University of Central Florida (UCF) ACG3173 Accounting for Decision-Makers Exam 3 Practice (Sample)

Study Guide

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<u>Questions</u>

1. What happens when a company buys back its own stock, also known as treasury stock?
   A. Stockholders' equity increases and cash remains constant
   B. Stockholders' equity decreases and cash decreases
   C. Cash increases and liabilities increase
   D. Assets and stockholders' equity both increase

2. What must occur before a dividend can be legally paid?
   A. It must be declared by the board
   B. It must be approved by shareholders
   C. It must be recorded in the company's books
   D. It must be funded from new investments

3. What distinguishes a capital budget from an operating budget?
   A. A capital budget is for long-term investments while an operating budget is for day-to-day operations
   B. An operating budget is for long-term investments while a capital budget is for day-to-day operations
   C. A capital budget only considers cash flows, while an operating budget includes non-cash items
   D. There is no difference; both are the same type of budget

4. What does net present value (NPV) represent?
   A. The total revenue generated from investments
   B. The difference between present value of cash inflows and outflows
   C. The overall profitability of a company
   D. A measure of liabilities compared to assets

5. What is the formula for the contribution margin ratio?
   A. Contribution margin divided by sales revenue
   B. Net profit divided by total assets
   C. Total revenue minus total expenses
   D. Sales revenue minus cost of goods sold

6. Which item is typically deducted from revenue to calculate gross profit?

A. Net income

B. Operating expenses

C. Cost of goods sold (COGS)

D. Interest expense

7. When calculating Debt Ratio, what should be included in the numerator?

A. Only end liabilities

B. Only total assets

C. End Debt plus proceeds from bonds

D. Only bonds payable

8. What formula is used to calculate Earnings Per Share (EPS)?

A. Net Income / Total Assets

B. Net Income / Shares Outstanding

C. Shares Outstanding / Net Income

D. Net Income / Total Liabilities

9. What is "Additional Paid-In-Capital"?

A. Capital that shareholders owe the company

B. The amount paid in excess of the par value of stock

C. Capital resulting from reinvested profits

D. Bond premiums received by the company

10. In the context of the balance sheet, why are Marketable Securities significant?

A. They indicate company liabilities

B. They show unrealized gains and losses

C. They can affect the debt ratio

D. They are a source of equity funding

Answers

1. B
2. A
3. A
4. B
5. A
6. C
7. C
8. B
9. B
10. B

Explanations

1. What happens when a company buys back its own stock, also known as treasury stock?

A. Stockholders' equity increases and cash remains constant

B. Stockholders' equity decreases and cash decreases

C. Cash increases and liabilities increase

D. Assets and stockholders' equity both increase

When a company buys back its own stock, often referred to as treasury stock, it decreases stockholders' equity because the company is essentially utilizing its cash to purchase its own shares, which reduces the total amount of equity available to shareholders. The cash used for this purchase also decreases as the company spends money to acquire these shares. This transaction does not contribute to an asset increase; instead, it reduces the company's cash balance while simultaneously affecting the equity section of the balance sheet. The shares purchased as treasury stock are accounted for as a reduction in total stockholders' equity. Thus, the cash outflow to buy back shares results in a direct decrease in total stockholders' equity alongside a decrease in cash, reflecting the financial maneuver's impact on the company's balance sheet. Other options reflect incorrect relationships between equity, cash, assets, and liabilities in the context of stock buybacks. For example, stockholders' equity cannot increase when treasury stock is acquired, nor can assets or liabilities increase simply due to the buyback of shares since it essentially represents a reallocation of capital within the company rather than an operational increase in assets or an obligation to pay liabilities.

2. What must occur before a dividend can be legally paid?

A. It must be declared by the board

B. It must be approved by shareholders

C. It must be recorded in the company’s books

D. It must be funded from new investments

A dividend must be declared by the board of directors before it can be legally paid. This declaration is a formal process in which the board reviews the company's financial status and decides whether to distribute earnings to shareholders in the form of dividends. The decision to declare a dividend typically takes into account several factors, including the company's profitability, financial health, and future investment needs. While shareholder approval is important in terms of understanding shareholder interests and preferences, it is not a legal requirement for the payment of dividends. Similarly, recording the dividend in the company’s books or linking it to new investments does not satisfy the legal prerequisites for declaring a dividend. The board's declaration is the critical step that initiates the process of dividend payment, ensuring that all required assessments are considered before funds are distributed to shareholders.

