BUSINESS-ENVIRONMENT-AND-CONCEPTS Q&As

Certified Public Accountant (Business Environment & Concept)

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QUESTION 1

What would be the primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt?

A. To cause the price of the company\\'s stock to rise.

B. To lower the company\\'s bond rating.

C. To reduce the risk for existing bondholders.

D. To reduce the interest rate on the bonds being sold.

Correct Answer: D

Note: The material tested in this question does not appear specifically on-point in our textbook, as the topic has rarely shown up on the CPA exam. The topics are covered in general in parts of our textbook, so we believe that our students would have answered this question correctly given the information they had. However, we have expanded our of this question to provide you with more detailed information.

Choice "d" is correct. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is to reduce the interest rate on NEW bonds being sold. A debt covenant is a provision in a bond indenture (contract between the bond issuer and the bond holders) that the bond issuer will either do (affirmative covenants) or not do (negative covenants) certain things. In this question, the issuer would agree not to issue bonds in the future over a certain percentage of its long-term debt. Such a provision would be good for the potential bondholders and would probably reduce the interest rate on the bonds being sold.

Choice "a" is incorrect. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is not to cause the price of the company\\'s stock to rise. Bond covenants affect bonds, not equity (at least not directly).

Choice "b" is incorrect. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is not to lower the company\\'s bond rating. Such a covenant might raise, not lower, a company\\'s bond rating because there would be less risk. Besides, why would a bond covenant be signed if it would lower the company\\'s bond rating?

Choice "c" is incorrect. The primary reason for a company to agree to a debt covenant limiting the percentage of its long-term debt is not to reduce the risk of existing bondholders, although a reduction in the risk of the existing bondholders certainly might result from such a covenant. As a general rule, more debt means more risk, less debt means less risk. So less debt would reduce the risk of all bondholders. This answer is a very close second.

QUESTION 2

The level of safety stock in inventory management depends on all of the following, except the:

A. Level of uncertainty of the sales forecast.

B. Level of customer dissatisfaction for back orders.

C. Level of uncertainty in lead-time for stock shipments.

D. Cost to reorder stock.

Correct Answer: D

Choice "d" is correct. Reorder costs do not impact the level of safety stock. Choices "a", "b", and "c" are incorrect. Safety stock levels are affected by:

1.

Uncertain sales forecasts - greater uncertainty means a higher level of safety stock should be carried.

2.

Dissatisfaction of customers - if customers are dissatisfied with back orders (which occur when there are stock outs), then more safety stock should be carried to prevent stock outs.

3.

Uncertain lead times - greater uncertainty means a higher level of safety stock is needed.

QUESTION 3

The treasury analyst for Garth Manufacturing has estimated the cash flows for the first half of next year (ignoring any short-term borrowings) as follows:

	Cash (millions)	
	Inflows	Outflows
January	$2	$1
February	2	4
March	2	5
April	2	3
May	4	2
June	5	3

Garth has a line of credit of up to $4 million on which it pays interest monthly at a rate of 1 percent of the amount utilized. Garth is expected to have a cash balance of $2 million on January 1 and no amount utilized on its line of credit. Assuming all cash flows occur at the end of the month, approximately how much will Garth pay in interest during the first half of the year?

A. $61,000

B. $80,000

C. $132,000

D. $240,000

Correct Answer: A

Choice "a" is correct. First, determine the amount and timing of cash needs: Comments 1 Given 2 Computed balance, positive cash flows 3 Computed balance, negative cash flows 4 Borrow from LOC 5 Computed balance, negative cash flows + interest 6 Cumulative LOC Balance 7 Computed positive cash flows 8 Computed balance, positive cash flows - interest 9 Immediate pay down of LOC Choices "b", "c", and "d" are incorrect, per the above calculation.

		Cash		
	Borrow	Inflows	Outflows	Balance
Beg. bal				$2,000,000 [1]
January		2,000,000	(1,000,000)	$3,000,000 [2]
February		2,000,000	(4,000,000)	$1,000,000 [2]
March		2,000,000	(5,000,000)	($2,000,000) [3]
Borrow	2,000,000			- [4]
April		2,000,000	(3,000,000)	($1,000,000) [3]
Interest paid on $2 mil			**(20,000)**	($1,020,000) [5]
Borrow	1,020,000			- [4]
Total debt	**3,020,000**			[6]
May		4,000,000	(2,000,000)	$2,000,000 [7]
Interest paid on $3.02 mil			**(30,200.00)**	$1,969,800 [8]
Pay LOC	(1,969,800)		(1,969,800)	- [9]
Total debt	1,050,200			[6]
June		5,000,000	(3,000,000)	$2,000,000 [7]
Interest on $1,050,200			**(10,502)**	$1,989,498 [8]

Total interest paid is sum of three interest payments

(20,000)

QUESTION 4

In inventory management, the safety stock will tend to increase if the:

A. Carrying cost increases.

B. Cost of running out of stock decreases.

C. Variability of lead-time increases.

D. Fixed order cost decreases.

Correct Answer: C

Choice "c" is correct. If lead times became more variable, the amount of safety stock needed to reduce the risk of stock outs will increase.

Choice "a" is incorrect. A high carrying cost would decrease safety stock.

Choice "b" is incorrect. A lower stockout cost would decrease safety stock.

Choice "d" is incorrect. If order costs decrease, then inventory will be ordered more frequently and less

safety stock will be needed.

QUESTION 5

If a nation has many rival domestic firms which are all competitive in the global marketplace for a product, which of the four major factors that Michael Porter has indicated impact the global competitive environment would allow this nation to fare better with respect to global competitive advantage?

A. Conditions of the factors of production.

B. Conditions of domestic demand.

C. Related and supporting industries.

D. Firm strategy, structure, and rivalry.

Correct Answer: C

Choice "c" is correct. The factor of related and supporting industries deals with whether there are suppliers of material inputs that exist within a nation or whether there are rival firms who are competitive in the international environment, both of which would increase the nation\\'s competitive advantage. Choice "a" is incorrect. If a nation has a strong set of factors of production (such as low-cost, high quality raw material inputs), that are required in a given industry, it will fare better with regard to competitive advantage. However, this factor is different from the "many rival domestic firms which are all competitive in the global marketplace for a product" as stated in the question. Choice "b" is incorrect. The factor of conditions of domestic demand related to the nation\\'s domestic demand for the product, which is directly related to the ability of the nation to fare better with regard to competitive advantage. However, this factor is different from the "many rival domestic firms which are all competitive in the global marketplace for a product" as stated in the question. Choice "d" is incorrect. The factor of firm strategy, structure, and rivalry relates to the practices of a nation with respect to how the companies are managed and organized, along with the laws of the nation that regulate the formation of the companies, and how intense the rivalry is with respect to competing firms in the nation. However, this factor is different from the "many rival domestic firms which are all competitive in the global marketplace for a product" as stated in the question.