CIA Test Preparation
Part III

Study Unit Seven:
Regulatory Legal and Economic Issues

March 2012

Agenda:

- Regulation of Business
- International Trade
- Currency Exchange Rates and Markets
- Methods of Taxation
- Economic Indicators
- Legal Rules of Evidence
- Contracts

7.1 Regulation of Business

Agencies and Commission

a)An agency or commission may regulate a specific industry or one area affecting all industries.

b)Administrative agency rules and regulations

- Should not go beyond the scope of the delegated authority of its enabling statutes
- May be issued under a general grant of authority to an agency to regulate and industry
- May be issued under a specific grant of authority to an agency to make detailed rules carrying out objectives of a statute.

c)Courts interpret statutes, regulations, and the actions of agencies when a dispute develops and one or both parties wish a judicial determination

d)Some rules and regulations, agencies, and legislation have sunset provisions that require periodic review and reenactment.

7.1 Regulation of Business

Economic Regulation

1. Such regulation usually affects prices and service to the public and is ordinarily industry specific.

Social Regulation

1. Social regulation has been criticized on the grounds that it (1) is costly; (2) contributes to overregulation; (3) may inhibit innovation; (4) increase inflation; and (5) may place a disproportionate burden on small entities.

2. Another criticism is that regulators are perceived to have little concern for the relation of marginal benefits and marginal costs.

7.1 Regulation of Business

Securities Law

1. To provide complete and fair disclosure to potential investors in an initial issuance of securities.
   - Disclosure is through a filing with a government agency. Potential investors may be required to receive a disclosure document.
   - Exemptions: Certain securities and transactions may be exempt
   - Civil liability may be imposed on parties associated with a filing that contains a misstatement or omission of a material fact
   - Antifraud liability may be imposed on sellers in an initial issuance of securities.

7.1 Regulation of Business

Securities Law

2. To regulated trading of securities after initial issuance
   - Registration may be necessary for (1) securities exchanges, (2) brokers and dealers, (3) securities traded on exchanges, and (4) high-volume securities traded over the counter
   - Insider trading is buying or selling securities of an entity by any individuals who are aware of material nonpublic information not available to the general public
   - Civil and criminal penalties for insider trading may be imposed.
   - In some countries, legislation prohibits secret payments to persons in foreign countries for purposes contrary to public policy such as corrupt payments to foreign officials.

7.1 Regulation of Business

Antitrust Law

1. Competition controls private economic power, increase output, and lowers prices. It promotes
    - Efficient allocation of resources
    - Greater choice by consumers
    - Greater business opportunities
    - Fairness in economic behavior
    - Avoidance of concentrated political power

2. Restraints of trade in domestic or foreign commerce may be prohibited
    - Price fixing is usually the most prosecuted violation

7.1 Regulation of Business

Antitrust Law (Cont'd)

1. Other antitrust law may prohibit the acquisition of shares or assets of another entity if the effect may be to lessen competition substantially or tend to create a monopoly.
   - Tying or tie-in sales: sales in which a buyer must take other products to buy the first product
   - Exclusive dealing: a requirement by the seller that a buyer not deal with the seller's competitors
   - Price discrimination: unfair discounts and other preference

2. Unfair methods of competition and unfair or deceptive acts in commerce, including false or misleading advertising, are antitrust violations in some countries.

7.1 Regulation of Business

Consumer Protection

1. A government agency may help to maintain the safety of drugs, food, cosmetics etc. and also may enforce laws requiring the labeling of hazardous substances

2. Other consumer protection laws may:
   - Prohibit deceptive packaging and labeling
   - Give consumers the right to obtain the information reported by credit agencies
   - Protect the public from unreasonable risk of injury from consumer products.
   - Prohibit discrimination in providing credit
   - Regulate written warranties on consumer products
   - Prohibit abuses of consumers' rights by collection agencies
   - Require disclosure of the terms and conditions of consumer credit

7.1 Regulation of Business

Environmental Protection

1. An agency may be created to centralize environmental controls functions of the national government
2. A national environmental policy may be established, and the consideration of environmental issues by government agencies may be promoted
3. Air quality standards may be established for listed pollutants.
4. The law also may establish national water quality standards and pollution standards for each industry
5. Other laws may be designed to control hazardous waste

7.1 Regulation of Business

Money Supply and Interest Rate

1. The central bank (a group of regional banks) controls the money supply. Any policy designed to affect the money supply, and thus the economy, is monetary policy.
2. The functions of a central bank include:
   - Control of the money supply
   - Check collection
   - Serving as the fiscal agent of the government
   - Supervision of the entire banking system
   - Holding deposits for member institute
3. A commercial bank usually must have on reserve a certain percentage of its total deposits. These fractional reserve requirements may be required by law
4. If a bank's actual reserves exceed the reserves required by law, the bank can extend its loan

7.1 Regulation of Business

Money Supply and Interest Rate (Cont'd)

1. Money multiplier. For the banking system as a whole, assuming no leakage, money creation is measured by a multiple of excess reserves as follows:

$$\boxed{D = 1/r}$$

2. A market exists for the lending by member banks of their reserves to each other.

7.1 Regulation of Business

Monetary Policy Tools

1. Open-market operations
   - Purchases are expansionary
   - Sales are contractional
   - Interest rate changes

2. Reserves
   - Lowering the percentage is expansionary
   - Raising the percentage has the opposite effect

3. Changing the rate
   - Lowering the rate: encourage borrowing between banks, increases money supply
   - Raising the rate: discourage borrowing, decreases money supply

Key Concept:

- Administrative agency is any public officer or body that makes rules and renders decisions.
- One purpose of securities law is to provide complete and fair disclosure to potential investors in an initial issuance of securities. They do not impose criminal sanction.
- Other purpose of securities law are to regulate trading of securities after initial issuance, provide adequate information to investors, and prevent insiders from unfairly using nonpublic information
- Insider trading is buying or selling securities of an entity by individuals with access to non public material information
- Antifraud provisions related to subsequent trading make unlawful any fraudulent scheme.
- Restraints of trade in domestic or foreign commerce may be prohibited. But only unreasonable restraints may be illegal.
- Other antitrust laws may prohibit the acquisition of shares or assets of another corporation if the effect may be to lessen competition substantially or tend to create a monopoly in any line of commerce in any part of the country.

