio focuses on company profitability. The accounts receivable turnover ratio does not account for liabilities. (Bisk 51-4-1, CSO: 3.3.1)

13. (d) The gross margin ratio (Profit / Total Sales) is a direct measure of profitability. The current ratio is a measure of liquidity. The inventory turnover ratio is a measure of inventory management. The debt to total assets ratio is a measure of financial stability. (Bisk 51-5-2, CSO: 3.2.0)

14. (c) Failure to remove former employees' user accounts poses the greatest security risk in that they would still be able to access the accounts payable system for improper purposes. Alpha-numeric passwords, documented procedures, and periodically reviewed security logs would not prevent or detect access by a former employee with a valid user account. (Bisk 55-4-1, CSO: 4.1.4)

15. (d) Batch processing is intermittent; conceivably, a batch system would permit users access to proprietary information before realizing users were unauthorized. Batch processing typically is not used for Internet transactions. Passwords, data encryption, and digital certificates are used to protect access to proprietary information. (Bisk 55-4-1, CSO: 4.1.4)

16. (c) Data entry and application programming should be delegated to separate individuals. Separation of duties typically delegates the functions of authorization, programming, and managing data to separate individuals. An application programmer who also does data entry would be in a position to circumvent internal controls, thus causing errors in output. Individuals doing network maintenance and wireless access, or data entry and antivirus management, or data entry and quality assurance would not violate the separation of duties. (Bisk 55-5-1, CSO: 4.2.2)

17. (c) In online processing, transactions are processed and files updated as the transactions occur. Therefore, the information for decision making is complete and up to date. Batch processing collects data in a batch and holds it until a later scheduled time. Therefore, there is a lag between when the transaction occurs and when it is processed and recorded in the system. Distributed processing refers to processing among a network of small computers all connected to a main computer system. This effectively reduces the work load of the main computer. Application processing refers to processing specific applications such as accounts receivable or purchasing. Distributed processing and application processing do not refer to the timeliness or completeness of the transactions being processed. (Bisk 55-1-6, CSO: 4.3.2)

18. (b) Edit checks are input controls that examine and verify data as it is being entered and before it is processed. This preventive type of control can identify erroneous data or transactions and prevent them from being processed. Run control totals, report distribution logs, and exception reports are edit checks that are run after the transactions have been processed. They are useful in detecting errors, but not preventing them. (Bisk 55-6-1, CSO: 4.3.2)

19. (b) A cold site is a disaster recovery site where equipment and power is available, but requires considerable effort to get the equipment in place and get an operational system functioning. A hot site is similar to a cold site except that the needed equipment is kept in place and available for immediate system functioning. A warm site and a flying start site are not commonly used terms in this context. (Bisk 55-4-2, CSO: 4.4.0)

20. (d) Direct material quantity variance is (actual quantity – standard quantity) × standard price. Direct material quantity variance = (6,500 – 6,000) × \$4.00 = \$2,000. The variance is unfavorable since actual quantity exceeds standard quantity. (Bisk 53-6-6, CSO: 5.1.3)

21. (b) Sales commissions would have a favorable variance since actual sales were less than budget and commissions are directly computed on level of sales. There would be no variance on building rent since this generally is a fixed cost and does not fluctuate with sales. (Bisk 53-6-7, CSO: 5.1.3)

22. (a) An increase in production levels would require more materials and labor. Therefore, total costs would increase. Variable costs per unit and total fixed costs do not fluctuate with changes in production levels. (Bisk 53-6-6, CSO: 5.3.2)

23. (c) Activity-based costing (ABC) follows the idea that heterogeneous products do not consume resources uniformly. ABC's purpose is to determine costs of activities performed in an organization and then assign costs to products according to each product's use of the activities. A single-product manufacturer gains no advantage from an ABC system as resources are used uniformly. A job order costing system is appropriate when direct costs can be identified with specific units. A process costing system is used when many different products are produced that homogeneously consume resources. (Bisk 53-5-1, CSO: 5.3.2)

24. (d) If variable costs increase by 20% then total variable costs at 10,000 units will increase by \$100,000 $[(\$50 \times 20\%) \times 10,000]$. As fixed costs will not change, total costs will increase by \$100,000, and profits will decrease by \$100,000. If production is increased to 12,000 units, total variable costs increase by \$120,000 $[(\$50 \times 20\%) \times 12,000]$ and revenues are \$1,020,000; total variable costs are \$720,000; and profits are \$0 which is a decrease of \$50,000. (Bisk 52-2-6, CSO: 5.3.3)

25. (b) The amount of the truck's delivery cost per pound is equal to total truck costs (125,000 miles \times \$0.13 per mile = \$16,250) divided by total pounds (28,000 pounds/load \times 250 loads = 7,000,000 pounds). $\$16,250 / 7,000,000$ pounds = \$0.00232 per pound. (Bisk 52-3-1, CSO: 5.3.3)

