

BUSINESS ENVIRONMENT & CONCEPTS

CPA2904US3-40

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About Updating Supplement Version 40.3

Information that is only six months old is eligible to be tested on the CPA exam. Candidates with the 40th edition and corresponding software (version 14 series) will find the information in the version 40.3 updating supplement more than adequate for the October-November 2011 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 39th edition and corresponding software also will want Updating Supplement Version 39.2. 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 39th 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.

Content Specifications Outline (CSO) Update

The AICPA has updated the reference list at the end of the BEC CSO to include the following:

- International Standards for the Professional Practice of Internal Auditing
- COBIT (The Control Objectives for Information and related Technology)

These changes are effective July 1, 2011 and only apply to the CSO references. They do not affect the current technical content or weight allocations specified in the CSOs.

Errata

The following errors are in the 40th 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 49—Corporate Governance

Pg 49-23, Question number 39 (ID 9662) should read as follows:

39. The responsibility to establish and maintain an internal control structure to adequately support reliable financial reporting resides with
- a. The board of directors
 - b. The audit committee
 - c. The internal auditors
 - d. Management
- (Editors, 9662)

Chapter 50—Economic Theory

Page 50-41, Section D. 1. should read as follows:

1. **Current Account** The current account includes the balance of goods and services, net interest and dividends, and **net unilateral transfers**.
 - a. **Balance of Trade** The difference between total imports and total exports of goods, excluding services, is the balance of trade.
 - b. **Balance of Goods & Services** The difference between total imports and total exports of goods, including services, is the balance of goods and services.
 - c. **Interest & Dividends** Total interest and dividends received within a country on investments outside of a country, offset by total interest and dividends paid outside a country on investments by foreign entities within a country.
 - d. **Unilateral Transfers** Net unilateral transfers effect the deficit or surplus depending on whether the transfer is out or in. Unilateral transfers include foreign aid and payments to relatives. Pension payments often are counted as unilateral transfers.

Chapter 53—Cost Accounting

Page 53-50, Answer to question 4: The answer should read as follows:

4. (a) Under weighted average, computing the average current period costs will combine the beginning inventory costs with current period costs. Under FIFO, costs in the beginning inventory are not combined with the current period costs, but are transferred out as a separate batch of goods at a different unit cost than units started and completed during the period. The weighted average and FIFO methods would result in equal **equivalent units** if no beginning inventory exists.

Coverage Related to Recently Added CSO References

While nominally eligible to be tested at this time, International Standards for the Professional Practice of Internal Auditing has not been tested explicitly in disclosed questions to date. It likely will appear on exams now that it has been named in the references following the CSO; however, it is unlikely to be tested heavily. It is eligible to be tested in the **July-August 2011** exam window.

International Standards for the Professional Practice of Internal Auditing

The Institute of Internal Auditors (IIA) has certain International Standards for the Professional Practice of Internal Auditing. These standards provide a framework for internal auditors to refer to in their job functions, irrespective of the environment in which they work.

A. Introduction to the International Standards

Internal auditing is conducted in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, conformance with the IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* is essential in meeting the responsibilities of internal auditors and the internal audit activity.

B. Standards Purpose

The purpose of the *Standards* is to:

1. Delineate basic principles that represent the practice of internal auditing.
2. Provide a framework for performing and promoting a broad range of value-added internal auditing.
3. Establish the basis for the evaluation of internal audit performance.
4. Foster improved organizational processes and operations.

C. Standards Definition

The *Standards* are principles-focused, mandatory requirements consisting of statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance, which are internationally applicable at organizational and individual levels.

D. Standards Structure

The structure of the *Standards* is divided between Attribute Standards and Performance Standards. The Attribute and Performance Standards are applicable to all internal audit services.

E. Attribute Standards

The Attribute Standards address the attributes of organizations and individuals performing internal auditing. The following is a listing of attribute standards:

1. **Internal Audit Charter** The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization.
2. **Independence and Objectivity** The internal audit activity must be independent, and internal auditors must be objective in performing their work.
 - a. **Independence** is the freedom from conditions that threaten the ability of the internal auditor to carry out internal audit responsibilities in an unbiased manner.
 - b. **Objectivity** is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others.
3. **Impairment to Independence or Objectivity** If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.
4. **Proficiency** Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities.
5. **Due Professional Care** Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor.
6. **Continuing Professional Development** Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.
7. **Reporting on Quality Assurance and Improvement Programs** The chief audit executive must communicate the results of the quality assurance and improvement programs to senior management and the board.
8. **Disclosure of Nonconformance** When nonconformance with the Definition of Internal Auditing, the Code of Ethics, or the *Standards* impacts the overall scope or operation of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.

