BUSINESS-ENVIRONMENT-AND-CONCEPTS[Q&As]

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QUESTION 1

Hedgehog International owes 500,000 local currency units to its foreign supplier in 90 days. The current spot rate of the local currency unit is $.60. Hedgehog purchases a call option to buy the local currency unit in 90 days for $.61 for a premium of $.005. The exchange rate for the local currency increases to $.63 in 90 days. What will Hedgehog do on the payables\\' settlement date?

A. Hedgehog will exercise its option and settle the payables with proceeds from the option contract at a gain.

B. Hedgehog will not exercise the option and settle the payables after purchase of the local currency unit at the spot rate.

C. Hedgehog will be indifferent as to whether it exercises the option or not.

D. Hedgehog will sell the option at the settlement date and use its proceeds along with local currency units purchased at the spot rate to satisfy the amount payable.

Correct Answer: A

Choice "a" is correct. Hedgehog will exercise its option and liquidate the payables associated with the proceeds. The exercise of the option represents a less costly alternative than acquisition of proceeds at the spot rate at the time the payables are due. The net impact of exercise of the option is computed as follows:

	Required LCU	Exchange @ Settlement	Call Price	Premium	Total	Payables Settlement
Settlement at spot	500,000	$0.63	$ -	$ -	$ -	$315,000
Settlement with option	500,000	$ -	$0.61	$0.005	$0.615	307,500
Net effect: Gain (Loss)						$ 7,500

The premium is a sunk cost and is irrelevant to the decision. Note that the premium is a factor in

determining the net gain (loss) but not in deciding whether to exercise the option.

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

QUESTION 2

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

A. Must pay federal income tax.

B. Is generally not considered a legal entity separate and apart from its owners.

C. Must have written articles of organization.

D. Must provide for apportionment of liability for the company\\'s debts.

Correct Answer: C

Choice "c" is correct. A limited liability company must have written articles of organization, which must be filed with the state. Choice "a" is incorrect. An LLC taxed under subchapter K of the Internal Revenue Code (the partnership subchapter) does not pay federal income tax; the members are taxed on their share of the LLC\\'s income. Choice "b" is incorrect. Unlike a general partnership, but like a corporation and a limited partnership, an LLC is considered a legal entity separate and apart from its owners. Choice "d" is incorrect. An LLC does not have to provide for apportionment of liability for LLC debts; the members of an LLC have limited liability.

QUESTION 3

The working capital financing policy that subjects the firm to the greatest risk of being unable to meet the firm\\'s maturing obligations is the policy that finances:

A. Fluctuating current assets with long-term debt.

B. Permanent current assets with long-term debt.

C. Permanent current assets with short-term debt.

D. Fluctuating current assets with short-term debt.

Correct Answer: C

Choice "c" is correct. The working capital financing policy that finances permanent current assets with short-term debt subjects the firm to the greatest risk of being unable to meet the firm\\'s maturing obligations. Choices "a" and "b" are incorrect because the use of long-term debt financing produces the smallest risk of being unable to meet maturing obligations. Choice "d" is incorrect because, although financing fluctuating current assets with short-term debt exposes the firm to some risk, it is not the greatest or the smallest.

QUESTION 4

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

A. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.

B. A limited partnership can be formed with limited liability for all partners.

C. A limited partner may not also be a general partner at the same time.

D. A limited partner may hire employees on behalf of the partnership.

Correct Answer: A

Choice "a" is correct. A limited partner has rights similar to those of a corporate shareholder; he must be allowed to review financial and tax information of the limited partnership. Choice "b" is incorrect. A limited partnership must have one or more general partners, whose liability is unlimited. Choice "c" is incorrect. One may be both a general and a limited partner simultaneously. Such a person has all of the rights and liabilities of both a limited partner and a general partner. Choice "d" is incorrect. A limited partner has no management authority, rather he is a passive investor, like a corporate shareholder.

QUESTION 5

The Moore Corporation is considering the acquisition of a new machine. The machine can be purchased for $90,000; it will cost $6,000 to transport to Moore\\'s plant and $9,000 to install. It is estimated that the machine will last 10 years, and it is expected to have an estimated salvage value of $5,000. Over its 10year life, the machine is expected to produce 2,000 units per year with a selling price of $500 and combined material and labor costs of $450 per unit. Federal tax regulations permit machines of this type to be depreciated using the straight-line method over 5 years with no estimated salvage value. Moore has a marginal tax rate of 40 percent.

What is the net cash flow for the tenth year of the project that Moore Corporation should use in a capital budgeting analysis?

A. $81,000

B. $68,400

C. $63,000

D. $60,000

Correct Answer: C

Choice "c" is correct. $63,000 net cash flow for the tenth year.

In year 10:			
Cash inflow from sales	(2,000 × $500) =	$1,000,000	
Cash outflow for mat'l & labor	(2,000 × $450) =	(900,000)	
Cash inflow from operations In year 10 (taxable income)		100,000	
Taxes to be paid at 40% × 100,000		(40,000)	
Cash inflow from operations after taxes			60,000
Salvage value of equipment in year 10		5,000	
Taxes paid at 40% × $5,000		– (2,000)	
Cash inflow from sale of equipment after taxes			3,000
Total cash inflow after taxes			$63,000

Alternate Computation:

In year 10, Moore will generate a $100,000 profit from the incremental sales (2000 units ?($500 - $450)). This profit will be taxed at 40%, so the net after-tax increase in cash flow is $60,000. The machine is fully depreciated in year 10 because it was depreciated over a 5-year life. The tax basis of the machine is zero on the date Moore receives a $5,000 salvage value for the machine. The gain on the machine of $5,000 ($5,000 SV - $0 Basis) is taxed at 40%, or $2,000 in total tax outflow for the gain, so the net inflows on the salvage is $3,000. Therefore, the total after-tax cash flows in year 10 for the new machine is $60,000 + $3,000 = $63,000.

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