Key Concept (Cont’d):

- Consumer protection law address (1) the safety of food, drugs, cosmetics (2) deceptive packaging and labeling (3) product safety (4) credit discrimination (5) written warranties on consumer products (6) fair credit billing (7) debt collection (8) truth in lending
- A national environmental policy and the consideration of environmental issues by government agencies may be promoted.
- A central bank controls the money supply. Any policy designed to affect the money supply, and thus the economy, is monetary policy
- If a bank’s actual reserves exceed the reserves required by law, it has excess reserves with which it can extend loans.

STOP! Review

1. Regulatory agencies usually do not have power to

    a) Impose agency taxes on private industry.

    b) Issue rules and regulations.

    c) Investigate violations of statues and rules.

    d) Conduct hearings and decide whether violations have occurred.

Answer (A): A regulatory agencies have the power to issue rules and regulations.

STOP! Review

2. The basic purpose of most rational securities laws is to regulate the issue of investment securities by

    a) Providing a regulatory framework for those local governments that do not have their own securities laws.

    b) Requiring disclosure of all relevant facts so that investors can make informed decisions.

    c) Prohibiting the issuance of securities that the government determines are not of investment grade.

    d) Channeling investment funds into uses that are economically most important.

Answer (B): The basic purpose of the securities laws is to provide disclosure of adequate information so that investors can evaluate investments. This is accomplished through reporting requirements concerning the issuance and subsequent trading of securities. However, the government does not assess the merits of these securities.

STOP! Review

3. An antifraud law that prohibits trading on the basis of inside information about a business corporation’s stock most likely applies to

   a) Officers and directors.

   b) All officers, directors, and shareholders.

   c) Officers, directors, and holders of a large amount of the corporation’s stock.

   d) Anyone who bases his/her trading activities on the inside information.

Answer (D): Such antifraud provisions typically prohibit any person from engaging in manipulative or deception acts in the purchase or sale of any security. It prohibits trading on the basis of inside information and applies to anyone who has not made a full disclosure of the inside information. It may apply not only to officers, directors, and shareholders, but also to tippees.

STOP! Review

4. Which of the following persons is not an insider of a corporation subject to the Securities Exchange Act of 1934 registration and reporting requirements?

    a) The president.

    b) A member of the board of directors.

    c) A shareholder who owns 8% of the outstanding common stock and whose spouse owns 4% of the outstanding common stock.

    d) An owner of 15% of the total face value of the corporation's outstanding debentures.

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Answer (D): Antitrust laws are designed to promote more efficient allocation of resources, greater choice for consumers, greater business opportunities, fairness in economic behavior, and avoidance of concentrated political power resulting from economic power. Competition results in greater output and lower prices than other market structures.

STOP! Review

5. Which one of the following examples of corporate behavior would most clearly represent a violation of antitrust law?

   a) A retailer offers quantity discounts to large institutional buyers.

   b) The members of a labor union meet and agree not to work for a specific entity unless the starting wage is at least a specified amount per hour.

   c) Two entities that are in different, unrelated industries merge.

   d) Two entities in the same industry agree in a telephone conversation to submit identical bids on a government contract.

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Answer (D): Antitrust laws are designed to promote more efficient allocation of resources, greater choice for consumers, greater business opportunities, fairness in economic behavior, and avoidance of concentrated political power resulting from economic power. Competition results in greater output and lower prices than other market structures.

7.2 International Trade

Comparative advantage

1. The laws of supply and demand affect imports and exports in the same way that they affect domestic goods
    - Net exports = country's exports - imports.

2. The exchange ratio:
    - (Country's export price index/import price index) x 100

3. Country vary greatly in their efficiency in producing certain goods because of difference in such factors:
    - Climate and geographical conditions
    - Human capacities
    - Supply and type of capital accumulation
    - Proportions of resources
    - Political and social climates

7.2 International Trade

Comparative advantage (Cont'd)

1. Mutually benefit from trade when:
   - Nations specialize and then exchange with others; more is produced and consumed than if each nation tries to be self-sufficient
   - Specialization of labor is beneficial for individuals
   - Comparative advantages: "relative opportunity costs" – each country has to sacrifice fewer units of another good to generate an additional unit of the first good.
   - Comparative advantage >> Exports!

7.2 International Trade

Trade Barriers

1. Protectionism is any measure taken by a government to protect domestic producers:
   - **Tariffs:** Consumption taxes designed to restrict imports (i.e. revenue tariff >> applies to products that are not produced domestically)
   - **Import quotas:** Set fixed limits on different products. In a short run, it helps country balance of payments position by increasing domestic employment (Embargo: total ban on some kinds of imports)
   - **Domestic content rules:** At least a portion of any imported product be constructed from parts manufactured in the importing nation. Usually applies to capital-intensive nations.
   - **Voluntary export restrictions:** Agreements entered into by exporters to reduce the number of products made available in a foreign country in an attempt to avoid official sanctions.

7.2 International Trade

Trade Barriers (Cont'd)

- **Trigger price mechanism:** Automatically imposes a tariff barrier against unfairly cheap imports by levying a duty (tariff) on all imports below a particular price
- **Antidumping rules:** Prevent foreign producers from selling excess goods on the domestic market at less than cost to eliminate competitors and gain control of the market.
- **Exchange controls:** Limit foreign currency transactions and set exchange rates to remove (repatriate) its earnings from the country.
- **Export subsidies:** Payments by the government to producers in certain industries in an attempt to increase exports.
- **Special tax benefits to exporters:** An indirect form of export subsidy.
- **Licenses**
- **Expropriation:** Greatest political risk of doing business abroad.

7.2 International Trade

Trade Barriers (Cont'd)

2. **Economic effects of tariffs and quotas:**

Tariff	Quota
• The excess paid by the customer for an imported good goes into the government treasury where it can be spent for any purpose. • Imposed on all importers equally. Thus, the more efficient ones will still be able to set their prices lower than the less efficient ones.	• Prices also are driven up, but the excess goes to the exporter in the foreign country. • Does not affect foreign importers equally. Import licenses may be assigned as much for political favoritism.