F. Performance Standards

The Performance Standards describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured. The following is a listing of performance standards:

1. **Managing and Planning the Internal Audit Activity** The chief audit executive must effectively manage the internal audit activity and establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.
2. **Resource Management** The chief audit executive must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.
3. **Policies and Procedures** The chief audit executive must establish policies and procedures to guide the internal audit activity.

4. **Reporting Responsibilities** The chief audit executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan.
5. **Governance** The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of objectives.
6. **Risk Management** The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.
7. **Control** The internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.
8. **Engagement Objectives and Scope** Objectives must be established for each engagement. The established scope must be sufficient to satisfy the objectives of the engagement.
9. **Performing the Engagement** Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement's objectives.
10. **Analysis and Evaluation** Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.
11. **Documenting Information** Internal auditors must document relevant information to support the conclusions and engagement results.
12. **Errors and Omissions** If a final communication contains a significant error or omission, the chief audit executive must communicate corrected information to all parties who received the original communication.
13. **Overall Opinions** When an overall opinion is issued, it must take into account the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.

Recently Released AICPA Questions

In April, 2011, the AICPA released several questions labeled as "Year 2011 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.

Problem 1 MULTIPLE-CHOICE QUESTIONS

1. Which of the following positions best describes the nature of the Board of Directors of XYZ Co.'s relationship to the company?
 - a. Agent
 - b. Executive
 - c. Fiduciary
 - d. Representative

(R/11, BEC, #19, 10204)

2. Which of the following is necessary to be an audit committee financial expert according to the criteria specified in the Sarbanes-Oxley Act of 2002?
- A limited understanding of generally accepted auditing standards
 - Education and experience as a certified financial planner
 - Experience with internal accounting controls
 - Experience in the preparation of tax returns (R/11, BEC, #18, 10203)
3. According to COSO, the use of ongoing and separate evaluations to identify and address changes in internal control effectiveness can best be accomplished in which of the following stages of the monitoring-for-change continuum?
- Control baseline
 - Change identification
 - Change management
 - Control revalidation/update (R/11, BEC, #17, 9997)
4. A company has a policy of frequently cutting prices to increase sales. Product demand is significantly elastic. What impact would this have on the company's situation?
- Quantity increases proportionally more than the price declines.
 - Quantity increases proportionally less than the price declines.
 - Price increases proportionally more than the quantity declines.
 - Price increases proportionally less than the quantity declines. (R/11, BEC, #11, 9991)
5. Which of the following indicates that the economy is in a recessionary phase?
- The rate of unemployment decreases
 - The purchasing power of money declines rapidly
 - Potential national income exceeds actual national income
 - There is a shortage of essential raw materials and costs are rising (R/11, BEC, #20, 10205)
6. Which of the following types of unemployment typically results from technological advances?
- Cyclical
 - Frictional
 - Structural
 - Short-term (R/11, BEC, #12, 9992)
7. Yarrow Co. is considering the purchase of a new machine that costs \$450,000. The new machine will generate net cash flow of \$150,000 per year and net income of \$100,000 per year for five years. Yarrow's desired rate of return is 6%. The present value factor for a five-year annuity of \$1, discounted at 6%, is 4.212. The present value factor of \$1, at compound interest of 6% due in five years, is 0.7473. What is the new machine's net present value?
- \$450,000
 - \$373,650
 - \$181,800
 - \$110,475 (R/11, BEC, #9, 9989)
8. A corporation obtains a loan of \$200,000 at an annual rate of 12%. The corporation must keep a compensating balance of 20% of any amount borrowed on deposit at the bank, but normally does not have a cash balance account with the bank. What is the effective cost of the loan?
- 12.0%
 - 13.3%
 - 15.0%
 - 16.0% (R/11, BEC, #10, 9990)

9. A corporation manages inventory performance by monitoring its inventory turnover. Selected financial records for the corporation are as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Annual sales	\$1,262,500	\$1,062,500	\$1,459,000
Gross annual profit percentage	45%	30%	40%

The beginning finished goods inventory for year 2 was 20% of year 2 sales. The ending finished goods inventory for year 2 was 18% of year 3 sales. What was the corporation's inventory turnover for year 2?

