

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

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QUESTION 1

When the overall price level is rising, nominal interest rates tend to be:

- A. Unaffected by changes in the price level.
- B. Falling.
- C. Rising.
- D. None of the above.

Correct Answer: C

Choice "c" is correct. The relationship between nominal interest rates and inflation can be seen by rearranging the equation for real interest rates as follows: Nominal Interest Rate = Real Interest Rate + Inflation Thus, if real interest rates do not change, a 1% increase in the inflation rate will lead to a 1% increase in nominal interest rates.

QUESTION 2

In a competitive market, an increase in the minimum wage will likely have the following effects:

- A. Firms currently paying above the new minimum wage would generally raise their pay rates (although the new minimum wage creates a new floor for employee wage bargaining purposes).
- B. Firms paying at the current minimum wage rate would generally be unaffected if the marginal revenue produced by the lowest paid workers does not exceed the new higher cost of the worker. Many firms would thus be forced to work more efficiently.
- C. Total employment will likely decrease in affected industries and generate unemployment. Employers will demand a smaller number of workers while a larger number of workers will be attracted by the higher wage.
- D. If a marginally more expensive form of capital is available to substitute for labor (e.g., due to technological advances), firms will reduce their use of labor.

Correct Answer: C

Choice "c" is correct. With an increase in the minimum wage, total employment will likely decrease in affected industries and generate unemployment. Employers will demand a smaller number of workers while a larger number of workers will be attracted by the higher wage. Choice "a" is incorrect. Firms currently paying above the new minimum wage would generally be unaffected, not raise their pay rates. Choice "b" is incorrect. Firms paying at the current minimum wage rate would attempt to reduce labor, not generally be unaffected. Choice "d" is incorrect. If a marginally cheaper, not more expensive.

QUESTION 3

A limited liability company taxed under subchapter K of the Internal Revenue Code (the partnership subchapter):

- A. Must pay federal income tax.
- B. Is generally not considered a legal entity separate and apart from its owners.



- C. Must have written articles of organization.
- D. Must provide for apportionment of liability for the company\\'s debts.

Correct Answer: C

Choice "c" is correct. A limited liability company must have written articles of organization, which must be filed with the state. Choice "a" is incorrect. An LLC taxed under subchapter K of the Internal Revenue Code (the partnership subchapter) does not pay federal income tax; the members are taxed on their share of the LLC\\'s income. Choice "b" is incorrect. Unlike a general partnership, but like a corporation and a limited partnership, an LLC is considered a legal entity separate and apart from its owners. Choice "d" is incorrect. An LLC does not have to provide for apportionment of liability for LLC debts; the members of an LLC have limited liability.

QUESTION 4

Harvey Co. is evaluating a capital investment proposal for a new machine. The investment proposal shows the following information:

Initial cost	\$500,000
Life	10 years
Annual net cash inflows	\$200,000
Salvage value	\$100,000

If acquired, the machine will be depreciated using the straight-line method. The payback period for this investment is:

- A. 3.25 years.
- B. 2.67 years.
- C. 2.5 years.
- D. 2 years.

Correct Answer: C

Choice "c" is correct. With even cash flows, payback period is calculated as initial cost / annual net cash inflows. That is, \$500,000 / \$200,000 = 2.5. Choice "a" is incorrect. We could not determine an obvious approach to obtain this answer. It is incorrect per the calculation above. Choice "b" is incorrect. This answer is calculated as follows: (initial cost - salvage value) / (annual net cash inflows - annual depreciation) or (\$500,000 - \$100,000) / (\$200,000 - \$50,000) = \$400,000 / \$150,000 = 2.67. With the payback period, depreciation should only be considered to the extent that it represents a tax shield. Choice "d" is incorrect. This answer appears to be the initial cost less salvage value divided by the annual net cash inflows ((\$500,000 - \$100,000) / \$200,000 = 2.0). Salvage value is not included in the correct calculation.

QUESTION 5

James Webb is the general manager of the Industrial Product Division, and his performance is measured using the residual income method. Webb is reviewing the following forecasted information for his division for next year.



Category
Working capital
Revenue
Plant and equipment

Amount (thousands) \$ 1,800 30,000 17,200

If the imputed interest charge is 15 percent and Webb wants to achieve a residual income target of \$2 million, what will costs have to be in order to achieve the target?

A. \$10,800,000

B. \$23,620,000

C. \$25,150,000

D. \$25,690,000

Correct Answer: C

Choice "c" is correct. \$25,150,000 costs to achieve residual income target of \$2 million.

Working capital	\$ 1,800,000
Plant and equipment	17,200,000
Asset base	19,000,000
Times:Imputed interest rate	15%
Hurdle income	2,850,000
Add: Residual income target	2,000,000
Total target income	4,850,000
Revenue forecast	\$ 30,000,000
Less: Total target income	(4,850,000)
Required costs to achieve target	\$(25,150,000)

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

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