7.2 International Trade

Trade Barriers (Cont'd)

3. Benefit of protectionism
   - Reduce imports protects domestic jobs
   - Certain industries are essential to national security
   - Industries need protection in the early stages of development

Key Concept:

- The laws of supply and demand affect imports and exports in the same way that they affect domestic goods.
- The exchange ratio is the ratio of a country's export price index to its import price index, multiply by 100
- The greatest advantage from trade is obtained when each nation specializes in what it can produce most efficiently
- Trade barriers cause resources to be misallocated in the country that established the barrier because inputs are used to produce products that could be produced more economically in other countries.
- Protectionism is any measure taken by a government to protect domestic producers
- Protectionism reduces economic efficiency, real wages, and world output.

STOP! Review

6. The total exports of Vietnam are US$20,000,000 worth of rice to Greece, and the total exports of Greece are US$18,000,000 worth of olives to Vietnam. The terms of trade are:

	Greece	Vietnam
a)	90	111
b)	120	180
c)	111	90
d)	97	103

Answer (A): A country's terms of trade are calculated by dividing its export price index by its import price index and multiply by 100. Greece's total exports (US $18,000,000)/total imports (US $20,000,000) equals 0.9x100 = 90. Vietnam's total exports (US $20,000,000)/imports (US $18,000,000) equals 1.11x10 = 111

STOP! Review

7. The economic reasoning dictating that each nation specialize in the production of goods that it produces relatively more efficiently than other nations and import those goods that are produced relatively more efficiently by other nations is called the doctrine of

   a) Efficient trade.

   b) Diminishing returns.

   c) Relatively competition.

   d) Comparative advantage.

Answer (D): The doctrine of comparative advantage relates to comparative costs within one country. It holds that a country should produce those products in which it has a comparative advantage, not necessarily those products in which it has an absolute advantage.

STOP! Review

8. Which of the following is a tariff?

   a) Licensing requirements.

   b) Consumption taxes on imported goods.

   c) Unreasonable standards pertaining to product quality and safety.

   d) Domestic content rules.

Answer (B): Tariffs are excise taxes on imported goods imposed either to generate revenue or protect domestic producers. Thus, consumption taxes on imported goods are tariffs.

STOP! Review

9. Which of the following is an economic rationale for government intervention in trade?

   a) Maintaining spheres of influence.

   b) Protecting infant industries.

   c) Preserving national identity.

   d) Dealing with friendly countries.

Answer (B): The infant-industry argument contends that protective tariffs are needed to allow new domestic industries to become established. Once such industries reach a maturity stage in their life cycles, the tariffs can supposedly be removed.

STOP! Review

10. Governments most likely restrict trade in the long run to
    - I. Help foster new industries.
    - II. Protect declining industries.
    - III. Increase tax revenues.
    - IV. Foster national security.

    a) I only.
    b) I and II only.
    c) II and III only.
    d) I, II and IV only.

Answer (B): Government limitations on global competition are generally imposed for the announced purpose of protecting local entities and jobs and developing new industries. Examples of governmental limitations are 1. tariffs 2. duties 3. quotas 4. domestic content rules 5. preferences for local entities regarding procurement, taxes, labor etc. 6. other law.