- a. 1.34
b. 2.83
c. 3.03
d. 3.13 (R/11, BEC, #13, 9993)
10. Each of the following periods is included when computing a firm's target cash conversion cycle, except the
- a. Inventory conversion period
b. Payables deferral period
c. Average collection period
d. Cash discount period (R/11, BEC, #15, 9995)
11. The ABC Company is trying to decide between keeping an existing machine and replacing it with a new machine. The old machine was purchased just two years ago for \$50,000 and had an expected life of 10 years. It now costs \$1,000 a month for maintenance and repairs due to a mechanical problem. A new machine is being considered to replace it at a cost of \$60,000. The new machine is more efficient and it will only cost \$200 a month for maintenance and repairs. The new machine has an expected life of 10 years. In deciding to replace the old machine, which of the following factors, ignoring income taxes, should ABC **not** consider?
- a. Any estimated salvage value on the old machine
b. The original cost of the old machine
c. The estimated useful life of the new machine
d. The lower maintenance cost on the new machine (R/11, BEC, #1, 9981)
12. The following information data pertains to a manufacturing company:
- | | |
|----------------------|----------|
| Total sales | \$80,000 |
| Total variable costs | 20,000 |
| Total fixed costs | 30,000 |
- What is the break-even level in sales dollars?
- a. \$30,000
b. \$40,000
c. \$50,000
d. \$80,000 (R/11, BEC, #3, 9983)
13. Black Co.'s breakeven point was \$780,000. Variable expenses averaged 60% of sales, and the margin of safety was \$130,000. What was Black's contribution margin?
- a. \$ 364,000
b. \$ 546,000
c. \$ 910,000
d. \$1,300,000 (R/11, BEC, #2, 9982)

14. Jackson Co. is considering a project that will use 2,000 square feet of storage space at one of its facilities to store used equipment. What will determine Jackson's opportunity cost?
- a. The net present value of the project
 - b. The internal rate of return of the project
 - c. The value of the next best use of the space
 - d. The depreciation expense on the space (R/11, BEC, #6, 9986)
15. Jones Corp. had an opportunity to use its capacity to produce an extra 5,000 units with a contribution margin of \$5 per unit, or to rent out the space for \$10,000. What was the opportunity cost of using the capacity?
- a. \$35,000
 - b. \$25,000
 - c. \$15,000
 - d. \$10,000 (R/11, BEC, #7, 9987)
16. Which of the following costing methods will yield the lowest inventory value?
- a. Absorption
 - b. Hybrid
 - c. Process
 - d. Variable (R/11, BEC, #14, 9994)
17. Limitations of an activity-based costing system include which of the following?
- a. Control of overhead costs is enhanced.
 - b. Activity-based costing systems are **less** reliable.
 - c. The expense of obtaining cost data is relatively high.
 - d. It eliminates arbitrary assignment of overhead costs. (R/11, BEC, #4, 9984)
18. An enterprise resource planning system is designed to
- a. Allow nonexperts to make decisions about a particular problem
 - b. Help with the decision-making process
 - c. Integrate data from all aspects of an organization's activities
 - d. Present executives with the information needed to make strategic plans (R/11, BEC, #16, 9996)
19. What is the correct ascending hierarchy of data in a system?
- a. Character, record, file, field
 - b. Field, character, file, record
 - c. Character, field, record, file
 - d. Field, record, file, character (R/11, BEC, #5, 9985)
20. In a large firm, custody of an entity's data is most appropriately maintained by which of the following personnel?
- a. Data librarian
 - b. Systems analyst
 - c. Computer operator
 - d. Computer programmer (R/11, BEC, #8, 9988)
-

Problem 2 MULTIPLE-CHOICE QUESTIONS

21. In order to comply with a director's duty of loyalty to a corporation, what action(s) should a director take when presented with a corporate opportunity?
- Reject the opportunity and **not** offer it to the corporation
 - Accept the opportunity and **not** offer it to the corporation
 - Accept the opportunity and disclose the acceptance to the corporation
 - Offer the opportunity to the corporation and accept it if the corporation rejects it
- (R/11, BEC, #21, 10206)
22. Which of the following types of variances would a purchasing manager most likely influence?
- Direct materials price
 - Direct materials quantity
 - Direct labor rate
 - Direct labor efficiency
- (R/11, BEC, #22, 10002)
23. Farrow Co. is applying for a loan in which the bank requires a quick ratio of at least 1. Farrow's quick ratio is 0.8. Which of the following actions would increase Farrow's quick ratio?
- Purchasing inventory through the issuance of a long-term note
 - Implementing stronger procedures to collect accounts receivable at a faster rate
 - Paying an existing account payable
 - Selling obsolete inventory at a loss
- (R/11, BEC, #23, 10207)
24. A corporation is considering purchasing a machine that costs \$100,000 and has a \$20,000 salvage value. The machine will provide net annual cash inflows of \$25,000 per year and has a six-year life. The corporation uses a discount rate of 10%. The discount factor for the present value of a single sum six years in the future is 0.564. The discount factor for the present value of an annuity for six years is 4.355. What is the net present value of the machine?
- \$(2,405)
 - \$ 8,875
 - \$20,155
 - \$28,875
- (R/11, BEC, #24, 10004)
25. A company has gathered the following information from a recent production run:
- | | |
|---------------------------------|------|
| Standard variable overhead rate | \$10 |
| Actual variable overhead rate | 8 |
| Standard process hours | 20 |
| Actual process hours | 25 |
- What is the company's variable overhead spending variance?
- \$50 unfavorable
 - \$50 favorable
 - \$40 unfavorable
 - \$40 favorable
- (R/11, BEC, #25, 10005)
26. Which of the following is a limitation of the profitability index?
- It uses free cash flows
 - It ignores the time value of money
 - It is inconsistent with the goal of shareholder wealth maximization
 - It requires detailed long-term forecasts of the project's cash flows
- (R/11, BEC, #26, 10208)