Solution 2

26. (d) A nonresident alien is not eligible to be a shareholder in an S corporation. An estate shareholder and a 501(c)(3) exempt organization are eligible to be shareholders. The maximum eligible number of shareholders for an S corporation is 100 shareholders. (Bisk 49-6-2, CSO: 1.1.3)

27. (a) As promoter, Davis is liable for all pre-incorporation debts. The general rule is that a corporation is not liable on pre-incorporation contracts entered into on behalf of the corporation by the promoter. However, the corporation can assume these liabilities by adoption. (Bisk 49-2-1, CSO: 1.3.0)

28. (c) Shareholders have the right to inspect the corporate books and records. The five days written notice is sufficient for the corporation to prepare records for inspection and confirm Ace is a shareholder. Ace is not required to purchase additional shares to exercise this right. Sharing corporate information with outsiders is not related to a shareholder's interests. (Bisk 49-4-1, CSO: 1.4.0)

29. (c) A derivative suit occurs when stockholders sue for the benefit of the corporation. In a derivative action, proof must be shown that the corporation suffered harm, such as in the case of recovering damages from a third party. Suits to compel payment of properly declared dividends, enforce access to corporate records, and protect preemptive rights benefit shareholders, not the corporation. (Bisk 49-4-1, CSO: 1.4.0)

30. (c) A general partner in a limited partnership is analogous to a partner in a general partnership. The general partner is responsible for the management and control of the partnership and is personally liable for its debts. The amount of the general partner's liability is unlimited for all partnership debts. (Bisk 48-6-1, CSO: 1.4.0)

31. (a) A characteristic of a perfectly competitive financial market is a large number of buyers and sellers acting independently. No traders can impact market prices more than others since perfect knowledge is assumed and available to anyone. The trading price is based upon the interaction of supply and demand and will settle at the point of marginal cost. (Bisk 50-1-8, CSO: 2.3.0)

32. (a) The foreign country's currency has depreciated or devalued from 1.5 to 1.7 to the U.S. dollar. Therefore, the country's exports are less expensive for the United States, its imports of U.S. goods are less affordable and its purchases of the U.S. dollar will cost more. (Bisk 50-3-3, CSO: 2.4.0)

33. (c) The expected net present value for this project will be the present value of an annuity for five years ($\$420,000 \times 3.79$) plus the present value of a lump sum for six years ($\$100,000 \times .56$) minus the initial investment ($\$1,800,000$) which equals $\$(152,200)$. (Bisk 51-2-3, CSO: 3.1.1)

34. (b) Return on investment measures the relationship of profit to invested capital and is calculated by dividing operating profit by average invested capital. The Passenger Division has a profit of $\$40,000$ divided by $\$250,000$ which yields an ROI of 16%. The Cargo Division has a profit of $\$50,000$ divided by $\$500,000$ which yields an ROI of 10%. An ROI of 16% is better than an ROI of 10%. (Bisk 51-5-4, CSO: 3.1.1)

35. (b) By definition, opportunity costs are the foregone benefits of alternatives not selected. Since Egan is going to continue with its plans to develop the land, then selling the land would be the alternative not selected and the sales price represents the opportunity costs. Sunk costs are funds already spent and can have no bearing on future alternatives. Future costs are costs that will be incurred in the future. Variable costs are costs that vary in total with production levels. (Bisk 52-3-1, CSO: 3.1.2)

36. (c) By definition, the payback method provides the years needed to recoup the investment in a project. Payback does not consider the time value of money and cannot indicate if an investment will be profitable. Payback is calculated by dividing the net investment by the annual cash inflows. (Bisk 51-5-2, CSO: 3.1.2)

37. (b) Debt has a relatively low after-tax cost due to the interest deduction. Creditors have greater priority than shareholders in bankruptcy and are paid interest before net income is calculated; dividends are paid based on retained earnings. Therefore, creditors assume less risk than shareholders. Correspondingly, creditors are willing to accept less return for their investment. Thus, debt tends to increase earnings per share. The increased financial risk and the reduction of Larson's control over the company generally would be considered disadvantages. (Bisk 51-6-4, CSO: 3.2.0)

38. (c) Average collection period of accounts receivable tells how quickly sales are turned into cash and is therefore a good determination of liquidity. It is not an indicator of any financing requirements, return on equity, or operating profitability. (Bisk 51-4-1, CSO: 3.3.1)

39. (b) The most critical part of a systems specification document is the collection of all relevant information, and would include the data elements needed. This lays the foundation for developing the specification document and would need to be known before developing any communication change management considerations, training requirements, or cost/benefit analysis. (Bisk 55-1-5, CSO: 4.1.1)

40. (b) Responsiveness and flexibility is increased in an ERP system since all modules are intricately connected and share data simultaneously. The interconnectivity among the modules generally means that modification to one module will automatically have an effect on other modules. There is less data redundancy in an ERP since multiple modules can access the same data from a single source. Because of their complexity and size, ERP implementation and training can be expensive; there is no assurance of any reduction in these costs over use of multiple independent systems. (Bisk 55-1-2, CSO: 4.1.1)

41. (c) A file in a relational data base refers to the collection of data pertinent to a whole group, such as vendors. A record refers to data pertinent to a single transaction or entity, such as a vendor. A field refers to one portion of a record, such as a telephone number. A byte refers to a portion of a character, such as within one digit of a phone number. (Bisk 55-1-2, CSO: 4.3.1)

42. (b) In batch processing, transactions are grouped before posting. Typically, each transaction has its own line entry in the appropriate ledger. (Bisk 55-1-6, CSO: 4.3.2)

43. (d) Establishing an off-site mirrored web server would ensure that in the event that the primary web server becomes unusable, the mirrored web server would take over immediately and the website would continue to operate. Backing up the server database daily and storing records off-site would help the site restore service after a natural disaster, but there would be a period of time when the website would be out of service.