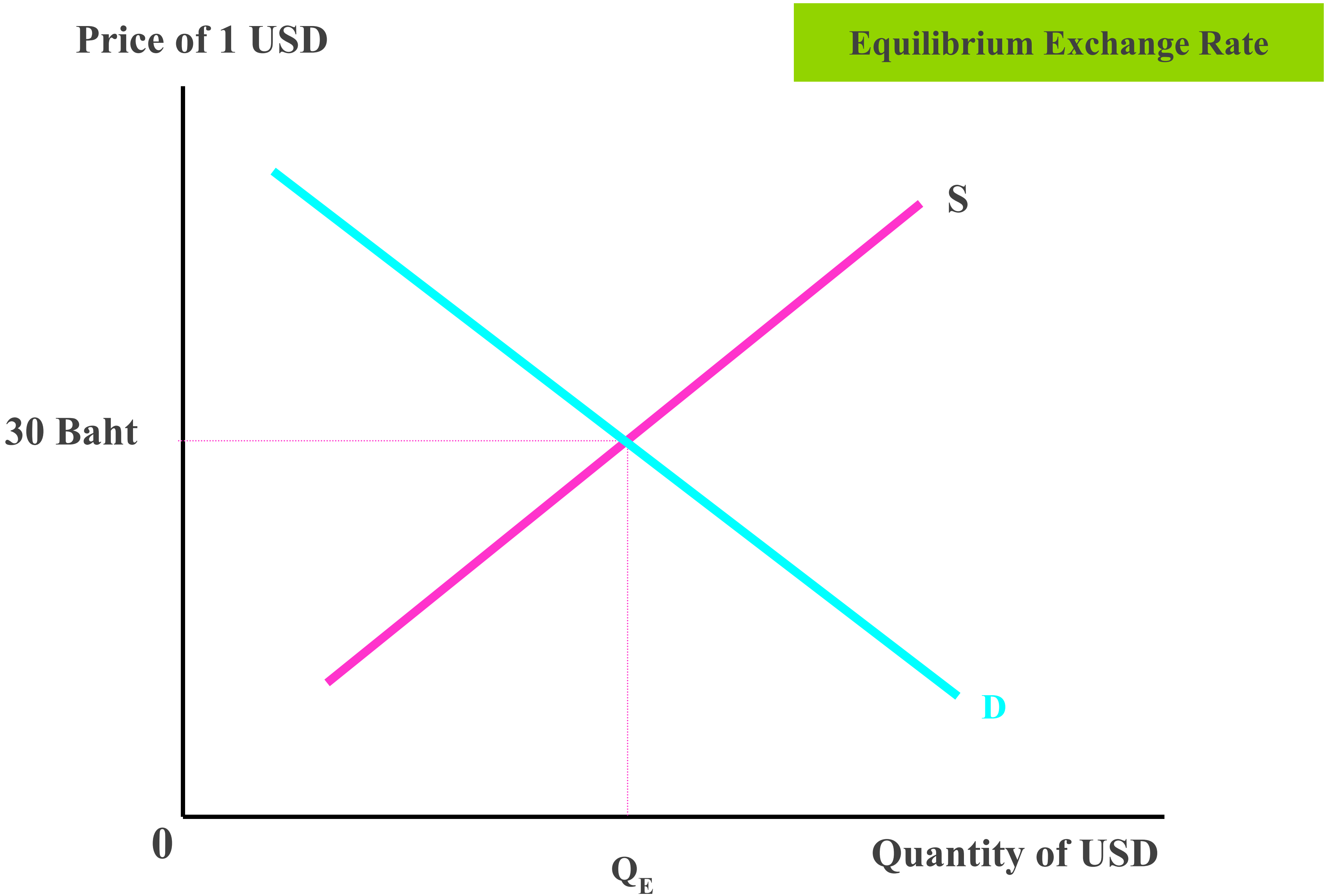
7.3 Currency Exchange Rates and Markets

Fixed Exchange Rates

1. One unit of a currency is set equal to a given number of units of another currency by law

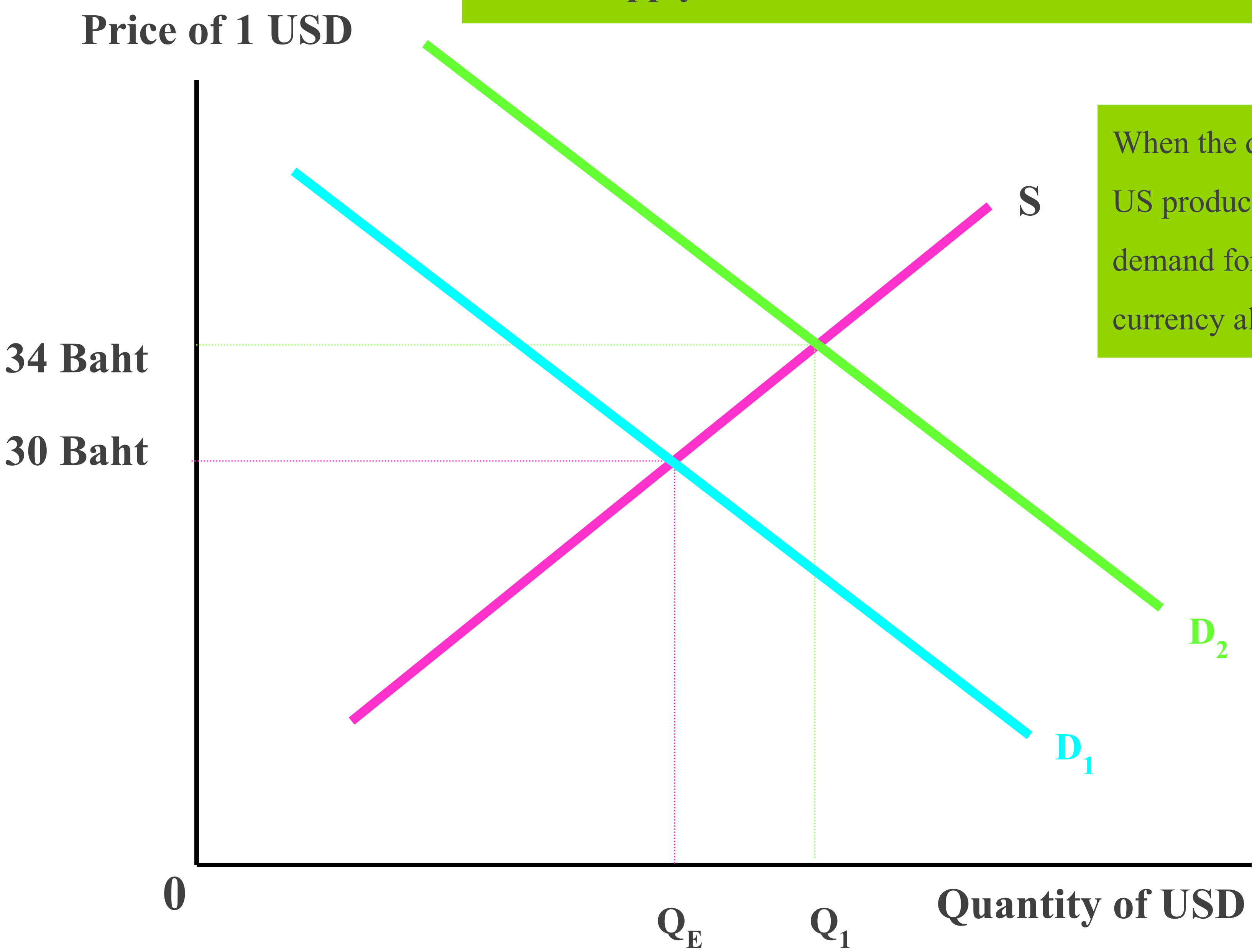
Floating Exchange Rates

1. The market is allowed to determine the exchange rate of two currencies
   - Thus, supply and demand functions exist for currencies
   - The rate at which the supply and demand for a currency in terms of another currency are equal is the equilibrium exchange rate
2. A seller normally wants to be paid in its own currency. Thus, when the demand for a foreign country's products rises, demand for its currency also rises
   - The purchasing power of a currency moves in the same direction as demand for that country's output


Equilibrium Exchange Rate
Price of 1 USD
30 Baht
S
D
0
Q_E
Quantity of USD

Supply and Demand functions for currencies

When the demand for a US products rises, demand for Baht currency also rises.



7.3 Currency Exchange Rates and Markets

Floating Exchange Rates

3. Domestic incomes also affect the demand for a foreign currency.
   - When incomes rise, buyers demand more goods and services
   - The result is depreciation of the local currency.

4. Relative interest rates affect the supply of a foreign currency
   - When the real interest rate in a foreign country is higher than that in the domestic economy, investors will tend to demand more of that foreign currency to take advantage of the higher rate.

7.3 Currency Exchange Rates and Markets

Interaction in Foreign Currency Markets

1. Relevant exchange rates
   - Spot Rate: Exchange rate in effect today to settle a transaction today
   - Forward Rate: Exchange rate in effect today for a transaction that will be settled in the future

2. The spot and forward rates are calculated using the ratio of foreign currency units to a local currency unit (FCUs to one LCU)

3. Discount or premium is determined by the following:

	LCU	FCU
Forward > Spot	Premium	Discount
Spot > Forward	Discount	Premium

Key Concept:

- As exchange rates fluctuate, buying power rises and falls. Currency appreciates when it can buy more units of another currency. Currency depreciates when it can purchases fewer unit of another currency. Equilibrium exchange rates in floating markets are determined by the supply of and demand for the currencies.
- When the demand for a country's goods, capital assets, and financial instruments rises, demand for its currency rises.
- Most currencies operate under a system of floating exchange rates – the equivalent amount of another currency can change under the influence of market forces.
- An entity may minimize the risk of exchange rate fluctuations by purchasing or selling furthers contracts, a practice called hedging.