27. Which of the following metrics equates the present value of a project's expected cash inflows to the present value of the project's expected costs?
- Net present value
 - Return on assets
 - Internal rate of return
 - Economic value-added (R/11, BEC, #27, 10209)
28. What is the primary objective of data security controls?
- To establish a framework for controlling the design, security, and use of computer programs throughout an organization
 - To ensure that storage media are subject to authorization prior to access, change, or destruction
 - To formalize standards, rules, and procedures to ensure the organization's controls are properly executed
 - To monitor the use of system software to prevent unauthorized access to system software and computer programs (R/11, BEC, #28, 10210)
29. Which of the following technologies is specifically designed to exchange financial information over the World Wide Web?
- Hypertext markup language (HTML)
 - Extensible business reporting language (XBRL)
 - Hypertext transfer protocol (HTTP)
 - Transmission control program/internet protocol (TCP/IP) (R/11, BEC, #29, 10211)
30. Variations between business cycles most likely are attributable to which of the following factors?
- The law of diminishing returns
 - Comparative advantage
 - Duration and intensity
 - Opportunity costs (R/11, BEC, #30, 10212)
31. A company has the following target capital structure and costs:
- | | <u>Proportion of capital structure</u> | <u>Cost of capital</u> |
|-----------------|--|------------------------|
| Debt | 30% | 10% |
| Common stock | 60% | 12% |
| Preferred stock | 10% | 10% |
- The company's marginal tax rate is 30%. What is the company's weighted-average cost of capital?
- 7.84%
 - 9.30%
 - 10.30%
 - 11.20% (R/11, BEC, #31, 10213)
32. A company recently issued 9% preferred stock. The preferred stock sold for \$40 a share with a par of \$20. The cost of issuing the stock was \$5 a share. What is the company's cost of preferred stock?
- 4.5%
 - 5.1%
 - 9.0%
 - 10.3% (R/11, BEC, #32, 10214)

33. A company produces and sells two products. The first product accounts for 75% of sales and the second product accounts for the remaining 25% of sales. The first product has a selling price of \$10 per unit, variable costs of \$6 per unit, and allocated fixed costs of \$100,000. The second product has a selling price of \$25 per unit, variable costs of \$13 per unit, and allocated fixed costs of \$212,000. At the break-even point, what number of units of the first product will have been sold?
- a. 52,000
 - b. 39,000
 - c. 25,000
 - d. 14,625
- (R/11, BEC, #33, 10215)
34. Which of the following types of risk can be reduced by diversification?
- a. High interest rates
 - b. Inflation
 - c. Labor strikes
 - d. Recessions
- (R/11, BEC, #34, 10216)
35. Which of the following solutions creates an encrypted communication tunnel across the Internet for the purpose of allowing a remote user secure access into the network?
- a. Packet-switched network
 - b. Digital encryption
 - c. Authority certificate
 - d. Virtual private network
- (R/11, BEC, #35, 10217)
36. Each of the following is a limitation of enterprise risk management (ERM), **except**
- a. ERM deals with risk, which relates to the future and is inherently uncertain.
 - b. ERM operates at different levels with respect to different objectives.
 - c. ERM can provide absolute assurance with respect to objective categories.
 - d. ERM is as effective as the people responsible for its functioning.
- (R/11, BEC, #36, 10218)
37. A manufacturing firm identified that it would have difficulty sourcing raw materials locally, so it decided to relocate its production facilities. According to COSO, this decision represents which of the following responses to the risk?
- a. Risk reduction
 - b. Prospect theory
 - c. Risk sharing
 - d. Risk acceptance
- (R/11, BEC, #37, 10219)
38. Which of the following is one of the four perspectives of a balanced scorecard?
- a. Just in time
 - b. Innovation
 - c. Benchmarking
 - d. Activity-based costing
- (R/11, BEC, #38, 10220)