RAID technology combines several hard disk drives into one logical unit; use of this technology by itself is insufficient to ensure continuity through a natural disaster. (Bisk 55-1-1, CSO: 4.4.0)

44. (b) A value-added network (VAN) is a network service that provides additional services beyond mere connections to the Internet, particularly services enabling EDI, including increased security. However, a VAN does not provide confidentiality for data transmitted over the Internet and tends not to be more cost effective than transmitting data over the Internet. A VAN typically does not enable a company to obtain trend information on data transmissions. (Bisk 55-1-2, CSO: 4.5.0)

45. (d) Residual income = operating Income – (cost of capital + taxes). Operating income = sales (\$750,000) × return on sales (8%) = \$60,000. Total assets = sales (\$750,000) / asset turnover 1.5 = \$500,000. Cost of capital = total assets (\$500,000) × imputed interest rate (12%) = \$60,000. Residual income = operating income (\$60,000) – cost of capital (\$60,000) = \$0. There would be no taxes since income is zero. (Bisk 51-5-5, CSO: 5.2.1)

46. (c) The weighted average cost of capital is equal to the after tax-cost of debt plus the cost of preferred stock plus the cost of common equity summed by their proportional amount of total capital. The formula would be cost of debt (6% × 60% [after tax rate] × 50%) + cost of preferred stock (7% × 10%) + cost of common equity (11.5% × 40%) = 1.8% + 0.7% + 4.6% = 7.10%. (Bisk 53-2-2, CSO: 5.2.1)

47. (b) Average assets = (beginning of year assets \$22,000,000 + end of year assets \$18,000,000) / 2 = \$20,000,000. The investment turnover is calculated by dividing sales by average investment; thus, total sales = average assets \$20,000,000 × investment turnover rate 2.5 = \$50,000,000. The operating income of \$5,000,000 before interest and taxes is a distracter. (Bisk 54-3-1, CSO: 5.2.1)

48. (b) Unfavorable labor efficiency variances indicate that inefficient labor methods resulted in more hours worked than had been budgeted for the level of production achieved. The inadequate maintenance of machinery for the last few months will require additional unanticipated maintenance labor to be incurred in the current period and cause an unfavorable labor efficiency variance. The increased wages from the new labor contract and the decision to use highly skilled workers (presumably, at a higher rate than budgeted) would cause a rate variance. Raw materials are not a component in determining labor efficiency variances. (Bisk 53-6-6, CSO: 5.3.1)

49. (a) Activity-based systems follow the idea that products consume activities. Its purpose is to assign costs to activities performed in an organization and then assign them to products according to each product's use of the activities. Boyle's only allocated costs are setup costs of \$400,000 divided among an aggregate 2,000 setup hours, or \$200 per setup hour. Product X = \$200 allocated costs/setup hour × 500 setup hours = \$100,000. Product Y = \$200 allocated costs/setup hour × 1,500 setup hours = \$300,000. (Bisk 53-5-1, CSO: 5.3.2)

50. (b) By definition, fixed costs within a relevant range do not change in response to changes in production. The gross profit for the special order will be a positive 10%, which means total income will increase. (Bisk 52-3-2, CSO: 5.3.3)

Solution 3

51. (b) Section 302 of the Sarbanes-Oxley Act requires an issuer to have an audit committee financial expert. If an issuer does **not** have an audit committee financial expert, the issuer must disclose the reason why the role is **not** filled. The financial expert cannot be from the current audit firm since the auditor must remain independent. The audit committee financial expert does not have to have industry-specific experience. The audit committee financial expert need not be the audit committee chairperson. (Bisk 40th edition textbook 49-1-2, 2011 CSO: 1.1.2)

52. (b) The 'Committee Of Sponsoring Organizations' (COSO) integrated framework includes five components. The internal control environment component encompasses the tone of the entity, the general philosophy around the organization's risk appetite, and management's integrity and ethical values. The information and communication component refers to the identification, retention, and transfer of information in a timely manner

enabling personnel to execute their responsibilities. Risk assessment is an entity's identification, analysis, and management of risks relevant to the preparation of the company's financial statements. Control activities are those policies and procedures established to provide reasonable assurance that management decisions are executed. (Bisk 40th edition textbook 49-1-2, 2011 CSO: 1.1.2)
