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E12-13

Overinvestment and Underinvestment [LO 5]

Consider two companies: Quantum Products and Aquafin Products. Senior managers at Quantum Products are evaluated in terms of increases in profit. In fiscal 2011, Quantum Products had a net operating profit after taxes of $2,500,000 and invested capital of $25,000,000. In fiscal 2012, the company had net operating profit after taxes of $3,000,000 and invested capital of $37,500,000. Senior managers at Aquafin Products are evaluated in terms of ROI. In fiscal 2012, ROI was 16 percent while the cost of capital was only 12 percent. Near the end of fiscal 2012, managers had an opportunity to make an investment that would have yielded a return of 14 percent. However, the senior managers did not support making the investment.
Explain why the senior managers at Quantum Products have an incentive to overinvest.

Explain why the senior managers at Aquafin Products have an incentive to underinvest.

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P12-16

Transfer Pricing [LO A1]

Montana Woolen Products has two divisions: a Fabric division that manufactures woolen fabrics, and a Clothing division that manufactures woolen dresses, coats, shirts, and accessories. All fabric used by the Clothing division is supplied by the Fabric division, which also supplies fabric to outside companies.
Suggest a transfer price for the fabric assuming that the Fabric division is operating at only 60 percent of capacity due to a surge in popularity of "easy-care" fabrics made of polyester and rayon.

Suggest a transfer price for fabric assuming that the Fabric division is operating at capacity due to a revival of consumer interest in natural products and development of lightweight, wrinkle-resistant woolen fabrics.

Explain how your choices in Parts a and b are related to the opportunity cost concept.