39. The New Wave Co. is considering a new method for allocating overhead to its two products, regular and premium coffee beans. Currently New Wave is using the traditional method to allocate overhead, in which the cost driver is direct labor costs. However, it is interested in using two different drivers: machine hours (MH) for separating and roasting beans, and pounds of coffee for packing and shipping. Machine hours for the current month are 700 hours, direct labor cost per pound of coffee is \$1.25, and direct materials cost per pound of coffee is \$1.50. There are 1,000 pounds of coffee packed and shipped for the current month. The following data are also available:

		<u>Regular</u>	<u>Premium</u>
Overhead for the current month	\$5,000		
Cost pool for separating and roasting beans	3,500	150 MH	550 MH
Cost pool for packing and shipping	1,500	500 pounds	500 pounds

What is the total cost per pound for the premium coffee using the new activity-based costing method?

- a. \$5.00
- b. \$5.75
- c. \$7.75
- d. \$9.75

(R/11, BEC, #39, 10221)

40. A company uses process costing to assign product costs. Available inventory information for a period is as follows:

	<u>Inventory (in units)</u>	<u>Material cost</u>	<u>Conversion cost</u>
Beginning	0		
Started during the period	15,000	\$75,000	\$55,500
Transferred out	13,500		
End of period	1,500		

The ending inventory was 25% complete as to the conversion cost. 100% of direct material was added at the beginning of the process. What was the total cost transferred out?

- a. \$130,500
- b. \$126,973
- c. \$121,500
- d. \$117,450

(R/11, BEC, #40, 10020)

Problem 3 Written Communication Question

With the passage of the Sarbanes-Oxley Act in 2002, the Securities and Exchange Commission (SEC) asked the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) to develop additional guidance to companies on the role and membership of audit committee so as to improve the effectiveness and independence of audit committees. In response to an inquiry from a senior manager of a company that is considering going public, write a memo discussing the expanded role of a company's audit committee in light of the provisions of the Sarbanes-Oxley Act.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

Problem 4 Written Communication Question

Gold, Inc. changed its credit policy several months ago in hopes of increasing sales. Since then, there has been a dramatic increase in the number of accounts receivable that are past due.

Currently, the company calculates the allowance for doubtful accounts based on a percentage of the ending receivables balance. The company's controller now thinks it is more appropriate to use a percentage-of-sales method to calculate the allowance for doubtful accounts.

Write a memorandum to the controller comparing and contrasting the two methods (percentage of accounts receivable balance vs. percentage-of-sales). Recommend the method you think Gold should use, and give reasons to support your conclusion.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