3. What distinguishes a capital budget from an operating budget?

A. A capital budget is for long-term investments while an operating budget is for day-to-day operations

B. An operating budget is for long-term investments while a capital budget is for day-to-day operations

C. A capital budget only considers cash flows, while an operating budget includes non-cash items

D. There is no difference; both are the same type of budget

A capital budget is distinctly focused on long-term investments, such as the acquisition of property, plant, and equipment, or other significant projects and assets that will benefit the organization over several years. This type of budget helps organizations plan for expenditures that are expected to generate value over a long period, typically more than one year. It involves evaluating potential investments by analyzing their expected returns and associated risks. On the other hand, an operating budget relates to the day-to-day operations of the organization. This budget accounts for expected revenues and expenses that the business incurs during a specific period, usually a fiscal year. It encompasses regular activities such as selling goods and services, paying employee salaries, and managing supplies. The core distinction lies in the time horizon and purpose of each budget: the capital budget concerns long-term positioning and values, while the operating budget concentrates on immediate and recurring financial activities. This difference is crucial for effective financial management and planning within an organization.

4. What does net present value (NPV) represent?

A. The total revenue generated from investments

B. The difference between present value of cash inflows and outflows

C. The overall profitability of a company

D. A measure of liabilities compared to assets

Net present value (NPV) is a financial metric that is used to evaluate the profitability of an investment or project by assessing the present value of its cash inflows compared to the present value of its cash outflows. It represents the difference between the present value of future cash inflows generated by the investment and the present value of the costs associated with that investment. By calculating the NPV, decision-makers can determine whether an investment is expected to yield a profit or a loss in today's dollars, taking into account the time value of money. If the NPV is positive, it indicates that the projected earnings (in present value terms) exceed the anticipated costs, suggesting that the investment would add value to the firm. A negative NPV means that the project would subtract value, while an NPV of zero suggests that the project would break even. Therefore, understanding NPV is crucial for informed decision-making regarding project selection and capital budgeting. In contrast, total revenue generated from investments simply reflects the gross monetary gains without accounting for the timing and magnitude of costs, while overall profitability and measures of liabilities versus assets focus on broader financial health and stability rather than the specific cash flow analysis provided by NPV.

5. What is the formula for the contribution margin ratio?

A. Contribution margin divided by sales revenue

B. Net profit divided by total assets

C. Total revenue minus total expenses

D. Sales revenue minus cost of goods sold

The contribution margin ratio is a critical metric used to assess how much of a company's sales revenue is available to cover fixed costs and contribute to profit after variable costs have been accounted for. The formula for the contribution margin ratio is indeed calculated by dividing the contribution margin by sales revenue. To elaborate, the contribution margin itself is determined by subtracting total variable costs from total sales revenue. The contribution margin ratio then expresses this margin as a percentage of sales revenue, providing a useful indication of the profitability of sales once variable costs are paid. This ratio is particularly valuable for decision-makers in understanding how changes in sales volume will affect overall profit. For instance, if a company's contribution margin ratio is high, it implies that a large portion of sales revenue is retained as profit after covering variable costs, which can guide pricing and sales strategies. Other options do not relate to the formula for the contribution margin ratio. For example, net profit divided by total assets pertains to return on assets, while total revenue minus total expenses relates to net income, and sales revenue minus cost of goods sold provides gross profit, neither of which directly convey the concept of contribution margin in relation to sales revenue.

6. Which item is typically deducted from revenue to calculate gross profit?

A. Net income

B. Operating expenses

C. Cost of goods sold (COGS)

D. Interest expense

To calculate gross profit, the commonly used formula is: Gross Profit = Revenue - Cost of Goods Sold (COGS) Cost of Goods Sold represents the direct costs attributable to the production of the goods sold by a company. This includes expenses such as materials and labor directly used to create the product. By deducting COGS from revenue, businesses can ascertain how much profit is generated directly from their sales activities before accounting for other expenses such as operating expenses, interest, and taxes. In contrast, net income is not deducted from revenue since it represents the overall profitability after all expenses, including COGS, operating expenses, taxes, and interest, have been accounted for. Operating expenses encompass broader costs related to running a business that are not directly tied to the production of goods, while interest expense pertains to costs related to borrowed funds, neither of which are involved in the calculation of gross profit.

