**Review Questions**

**Multiple Choice**

*Identify the letter of the choice that best completes the statement or answers the question.*

\_\_\_\_ 1. Statement 1: “Manufacturing firms sometimes find it advantageous to build factories with greater production capacity than they ordinarily need in order to frighten potential competitors.”

Statement 2: “A ***specific asset*** is a technical term created by economists to describe a durable item that a firm acquires because it provides value in the production of more than one product.”

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| a. | Statement 1 is true, but 2 is false. |
| b. | Statement 2 is true, but 1 is false. |
| c. | Both statements are true. |
| d. | Both statements are false. |

\_\_\_\_ 2. Some firms set the transfer price of a good produced in an internal division by identifying the price charged for similar products produced outside the firm. This is an especially attractive approach when which of the following situations occurs?

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| a. | The production of the internal divisions product has no synergies with other internal divisions. |
| b. | The production of the internal division’s product is an extremely ‘specific asset’ |
| c. | The production of the internal division is a long way from capacity. |
| d. | The production of the internal division’s product is very near to capacity. |

\_\_\_\_ 3. Your company makes “Wrackspurts” and sells them to a monopoly retailer named “Potterisms.” Which of the following statements is most likely to be true given the material presented in this class?

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| a. | If your firm buys out Potterisms, it is likely that the combined company will make more money than the two firms did separately because you can eliminate the problem of double monopoly markup. |
| b. | If your firm buys out Potterisms, it is likely that the combined company will make more money than the two firms did separately due to asset specificity. |
| c. | If your firm buys out Potterisms, it is likely that the combined company will make about the same amount of money as the two firms did separately before. |
| d. | None of the above statements are likely to be true given the material presented in class. |

\_\_\_\_ 4. Statement 1: “The services provided by expense centers are frequently under-used in the firms they operate in.”

Statement 2: “The projects selected by investment centers tend to be very risky if the center’s manager is rewarded based on the divisions return on assets.”

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| a. | Statement 1 is true, but 2 is false |
| b. | Statement 2 is true, but 1 is false |
| c. | Both statements are true |
| d. | Both statements are false |

\_\_\_\_ 5. Your firm is significantly vertically integrated. Its manufacturing division assembles the product. The shipping divisions ships the product from manufacturing to retail. The retail division sells the product to customers. The accounting division keeps track of costs, revenues and profits for all three divisions. Which division is not part of the vertical chain?

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| a. | Accounting |
| b. | Manufacturing |
| c. | Shipping |
| d. | Retail |

\_\_\_\_ 6. Biffco provides secretarial help to medical doctors in the Los Angeles area. Biffco’s secretaries could work effectively for any of thousands of doctors in the LA area. The longer a secretary stays with a particular doctor, the more she knows about the doctor’s way of doing business that is different from other doctors. This can include the specialized billing systems in the office, and may even extend to getting to know the needs of long term clients of the doctor.

Overtime Biffco has noticed that secretaries that work for the same doctor for a long time tend to get hired by the doctor they work for, and Biffco loses a good employee. This is irritating to Biffco because they expected to be able to charge more for long term secretaries as they became more valuable to the doctor. Which of the following notions discussed in class is most likely to be a reason for doctors to hire the long term secretaries?

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| a. | Secretaries that have worked in your office for years are what economists call ‘specific assets’ so vertical integration will increase profitability. |
| b. | Secretaries who have worked only briefly in your office are more likely to be subject to what economists call “hold-up problems” than those who have been around for a while, so Doctors only hire the latter group. |
| c. | The doctors are trying to avoid paying unemployment insurance tax on long-term secretaries. |
| d. | All of the above stories are used by economists to explain why doctors want to hire the long-term secretaries away from Biffco. |

\_\_\_\_ 7. Your company produces dolls, that are manufactured in Iowa and sold at retail outlets operated by your firm in Iowa, New York and Los Angeles. Each doll costs $2 to make, and the per doll share of fixed costs is currently $3. You can make 1000 dolls in time for Christmas sales, but any more is impossible due to the limitations of your machinery. The managers of the retail divisions in Iowa, New York and Los Angeles all say that they could sell 1000 dolls by Christmas. In Iowa they could get $15 for each doll, in New York $20, and in Los Angeles $18. Which of the following would be the most profitable transfer price for these dolls in December?

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| a. | $2 |
| b. | $5 |
| c. | $18.01 |
| d. | $15 |

\_\_\_\_ 8. Statement 1: “As a general rule, the correct transfer price between divisions within a firm is most profitably set using the price an outside firm charges for the same item.”

Statement 2: “When a firm is at capacity, the marginal cost of production is the theoretically best transfer price if the firm wishes to maximize profit.”

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| a. | Statement 1 is correct, but 2 is not. |
| b. | Statement 2 is correct, but 1 is not. |
| c. | Both statements are correct. |
| d. | Neither statement is correct |