Solution 1 MULTIPLE-CHOICE ANSWERS

1. (c) The Board of Directors are vested with the right and responsibility to manage the affairs of a corporation while keeping the entity's and stakeholders' interests in the forefront. This reflects the fiduciary nature of the Board of Directors relationship to the company. (Bisk: 49-1-1; CSO: 1.1.3)
2. (c) The Sarbanes-Oxley Act of 2002 specifies that an audit committee financial expert could gain their financial expertise through an understanding of generally accepted accounting principles and financial statements, an understanding of audit committee functions, and experience with internal accounting controls. (Bisk: 49-1-2; CSO: 1.1.2)
3. (b) The use of ongoing and separate evaluations to identify and address changes in internal control effectiveness can best be accomplished in the change identification stage. (Bisk: 49-6-3; CSO: 1.2.2)
4. (a) Increases in a product's elasticity would indicate that demand changes are relatively greater than changes in price. Therefore, quantity demanded will increase proportionally more than the price declines. (Bisk: 50-1-4; CSO: 2.3.0)
5. (c) A recession is characterized by increases in unemployment, increases in inventories, and a decline in income levels. Thus, potential national income exceeds actual national income. (Bisk: 50-2-2; CSO: 2.1.0)
6. (c) In structural unemployment the aggregate demand is equal to aggregate labor supply, but the nature of the supply doesn't match the nature of the demand. Technological advances typically result in manual labor intensive tasks being replaced by mechanical tasks. So unemployment in the unskilled labor market increases when technological advances occur. (Bisk: 50-2-8; CSO: 2.3.0)
7. (c) Net present value is determined based on net cash flows. Net Income is not relevant. The present value of the net cash flows per year equals \$150,000 times the present value factor for a five-year annuity 4.212 which equals \$631,800. Subtracting out the initial cash outflow of \$450,000 yields a net present value of \$181,800. (Bisk: 51-2-3; CSO: 3.1.1)
8. (c) The annual costs of the loan are \$200,000 times 12% which equals \$24,000 per year. But since the corporation must keep a compensating balance of 20% of the amount borrowed (\$40,000) then they only have used of 80% of the loan or \$160,000. The effective cost of the loan is \$24,000 divided by \$160,000 equals 15.0%. (Bisk: 51-4-1; CSO: 3.3.2)
9. (d) Cost of goods sold for year 2 equals sales of \$1,062,500 times $(1 - .30 = .70)$ equals \$743,750. Average inventory for year 2 equals beginning finished goods inventory $(\$1,062,500 \times 20\%)$ plus ending finished goods inventory $(\$1,459,000 \times 18\%) / 2$ equals \$237,500 average inventory balance. Inventory turnover for year 2 equals cost of goods sold \$743,750 / average inventory balance \$237,500 = 3.13. (Bisk: 51-4-1; CSO: 3.2.2)
10. (d) The target cash conversion cycle is a metric that expresses the length of time, in days, that it takes for a company to convert resource inputs into cash flows. This metric looks at the amount of time needed to sell inventory (inventory conversion period), the amount of time needed to collect receivables (average collection period) and the length of time the company is afforded to pay its bills without incurring penalties (payables deferral period). The cash discount period is not included in this metric. (Bisk: 51-4-1; CSO: 3.2.2)
11. (b) Only the future costs associated with keeping the existing machine and the future costs of replacing the machine are factors to be included in the decision-making process. Historical (or Sunk) costs are irrelevant since they cannot be altered regardless of which decision is made. Therefore, the original cost of the old machine should not be considered in this analysis. (Bisk: 51-5-2 ; CSO: 3.2.2)
12. (b) Break-even Sales equals Total Fixed Costs divided by the Contribution Margin Percentage. The Contribution Margin Percentage equals $(\text{Total Sales minus Total Variable costs}) / \text{Total Sales}$.

Sales. $(\$80,000 - \$20,000) / \$80,000$ equals 75%. Fixed Costs \$30,000 divided by Contribution Margin Percentage 75% equals \$40,000. (Bisk: 52-2-4; CSO: 5.1.0)

13. (a) Total Sales equals Breakeven Sales plus Margin of Safety $(\$780,000 + \$130,000 = \$910,000)$ Contribution Margin Percentage equals 100% minus Variable Expense Margin $(100\% - 60\% = 40\%)$ Contribution Margin equals Total Sales \times Contribution Margin Percentage $(\$910,000 \times 40\% = \$364,000)$. (Bisk: 52-2-8; CSO: 6.1.1)

14. (c) Opportunity Costs are the foregone benefits (revenues minus costs) from alternatives not selected. In Jackson's scenario, the opportunity costs equal the value of the next best use of the space. (Bisk: 52-3-1; CSO: 5.2.0)

15. (d) The opportunity cost of using the capacity would equal the benefits of selecting the alternative activity of renting out the space for \$10,000. (Bisk: 52-3-1; CSO: 5.2.0)

16. (d) Variable Costing (Direct Costing) is an inventory costing method whereby direct materials, direct labor, and variable manufacturing overhead are considered to be product costs (inventory costs), while fixed manufacturing overhead is considered to be a period cost. Variable Costing will yield the lowest inventory value due to the exclusion of fixed manufacturing overhead from inventory. (Bisk: 52-4-1; CSO: 6.2.0)

17. (c) Activity Based Costing's 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. Capturing cost data at this level can be relatively expensive. But capturing cost data at this level makes ABC systems **more** reliable. Overhead costs may still be arbitrary to assign so control of overhead costs is not enhanced. (Bisk: 53-5-1; CSO: 6.2.0)

18. (c) An enterprise resource planning system consists of complex, highly integrated, multi-module applications that manage a business' different aspects, from traditional accounting to inventory management and advanced planning and forecasting. This is accomplished by integrating data from all aspects of an organization's activities. (Bisk: 55-1-2; CSO: 4.5.0)

19. (c) Files consist of records. Records consist of fields. Fields consist of Characters. Therefore, the ascending hierarchy of data in a system is Character, Field, Record, File. (Bisk: 55-1-4; CSO: 4.1.1)

20. (a) The data librarian provides control over the data tapes, disks, programs, and documentation when they are not in use by maintaining custody. The Systems Analyst investigates a business system and decides how the computer can be applied. The Computer Operator physically runs the computer equipment. The Computer Programmer writes, tests, and debugs the programs for the applications or the systems. (Bisk: 55-1-7; CSO: 4.2.5)