STOP! Review

11. If the value of the U.S. dollar in foreign currency markets changes from $1 = 0.95 euros to $1 = 0.90 euros,

    a) The euro has depreciated against the dollar.

    b) Products imported from Europe to the U.S. will become more expensive.

    c) U.S. tourists in Europe will find their dollars will buy more European products.

    d) U.S. exports to Europe should decrease.

Answer (B): The dollar has declined in value relative to the euro. If the American had previously wished to purchase a European product that was priced at 10 euros, the price would have been about US $10.53. After the dollar's decline in value, the price of the item has increased to about US $11.11. Hence, imports from Europe should decrease and exports increase.

STOP! Review

12. Two countries have flexible exchange rate systems and an active trading relationship. If income <List A> in country 1, everything else being equal, then the currency of country 1 will tend to <List B> relative to the currency of country 2.

	List A	List B
a)	Rise	Remain constant
b)	Fall	Depreciate
c)	Rise	Depreciate
d)	Remain constant	Appreciate

Answer (C): If income in country 1 rise, consumers in country 1 will increase their imports from country 2. The resulting increase in the supply of currency 1 will result in a tendency for it to depreciate relative to the currency of country 2.

STOP! Review

13. An entity has a foreign-currency-denominated trade payable, due in 60 days. To eliminate the foreign currency exchange-rate risk associated with the payable, the entity could

    a) Sell foreign currency forward today.

    b) Wait 60 days and pay the invoice by purchasing foreign currency in the spot market at that time.

    c) Buy foreign currency forward today.

    d) Borrow foreign currency today, convert it to domestic currency on the spot market, and invest the funds in a domestic bank deposit until the invoice payment date.

Answer (C): The entity can arrange to purchase the foreign currency today rather than in 60 days by buying the currency in the forward market. This hedging transaction will eliminate the exchange-rate risk associated with the trade payable.

7.4 Methods of Taxation

Tax Rate Structure

1. Progressive: Higher income persons pay a higher percentage of their income in taxes.
   - Indexing is a means of avoiding the unfairness that results when inflation increases nominal but not real taxable income, subjecting it to higher tax rates.

2. Proportional: At all levels of income, the percentage paid in taxes is constant

3. Regressive: As income increases, the percentage paid in taxes decreases

7.4 Methods of Taxation

Tax Rate

1. Marginal tax rate: The rate applied to the last unit of taxable income
    - **Average tax rate:** total tax liability divided by the amount of taxable income
    - **Effective tax rate:** total tax liability divided by total economic income

