

BUSINESS-ENVIRONMENT-AND- CONCEPTS^{Q&As}

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QUESTION 1

Foster Inc. is considering implementing a lock-box collection system at a cost of \$80,000 per year. Annual sales are \$90 million, and the lock-box system will reduce collection time by 3 days. If Foster can invest funds at 8 percent, should it use the lock-box system? Assume a 360-day year.

- A. Yes, producing savings of \$60,000 per year.
- B. No, producing a loss of \$20,000 per year.
- C. No, producing a loss of \$60,000 per year.
- D. No, producing a loss of \$140,000 per year.

Correct Answer: B

Choice "b" is correct. No, do not use the lock-box system, which produces a loss of \$20,000 per year.

$$\frac{3 \text{ days}}{360 \text{ days}} \times \$90,000,000 \times \frac{8}{10} = \begin{array}{l} \$80,000 \text{ Lock-box cost} \\ \underline{60,000} \text{ Investment income} \\ \underline{\underline{\$20,000}} \text{ Loss per year} \end{array}$$

QUESTION 2

Stagflation refers to:

- A. A combination of rising unemployment and rising real GDP.
- B. A combination of rising unemployment and a rising price level.
- C. High inflation rates.
- D. High unemployment rates.

Correct Answer: B

Choice "b" is correct. Stagflation occurs when the economy suffers a recession that is characterized by falling output, rising unemployment, and a rising price level.

Choice "a" is incorrect. Real GDP is falling during stagflation, not rising.

Choice "c" is incorrect. High inflation rates is just one aspect of stagflation; the other is falling output and rising unemployment. Choice "d" is incorrect. High unemployment rates are just one aspect of stagflation; the other is a rising overall price level (high inflation).

QUESTION 3

Which of the following factors is inherent in a firm's operations if it utilizes only equity financing?

- A. Financial risk.
- B. Business risk.
- C. Interest rate risk.
- D. Marginal risk.

Correct Answer: B

Choice "b" is correct. Business risk represents the risk associated with the unique circumstances of a particular company, as they might affect the shareholder value of that company. If an entity purely uses its own cumulative earnings in capitalizing its operations, it is exposed to the risks of its own unique circumstances. Choice "a" is incorrect. Financial risk, also called default risk, relates to the exposure of lenders to the failure of borrowers to repay principal and interest on debt. An entity using its own cumulative earnings in capitalizing its operations is not exposed to default risk. Choice "c" is incorrect. A business that exclusively uses equity capitalization would not be exposed to the risk that the value of its financial instruments will change as a result of changes in interest rates. Choice "d" is incorrect. Incremental changes in risk would be limited if a firm exclusively used its own equity financing to capitalize its operations.

QUESTION 4

In order to increase production capacity, Gunning Industries is considering replacing an existing production machine with a new technologically improved machine effective January 1, 1997. The following information is being considered by Gunning Industries.

•

The new machine would be purchased for \$160,000 in cash. Shipping, installation, and testing would cost an additional \$30,000.

•

The new machine is expected to increase annual sales by 20,000 units at a sales price of \$40 per unit. Incremental operating costs are comprised of \$30 per unit in variable costs and total fixed costs of \$40,000 per year.

•

The investment in the new machine will require an immediate increase in working capital of \$35,000.

•

Gunning uses straight-line depreciation for financial reporting and tax reporting purposes. The new machine has an estimated useful life of five years and zero salvage value.

•

Gunning is subject to a 40 percent corporate income tax rate.

Gunning uses the net present value method to analyze investments and will employ the following factors and rates.

<u>Present</u>	<u>Present Value of \$1 at 10%</u>	<u>Present Value of an Ordinary Annuity of \$1 at 10%</u>
1	.909	.909
2	.826	1.736
3	.751	2.487
4	.683	3.170
5	.621	3.791

The overall discounted cash flow impact of Gunning Industries\' working capital investment for the new production machine would be:

- A. \$(7,959)
- B. \$(10,680)
- C. \$(13,265)
- D. \$(35,000)

Correct Answer: C

Choice "c" is correct. \$(13,265) overall discounted cash flow impact of working capital investment.

<u>Period</u>	<u>Cash Flow</u>		<u>PV Interest Factor</u>	=	<u>PV of Cash Flow</u>	
0	35,000	×	1,000	=	(35,000)	PV of cash outflow (increase in working capital) in year 1
5	35,000	×	(.621)	=	<u>21,735</u>	PV of cash inflow release of working capital) in year 5
					(13,265)	Overall discounted cash flow impact of working capital investment

QUESTION 5

Unless the partnership agreement prohibits it, a partner in a general partnership may validly assign rights to:

	<u>Partnership property</u>	<u>Partnership distributions</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Choice "c" is correct.

Rules: A partner has no right to assign an interest in partnership property because a partner's rights in

partnership property are limited to using the property for partnership purposes. However, a partner does have a right to assign her interest in partnership distributions. The assignee does not become a partner, but merely has a right to receive whatever distributions the assignor would have received.

Choices "a", "b", and "d" are incorrect, per the above rules.

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