Solution 2 MULTIPLE-CHOICE ANSWERS

21. (d) Board members may not use the entity's assets, opportunities, or information for their own profit without the consent of the corporation, and cannot compete directly with the company. The corporation should be offered all identified opportunities and only if the corporation rejects it can the board member then accept it. (Bisk: 49-1-1; CSO: 1.1.3)

22. (a) A purchasing manager is involved in material purchasing decisions and is concerned with the price of materials purchased. However, the purchasing manager is not in a position to manage how efficiently materials are used (materials quantity) or manage the aspects of labor (either labor rates or labor efficiency). (Bisk: 53-6-6; CSO: 5.3.1)

23. (d) The quick ratio is calculated as cash + marketable securities + net receivables / current liabilities. Inventory and long-term notes are not encompassed in the quick ratio. Collecting accounts receivable at a faster rate would increase cash while decreasing receivables for the same amount, so no effect on the quick ratio. Paying an existing account payable would decrease cash and decrease current liabilities with an indeterminable impact on the quick ratio (since both sides of the equation are impacted). Selling obsolete inventory, even at a loss, would increase cash and, thus, increase the quick ratio. (Bisk: 51-1-4; CSO: 2.4.1)

24. (c) Net present value equals the summation of the present value of all net cash flows. The present value of the net annual cash inflows equals \$25,000 times the present value of an annuity for six years at 10% rate ($\$25,000 \times 4.355 = \$108,875$). The present value of the salvage value equals \$20,000 times the present value of a single sum at 6 years at 10% interest rate ($\$20,000 \times 0.564 = \$11,280$). The present value of all net cash flows equals $\$108,875 + \$11,280 - \$100,000 = \$20,155$. (Bisk: 51-2-3; CSO: 3.1.1)

25. (b) The variable overhead spending variance is calculated as (Actual Price – Standard Price) × Actual Quantity. $(\$8 - \$10) \times 25 = -\$50$. The variance is favorable since actual price is less than standard price. (Bisk: 53-6-7; CSO: 5.3.1)

26. (d) The advantages of using a profitability index is that it uses free cash flows, recognizes the time value of money, and is consistent with the goal of shareholder wealth maximization. A limitation of the profitability index is that it requires detailed long-term forecasts of the project's cash flows which can be difficult given uncertainties of the future. (Bisk: 51-5-2; CSO: 3.1.1)

27. (c) By definition, the internal rate of return is the rate which would exactly equate the present value of a project's expected cash inflows to the present value of the project's expected costs. (Bisk: 51-2-3; CSO: 3.1.1)

28. (b) The primary objective of data security controls is to ensure that storage media are subject to authorization prior to access, change, or destruction. (Bisk: 55-4-1; CSO: 4.3.1)

29. (b) Extensible business reporting language (XBRL) is an open-information format standard enabling automated sharing of financial information contained in financial statements and other business reports over the World Wide Web. (Bisk: 55-1-3; CSO: 4.1.3)

30. (c) Variations between business cycles most likely are attributable to duration and intensity. The law of diminishing returns indicates a point beyond which additional units of variable input will contribute less and less to total production. Opportunity costs are the costs associated with choosing an alternative project or course of action. Comparative advantage for a good exists when the opportunity cost of producing that good is less than the cost of producing other goods in the same country, compared to another country. (Bisk: 50-2-2; CSO: 2.1.0)

31. (c) The weighted-average cost of debt equals 30% times (10% × 1 – Marginal Tax Rate) equals 2.1%. The weighted-average cost of common stock equals 60% times 12% equals 7.2%. The weighted-average cost of preferred stock equals 10% times 10% equals 1%. The weighted-average cost of capital equals 2.1% + 7.2% + 1% = 10.3%. (Bisk: 51-5-3; CSO: 3.2.1)

32. (b) The cost of preferred stock is equal to the dividend outflow ($9\% \times \$20 = \1.80) divided by the net cash inflow ($\$40 \text{ sales price} - \$5 \text{ issuance cost} = \35). $\$1.80 / \$35 = 5.1\%$. (Bisk: 51-6-3; CSO: 3.2.1)

33. (b) Testing a sales volume of 39,000 for the first product (75% of total sales) indicates a sales volume of 13,000 for the second product (25% of total sales). The contribution margin for the first product equals $39,000 \times (\$10 - \$6) = \$156,000$. The contribution margin for the second product equals $13,000 \times (\$25 - \$13) = \$156,000$. $\$156,000 + \$156,000 = \$312,000$ which is just enough to cover the total fixed costs of $\$100,000 + \$212,000$. (Bisk: 52-2-4; CSO: 5.3.2)