Direct vs. Indirect

1. Direct taxes are imposed upon the taxpayer and paid directly to the government (i.e. personal income tax)

2. Indirect taxes are levied against others and therefore only indirectly on the individual (i.e. corporate tax)

7.4 Methods of Taxation

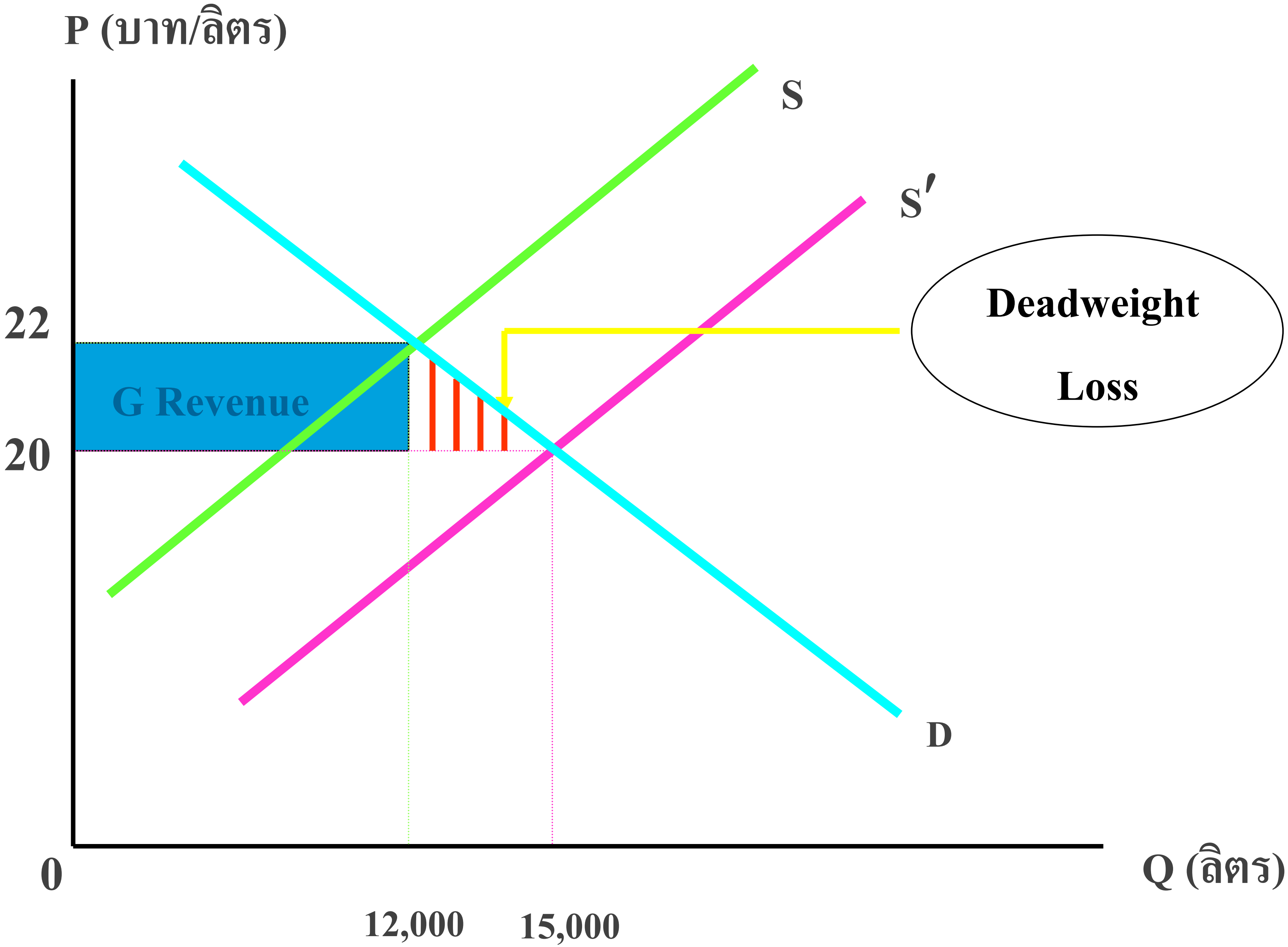
Tax Credits

1. Deductions on the income tax return (i.e. investment tax credit)

Incident of Taxation

1. **Deadweight loss:** Combined loss of sellers and buyers because of excess burden of taxation. Passing on the entire tax might reduce unit sales unacceptable by raising the price too high.

2. **Windfall profits tax:** are not shifted to customers via higher prices. This tax levied on part of the output produced does not increase the equilibrium price of the taxed good.


P (บาท/ลิตร)
S
S′
22
20
G Revenue
Deadweight
Loss
D
0
Q (ลิตร)
12,000
15,000

Laffer Curve: Explain how people react to varying rates of income taxes

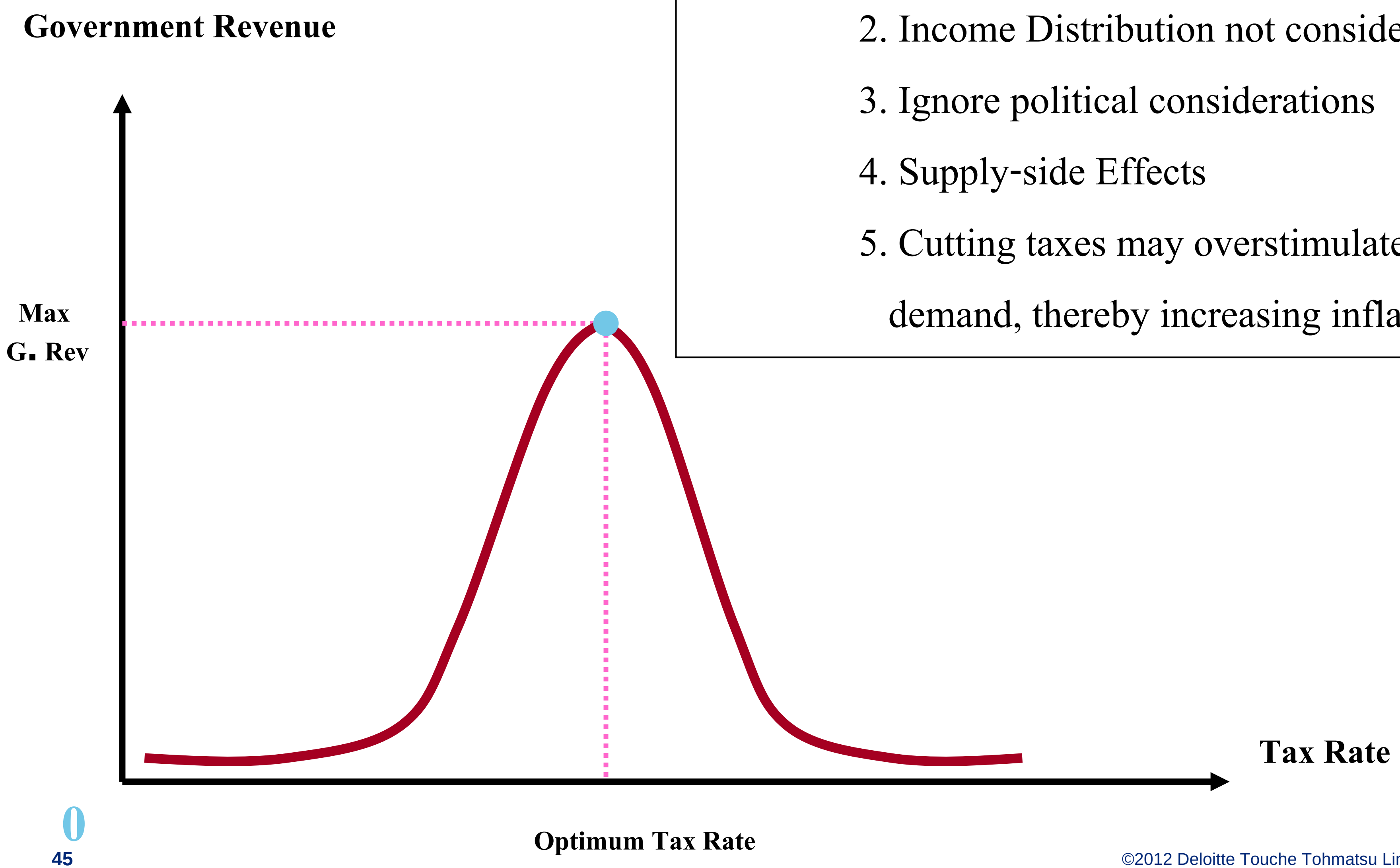
Concern: 1. Optimal Tax Rate is unknown

2. Income Distribution not considered

3. Ignore political considerations

4. Supply-side Effects

5. Cutting taxes may overstimulate demand, thereby increasing inflation



7.4 Methods of Taxation

International Tax Considerations

1. Multinational corporation: frequently derive income from several countries.

2. Treaties: To avoid double taxation, two or more countries may adopt treaties to coordinate or synchronize the effects of their taxing statutes

3. Multinational Corporations
    - Most countries tax only the income sourced to that country
    - But some countries tax worldwide income
    - Foreign corporations: a country may tax only income sourced to it

7.4 Methods of Taxation

Value-Added Tax (VAT)

1. The tax is levied on the value added to goods by each business unit in the production and distribution chain.

2. The consumer bears the tax through higher prices

3. VAT encourages consumer savings because taxes are paid only on consumptions, not on savings.

4. VAT requires all business to pay, regardless of income

5. VAT is not a useful tool for fiscal policy purposes

Key Concept:

- Government finances its expenditures by taxation. Thus, tax generate government revenues. National governments also use taxation as a means of implementing fiscal policy regarding inflation, full employment etc.
- Tax structures may be progressive, proportional or regressive
- The incidence of taxation refers to who actually bears a particular tax.
- Multinational corporations frequently derive income rom several countries. The government of each country in which a corporation does business may enact statutes imposing one or more types of tax on the corporation.
- Many major industrial nations have adopted VAT

STOP! Review

14. An individual had taxable income of $23,000 per year and paid $8,000 in income tax. The individual's taxable income then increased to $30,000 per year resulting in a $10,000 income tax liability. The personal tax system being applied to this individual is

    a) Progressive.

    b) Regressive.

    c) Marginal.

    d) Proportional.