7. When calculating Debt Ratio, what should be included in the numerator?

A. Only end liabilities

B. Only total assets

C. End Debt plus proceeds from bonds

D. Only bonds payable

The numerator in the Debt Ratio calculation consists of total liabilities, which reflects all obligations a company has, including various forms of debt. This encompasses both current and long-term liabilities, which would include loans, lease obligations, and indeed the proceeds from bonds, representing borrowed funds that the company must repay. While it might seem logical to consider only specific types of debt, such as bonds payable, or focus solely on certain liabilities, the Debt Ratio is meant to provide a comprehensive view of a company's leverage by measuring the proportion of total assets that are financed through debt. Therefore, including end debt (which covers all obligations) alongside proceeds from bonds captures the overall indebtedness of the firm relevant for assessing financial risk and leverage. In contrast, only considering end liabilities would omit important components of total debt. Similarly, including only total assets ignores the debt aspect entirely. Limiting the numerator to bonds payable would not provide a complete picture of a company's debt situation. Thus, including both end debt and proceeds from bonds best reflects total liabilities for the Debt Ratio calculation.

8. What formula is used to calculate Earnings Per Share (EPS)?

A. Net Income / Total Assets

B. Net Income / Shares Outstanding

C. Shares Outstanding / Net Income

D. Net Income / Total Liabilities

The formula for calculating Earnings Per Share (EPS) is derived from the financial performance of a company and focuses on how much profit is attributable to each share of common stock. By dividing net income by the number of shares outstanding, this formula provides a clear indication of a company's profitability on a per-share basis. This is particularly useful for investors as it allows them to compare the earnings generated by different companies on a standardized basis. Using net income in the numerator reflects the company’s total earnings after all expenses, taxes, and costs have been deducted. The denominator, which is the number of shares outstanding, represents the total number of shares issued by the company that are currently held by shareholders. Together, this results in EPS, a key metric that helps investors assess financial performance and make informed investment decisions. In contrast, the other options provided do not accurately represent the formula for EPS, as they involve different variables that do not directly relate to calculating earnings on a per-share basis.

9. What is "Additional Paid-In-Capital"?

A. Capital that shareholders owe the company

B. The amount paid in excess of the par value of stock

C. Capital resulting from reinvested profits

D. Bond premiums received by the company

"Additional Paid-In-Capital" refers to the amount shareholders pay for their shares above the par value of the stock. When a company issues stock, it often sets a nominal par value for its shares, which is an accounting measure rather than a reflection of true market value. Any amount that shareholders pay above this par value is recorded as "Additional Paid-In-Capital." This concept is essential for understanding a company's equity section on its balance sheet. For instance, if a company issues shares with a par value of $1 at a price of $10, the $1 is recorded as the common stock value, and the additional $9 is recorded as Additional Paid-In-Capital. This demonstrates the confidence investors have in the company's potential, as they are willing to pay a premium over the nominal value of the stock. Understanding the components of equity, including Additional Paid-In-Capital, helps in evaluating a company's financial health and its ability to raise capital from investors. It reflects how much capital the company has raised from shareholders beyond the minimum required equity, indicating both financial support and trust from investors.

10. In the context of the balance sheet, why are Marketable Securities significant?

A. They indicate company liabilities

B. They show unrealized gains and losses

C. They can affect the debt ratio

D. They are a source of equity funding

Marketable securities are significant in the context of the balance sheet primarily because they are financial instruments that can be easily converted into cash, such as stocks and bonds. These securities can fluctuate in value, leading to unrealized gains and losses, which are not yet realized through a sale but still provide important insights into a company's financial health. When the value of marketable securities increases, it reflects positively on the company's financial position, potentially enhancing its net worth. Conversely, a decrease in their value can signal potential financial troubles. Thus, the presence of marketable securities on the balance sheet highlights their role not just as an asset, but also as an indicator of the company’s liquidity and the potential volatility of its investment holdings. This understanding can help investors assess the risks associated with the company’s assets and make more informed decisions regarding the company’s overall financial strategy. The ability to recognize these unrealized gains and losses is crucial when evaluating a company’s performance and investment portfolio over time.