34. (c) High interest rates, the rate of inflation, and the impacts of recessions are all felt across all projects or ventures. However, seeking out projects or ventures (diversifying) that are not subject to the risks associated with labor unions would help mitigate the risk of labor strikes. (Bisk: 50-2-8; CSO: 2.4.2)

35. (d) A virtual private network combines public and private resources that appears as if a remote user is accessing a private network directly by creating an encrypted communication tunnel across the Internet. (Bisk: 55-1-3; CSO: 4.1.2)

36. (c) Enterprise risk management (ERM) is how a company deals with risk, which relates to the future and is inherently uncertain. ERM operates at different levels with respect to different objectives, and is only as effective as the people responsible for its functioning. Given these limitations, ERM cannot provide absolute assurance with respect to objective categories. (Bisk: 49-4-1; CSO: 1.1.3)

37. (a) There are four ways an entity can deal with risk. First is risk sharing, such as through joint ventures. Second is risk acceptance, which is accepting the project or activity as is, with the belief that current levels of risk are manageable and acceptable. Third is risk avoidance, where an entity declines to proceed with the project. Fourth is risk reduction, where an entity takes certain actions in order to reduce the level of risk. Relocating its production facilities is an example of how this manufacturing firm is trying to reduce its risk. (Bisk: 49-4-1; CSO: 1.1.3)

38. (b) The four types of information contained in a balanced scorecard are customer, strategic, financial, and innovation. The innovation information elements tend to answer the question, "Can we continue to improve?" This also may be called the learning and growth perspective. (Bisk: 54-3-1; CSO: 6.3.3)

39. (d) The overhead allocated to premium coffee for separating and roasting beans = $\$3,500 \times (550 / (550 + 150)) = \$2,750$. The overhead allocated to premium coffee for packing and shipping = $\$1,500 \times (500 / (500 + 500)) = \750 . Total overhead per pound allocated to premium = $\$2,750 + \$750 / 500 \text{ pounds} = \7.00 per pound . Total cost per pound for premium coffee = $\$7.00 \text{ overhead} + \$1.25 \text{ labor} + \$1.50 \text{ material} = \9.75 . (Bisk: 53-5-2; CSO: 6.2.0)

40. (c) Material cost transferred out = $\$75,000 \times (13,500 / (13,500 + 1,500)) = \$67,500$. Conversion cost transferred out = $\$55,500 \times (13,500 / (13,500 + (1,500 \times .25))) = \$54,000$. Total cost transferred out = $\$67,500 + \$54,000 = \$121,500$. (Bisk: 53-2-2; CSO: 6.2.0)

Solution 3

To: Senior Manager
Subject: Sarbanes-Oxley Act

The Sarbanes-Oxley Act (SOX) specifies that an audit committee, not management, is responsible for appointment and oversight of any audit work performed by an audit firm. The audit committee of an issuer of publicly traded securities must approve all auditing and nonauditing services provided to the issuer by its auditor. Under the Sarbanes-Oxley Act, each member of the audit committee of a listed company must be independent, meaning that the person cannot accept any consulting, advisory, or other compensatory fees from the company, and cannot be an affiliated person of the company or any of its subsidiaries.

Responsibilities of the audit committee typically include overseeing the financial reporting process, monitoring the choice of accounting policies and principles, monitoring the internal control process, appointment, compensation, and oversight of the external auditors, and receipt of communications and audit reports directly from the external auditors.

Solution 4

To: Controller
Subject: Percentage of accounts receivable balance vs. percentage-of-sales

The primary advantage of using a percentage-of-sales method for calculation of the allowance for doubtful accounts is its simplicity and ease of calculation. A quick review of historical sales periods and the corresponding level of bad debt expense should yield a reasonable estimate of current and future estimates of the allowance for doubtful accounts. However, an inherent weakness of the percentage-of-sales method is that it includes cash sales in total sales, and cash sales by its very nature is not subject to bad accounts.

On the other hand, calculating the allowance for doubtful accounts based on a percentage of the ending receivables balance should yield a more accurate estimate since it recognizes a more causal effect. That is, bad accounts are an inherent component of accounts receivable balances. This methodology can be further refined by preparing an Accounts Receivable Aging Schedule. Long overdue accounts are more prone to default than current accounts. An Accounts Receivable Aging Schedule highlights overdue accounts, providing a simple means of evaluating the quality of accounts receivable and a more accurate basis for estimating the allowance for bad accounts.

The percentage of ending receivables balance method is recommended over the percentage-of-sales method when estimating the allowance for bad accounts.