Answer (B): The average tax rate of the individual has decreased from 34.8% (US $ 8,000/23,000) to 33.3% (US $10,000/$30,000). Under a regressive tax system , the average tax rate fails as income rises, although the amount of tax paid may rise.

STOP! Review

15. In most countries <List A> taxes tend to be <List B> with respect to income.

	List A	List B
a)	General sales	Proportional
b)	Property	Regressive
c)	Personal income	Proportional
d)	Personal income	Regressive

Answer (B): Property taxes tend to be regressive. Taxpayers with lower incomes must pay a higher portion of their incomes for necessities, such as housing.

STOP! Review

16. Which of the following designations refers to taxes that will not necessarily take a larger absolute amount of income as income rises?

    a) Progressive.

    b) Proportional.

    c) Regressive.

    d) Regenerative.

Answer (C): Regressive taxes are those for which the average tax rate fails as income rises. They take a smaller percentage of income as income rises, so they will no necessarily take a larger absolute amount of income as income rises.

STOP! Review

17. On what basis is value-added tax collected?

    a) The difference between the value of an entity’s sales and the value of its purchases from other domestic entities.

    b) The difference between the selling price of a real estate property and the amount the entity originally paid for the property.

    c) The value of an entity’s sales to related companies.

    d) The profit earned on an entity’s sales.

Answer (A): The value-added tax (VAT) is collected on the basis of the value created by the entity. This tax is measured by the difference between the value of the entity’s sales and the value of tis purchases. A VAT is in effect a retail sales tax. Because a consumer can avoid the tax by not purchasing, a VAT encourages saving and discourage consumption.

7.5 Economic Indicators

Economic Indicators

1. Leading indicators:
   - Average workweek for production workers
   - Price of the ordinary shares of 500 companies
   - Average weekly initial unemployment insurance claims
   - New orders for consumer goods and materials
   - New orders for nondefense capital goods
   - Building permits for homes
   - Vendor performance
   - Money supply
   - Index of consumer expectations
   - Interest rate spread

7.5 Economic Indicators

Economic Indicators (Cont'd)

2. Lagging Indicators
   - Average duration of unemployment in weeks
   - Change in index of labor cost per unit of output
   - Average prime rate charged by banks
   - Ratio of manufacturing and trade inventories to sales
   - Commercial and industrial loans outstanding
   - Ratio of consumer installment credit outstanding to personal income
   - Change in consumer price index for services

3. Coincident Indicators
   - Employees on nonagricultural payrolls
   - Personal income minus transfer payments
   - Industrial production
   - Manufacturing and trade sales

7.5 Economic Indicators

National Income Accounting

1. The Gross Domestic Product (GDP) is the principal measures.
   - GDP is calculated without regard to the ownership of productive resources.

7.5 Economic Indicators

Income (resource cost) Approach

GDP or Y = Employee Compensation, Interest, and rents

+ Self-employment income

+ Depreciation (Consumption of fixed capital)

+ Indirect business taxes (sales tax)

+ Rents, interest income, and corporate profits

+ Net income of foreigners (a positive number if the amount earned domestically by foreigners exceeds the amount earned abroad by citizens.)

7.5 Economic Indicators

Expenditure Approach

GDP or Y	= Personal Income Expenditure	C
	+ Gross Private Domestic Investment	I
	+ Government Purchases	G
	+ Net Exports	(X-M)

** Note: Double counting must be avoided

7.5 Economic Indicators

GDP is not an ideal measure because

1. GDP is a monetary measure
2. Increase in GDP often involve environmental damage
3. GDP is not adjusted for changes in the population
4. Changes in the value of leisure time are not considered
5. Some nonmarket transactions are excludes (i.e. the value of homemakers' work)
6. Military expenditures are included at cost, not incremental total value.

7.5 Economic Indicators

Other National Income Concepts

1. Net Domestic Income Concept (NDP) = GDP – Depreciation

2. National Income (NI) = NDP + net income earned abroad - indirect business taxes (e.g., sales taxes)

3. Personal Income (PI) = NI - corporate income taxes and undistributed profits - required contributions to governmental social security programs + transfer payments (public and private)

4. Disposable Income = PI - personal income taxes

7.5 Economic Indicators

Measuring Inflation

(Price of specified items in a given year/Price of the same items in the base year) x 100

1. Nominal income: The amount in money received by a consumer as wages, interest, rent and profits.

2. Real income: Purchasing power of the income received. Purchasing power relates directly to the consumer's standard of living

7.5 Economic Indicators

Unemployement

1. **Frictional unemployment:** amount of unemployment caused by the normal operation of the labor market.

2. **Structural unemployment:** results when the composition of the workforce does not match the need. It is the result of changes in consumer demand, technology and geographical location.

3. **Cyclical unemployment:** directly related to the level of an economy's output. For this reason, it is sometimes called deficient-demand unemployment

4. **Full employment:** The natural rate of unemployment consists of the sum of frictional and structural unemployment

Key Concept:

- Economists use economic indicators to forecast changes in economic activity. Economic indicators are variables that in the past have head a high correlation with aggregate economic activity.
- National income accounting measures the output and performance of the economy. The gross domestic product (GDP) is the principal measure.
- GDP may be calculated using an income or and expenditure approach
- Other national income concepts are (1) gross national product, (2) net domestic product, (3) national income, (4) personal income, (5) disposable income
- The GDP deflator measures inflation using a price index that includes every item produced in the economy at the price at which it entered the GDP account.

STOP! Review

18. Which of the following may provide a leading indicator of a future increase in gross domestic product?

    a) A reduction in the money supply.

    b) A decrease in the issuance of building permits.

    c) An increase in the timeliness of delivery by vendors.

    d) An increase in the average hours worked per week of production workers.

