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AICPA

BEC

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QUESTION: 245
The imputed interest rate used in the residual income approach to performance evaluation can best be described as the:

A. Historical weighted average cost of capital for the company.
B. Target return on investment set by the company's management.
C. Average return on investments for the company over the last several years.
D. Marginal after-tax cost of capital on new equity capital.

Answer: B

Explanation:
Choice "b" is correct. The imputed interest rate used in the residual income approach can best be described as the target return on investment set by the company's management.
Choice "a" is incorrect, but it is a close second. The historical weighted average cost of capital may be how management sets the target return on investment.
Choice "c" is incorrect. The average return on investments for past years may not be a good indication of management's future intentions.
Choice "d" is incorrect. Marginal after-tax cost of capital on new equity may be how management sets its targets, but it may not be, too.

QUESTION: 246
One approach to measuring divisional performance is return on investment. Return on investment is expressed as operating income:

A. Divided by the current year's capital expenditures plus cost of capital.
B. Divided by fixed assets.
C. Divided by current assets.
D. Divided by total assets.

Answer: D

Explanation:
Choice "d" is correct. Return on investment is operating income divided by total assets.
Choice "a" is incorrect. Current year's capital expenditures plus cost of capital would be a meaningless denominator.
Choice "b" is incorrect. This omits the current assets employed by the division. Choice "c" is incorrect. This omits fixed assets.

QUESTION: 247
The following selected data pertain to the Darwin Division of Beagle Co. for 1994:

Sales	$400,000
Operating income	40,000
Capital turnover	4
Imputed interest rate	10%

What was Darwin's 1994 residual income?

A. $0
B. $4,000
C. $10,000
D. $30,000

Answer: D

Explanation:
Choice "d" is correct. Residual income is income less the imputed interest rate times average invested capital. Capital turnover is equal to sales / average invested capital.

Average invested capital	=	($400,000 ÷ 4)
	=	$100,000
Residual income	=	$ 40,000 - (10% x $100,000)
	=	$ 30,000

Choice "a" is incorrect. Residual income is greater than zero. The imputed interest rate times average invested capital needs to be compared with operating income.
Choice "b" is incorrect. Residual income is not simply the imputed interest rate times operating income. The imputed interest rate times average invested capital needs to be compared with operating income. Choice "c" is incorrect. Residual income is not simply imputed interest rate times average invested capital. The operating income must be considered.

QUESTION: 248
Select Co. had the following 1994 financial statement relationships: Asset turnover 5 Profit margin on sales 0.02 What was Select's 1994 percentage return on assets?

A. 0.1 percent.
B. 0.4 percent.
C. 2.5 percent.
D. 10.0 percent.

Answer: D

Explanation:
Choice "d" is correct. Return on assets equals income divided by average assets. This formula can be further divided into the components of profit margin times asset turnover (referred to as the Dupont formula):

$$\frac{\text{Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Average Assets}}$$

Return on assets = 0.02 x 5 = **10%**

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

QUESTION: 249
The following information pertains to Quest Co.'s Gold Division for 1993:

Sales	$311,000
Variable cost	250,000
Traceable fixed costs	50,000
Average invested capital	40,000
Imputed interest rate	10%

Quest's return on investment was:

A. 10.00 percent.
B. 13.33 percent.
C. 27.50 percent.
D. 30.00 percent.

Answer: C

Explanation:
Choice "c" is correct. Return on investment equals net income divided by average invested capital: Choices "a", "b", and "d" are incorrect, per the above calculation.

ROI = Net income / Average invested capital
= ($311,000 – $250,000 – $50,000) / $40,000
= $11,000 / $40,000
= 27.5%

QUESTION: 250
Williams, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.
. Williams can raise cash by selling $1,000, 8 percent, 20-year bonds with annual interest payments.
In selling the issue, an average premium of $30 per bond would be received, and the firm must pay floatation costs of $30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.
. Williams can sell 8 percent preferred stock at par value, $105 per share. The cost of issuing and selling the preferred stock is expected to be $5 per share.
. Williams' common stock is currently selling for $100 per share. The firm expects to pay cash dividends of
$7 per share next year, and the dividends are expected to remain constant. The stock will have to be underpriced by $3 per share, and floatation costs are expected to amount to $5 per share.
. Williams expects to have available $100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.
. Williams' preferred capital structure is: Long-term debt 30%
Preferred stock 20 Common stock 50
The cost of funds from retained earnings for Williams, Inc. is:

A. 7.0 percent.
B. 7.4 percent.
C. 8.1 percent.
D. 7.8 percent.

Answer: A

Explanation:
Choice "a" is correct. 7.0 percent cost of funds from retained earnings.
The cost of retained earnings is equal to the rate of return required by the firm's common

shareholders (or, in effect, the return "lost" by them when the firm chooses to fund with retained earnings). While oftentimes this rate is somewhat subjective, we are given the facts to exactly answer the question in this case. The stock is currently selling for $100/share, and the dividend is given at $7/share.

$7 / $100 = 7%

Choices "b", "c", and "d" are incorrect, per the above Explanation:/calculation.