Answer (D): An economic indicator is highly correlated with changes in aggregate economic activity. A leading indicator changes prior to a change in the direction of the business cycle.

STOP! Review

19. The two main variables that contribute to increases in real gross domestic products (GDP) derived from labor inputs are labor productivity and

    a) The potential labor force.

    b) The inflation rate.

    c) Quality of output.

    d) Total worker hours.

Answer (D): Real GDP increases when resources inputs and their productivity increases. Thus, to the extent that real GDP depends on labor inputs, real GDP equals total worker hours (labor hours) times labor productivity (real output per worker per hour).

STOP! Review

20. Net domestic product is composed of the total market value of all

    a) Final goods and services produced in the economy in 1 year.

    b) Goods and services produced in the economy in 1 year.

    c) Final goods and services produced in the economy in 1 year minus the capital consumption allowance.

    d) Goods and services produced in the economy in 1 year minus the capital consumption allowance.

Answer (C): Net domestic product is the market value of all final goods and services produced within the boundaries of a country within 1 year minus the capital consumption allowance.

7.6 Legal Rules of Evidence

Type of Evidence

1. **Best Evidence or Primary Evidence** such as Original Contract, Deed, Business Records, etc.

2. **Secondary Evidence** such as Copies of Original Documents or Oral Evidence

3. **Direct Evidence** is proof without presumption or inference

4. **Circumstantial evidence** is indirect evidence

5. **Conclusive evidence** is so powerful it permits only one reasonable conclusion

7.6 Legal Rules of Evidence

Type of Evidence (Cont'd)

6. **Corroborative evidence** supports other evidence

7. **Opinion evidence** is usually excluded because of its potentially prejudicial effect

8. **Hearsay evidence** is a statement other than one made by the declarant while testifying at the trial or hearing

Key Concept:

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STOP! Review

21. A contract dispute has arisen between an organization and a major supplier. To resolve the dispute, the most competent evidence is

    a) Oral testimony of contracting parties.

    b) The original contract.

    c) Actions by parties to the contract.

    d) A letter from the supplier’s attorney.

Answer (B): The best (primary) evidence is the most persuasive evidence. Reliability and the best evidence rule is closely related. The best evidence rule is ordinarily applied only to documentary evidence especially to proof of a writing.

STOP! Review

22. During interviews with the inventory management personnel, an internal auditor learned that salespersons often order inventory for stock without receiving the approval of the vice president of sales. Also, detail testing showed that there are no written approvals on purchase orders for replacement parts. The detail testing is a good example of

    a) Indirect evidence.

    b) Circumstantial evidence.

    c) Corroborative evidence.

    d) Subjective evidence.

Answer (C): Corroborative evidence is evidence from a different source that supplements and confirms other evidence.

STOP! Review

23. Much of the internal auditor’s work involves accumulation of engagement information. A duplicate of a contract rather than the original is an example of what kind of evidence?

    a) Secondary.

    b) Circumstantial.

    c) Hearsay.

    d) Opinion.

Answer (A): Secondary evidence according to the legal view is acceptable if primary evidence (the strongest evidence) has been destroyed or is not reasonable procurable. Secondary evidence must be a proper representation of primary evidence.

7.7 Contracts

Elements

1. **Agreement:** Requires mutual assent of the contracting parties reached through an offer by the offeror and acceptance by the offeree.
    - **An offer**
    - Communication
    - Definite and Certain
    - Termination of an offer
    - **Acceptance**

2. **Consideration:** Primary basis for the enforcement of agreements in contract law.

3. **Capacity:** The mental ability to make a rational decision.

4. **Legality:** An essential requirement for an agreement to be valid and enforceable.

7.7 Contracts

Written Contracts

1. An oral contract is as enforceable as written contract. However, a statute may require that some contracts be in writing.

Key Concept:

- A contract is a promise or an agreement that the law recognizes as establishing a duty of performance. It is enforceable by applying a remedy for its breach.

- The elements of a contract are (1) an offer (2) acceptance (3) consideration (4) capacity of each party to enter into contracts and (5) legality

STOP! Review

24. Which of the following is not a required element of a contract?

    a) Legality.

    b) Consideration.

    c) Legal Capacity.

    d) A writing.

Answer (D): The four essential elements of a contract are and agreement, legal, capacity of the parties to contract, and a legal objective or purpose.

STOP! Review

25. The necessary elements of a contract include.

    a) Some form of writing, equal consideration, and legal capacity.

    b) Formal execution, definite terms, and a valid offer and acceptance.

    c) Offer and acceptance, consideration, legal capacity, and mutual assent.

    d) Bilateral promises, legal capacity, and legality of purpose.

Answer (C): Contracts require each of the following:

- Offer and acceptance
- Mutual Assent (meeting of the minds)
- Consideration (bargained-for exchange)
- Legality (Legal purpose)
- Capacity of parties (legal ability)

STOP! Review

26. Consideration consists of

    a) Something with monetary value.

    b) Each party's receiving an actual benefit only.

    c) Two promises.

    d) Legal sufficiency and bargained-for exchange.

Answer (D): Consideration must be legally sufficient and intended as a bargained-for exchange. A promisee has provided legally sufficient consideration if he incurs a legal detriment or if the promisor receives a legal benefit.

STOP! Review

27. Lamar became homeless at a very young age and was taken in by Aunt and Uncle. Many years later, Lamar became a detective in the city police department . When Aunt disappeared and was not heard from for a month, the case was assigned to Lamar. Uncle also came to Lamar and asked him to promise to find Aunt in return for the years of support. Lamar agreed to Uncle's request. Which of the following is true?

    a) Lamar's contractual duty to find Aunt is based on past consideration.
    b) Lamar has no contractual duty to find Aunt.
    c) If Uncle had also promised Lamar US $1,000 for finding Aunt, he would be liable when Lamar found her.
    d) Lamar will be liable for breach of contract if he does not find Aunt.

Answer (B): Lamar has a pre-existing legal duty to find Aunt. Consideration does not exist if an existing duty was imposed by law or a person is already under a contractual agreement to render a specified performance. Lamar will suffer no new legal detriment by promising to find Aunt. Thus, no contractual obligation exist.

Thank you

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