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QUESTION 1

Martin Corporation
Statement of Financial Position
December 31, 1994
(Dollars in millions)

Assets	
Current assets	\$ 75
Plant and equipment	<u>250</u>
Total assets	<u>\$325</u>
Liabilities and shareholders' equity	
Current liabilities	\$ 46
Long-term debt (12%)	64
Common equity:	
Common stock, \$1 par	10
Additional paid-in capital	100
Retained earnings	<u>105</u>
Total liabilities and shareholders' equity	<u>\$325</u>

Additional Data

- The long-term debt was originally issued at par (\$1,000/bond) and is currently trading at \$1,250 per bond.
- Martin Corporation can now issue debt at 150 basis points over U.S. treasury bonds.
- The current risk-free rate (U.S. treasury bonds) is 7 percent.
- Martin's common stock is currently selling at \$32 per share.
- The expected market return is currently 15 percent.



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The beta value for Martin is 1.25.

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Martin's effective corporate income tax rate is 40 percent.

Using the Capital Asset Pricing Model (CAPM), Corporation's current cost of common equity is:

A. 10.00 percent.

B. 15.00 percent.

C. 17.00 percent.

D. 18.75 percent.

Correct Answer: C

Choice "c" is correct. 17.00 percent. Using the CAPM model, Martin's current cost of common equity would be:

Cost of equity = Capital risk free rate + Beta (market rate - risk free rate)

Cost of equity = 7% + 1.25 (15% - 7%)

Cost of equity = 7% + 1.25 (8%)

Cost of equity = 7% + 10%

Cost of equity = 17%

QUESTION 2

All of the following capital budgeting analysis techniques use cash flows as the primary basis for the calculation, except for the:

A. Net present value.

B. Internal rate of return.

C. Discounted payback period.

D. Accounting rate of return.

Correct Answer: D

Choice "d" is correct. The accounting rate of return does not use cash flows as the primary basis for the calculation. It measures the accrual accounting return instead of cash flows:



$$\text{Accounting rate of return} = \frac{\text{Increase in expected average annual net income}}{\text{Average investment}}$$

Choice "a" is incorrect. Net present value method discounts cash flows for an investment over its life to time period zero using a desired or minimum rate of return. Choice "b" is incorrect. Internal rate of return (IRR) determines the compound interest rate of an investment where the present value of the cash inflows equals the present value of the cash outflows. The IRR is the discount rate that results in a net present value of zero. Choice "c" is incorrect. The discounted payback period is the time period required for discounted cash inflows to equal the initial investment. The time value of money is considered.

QUESTION 3

An advantage of the net present value method over the internal rate of return model in discounted cash flow analysis is that the net present value method:

- A. Computes a desired rate of return for capital projects.
- B. Can be used when there is no constant rate of return required for each year of the project.
- C. Uses a discount rate that equates the discounted cash inflows with the outflows.
- D. Uses discounted cash flows whereas the internal rate of return model does not.

Correct Answer: B

Choice "b" is correct. When using the net present value method of capital budgeting, different hurdle rates can be used for each year of the project. Choice "a" is incorrect. The desired rate of return for capital projects is established by management. Choice "c" is incorrect. The internal rate of return determines the discount rate that will equate the discounted cash inflows with the outflows, thus resulting in no gain or loss (breakeven). Choice "d" is incorrect. Both the net present value method and the internal rate of return model are discounted cash flow methods.

QUESTION 4

Which of the following activities is considered a support activity?

- A. Delivery of products.
- B. Procurement of materials.
- C. Product advertising.
- D. In-home warranty service.

Correct Answer: B

Choice "b" is correct. Support activities are those activities that are performed by the support staff of an



organization (e.g., purchasing of materials and supplies, development of the technology used, management of employees, accounting, finance, strategic planning, etc.).

Choices "a", "c", and "d" are incorrect, as these are all considered primary activities. Primary activities are those that are involved with the direct manufacture of products, the delivery of products through distribution channels, and the support of the product that exists after the sale is made (e.g., handling the raw materials, the manufacturing process, taking orders for the product, advertising the product, and servicing the product after it is sold).

QUESTION 5

An American importer expects to pay a British supplier 500,000 British pounds in three months. Which of the following hedges is best for the importer to fix the price in dollars?

- A. Buying British pound call options.
- B. Buying British pound put options.
- C. Selling British pound put options.
- D. Selling British pound call options.

Correct Answer: A

Choice "a" is correct. To fix a price in dollars to buy British pounds, British pound call options should be purchased. Call options would allow, but not require, the purchaser of the call to acquire the currency (British pounds) for a specified price at or before a specified time in the future. If the price goes down, the purchaser (the importer) would exercise the options; if not, the purchaser (importer) would buy the British pounds in the market and let the options expire. British pound futures could also be used, but that was not one of the choices listed. Choice "b" is incorrect. Buying British pound put options would allow, but not require, the purchaser of the put to sell the currency for a specified price at a specified time in the future. Since the importer needs British pounds, buying put options would not work. The importer needs to end up with British pounds. Choice "c" is incorrect. Selling British pound put options would not work. The importer needs to end up with British pounds. Selling put options could work, but the option would be exercised, or not, by the purchaser and not by the importer. If the options were not exercised, the importer could end up with nothing (other than the option premium). Choice "d" is incorrect. Selling British pound call options would not work. The importer needs to end up with British pounds; if call options are sold, the other party can exercise the options or let them expire, and if the options were exercised, the importer would have to supply the British pounds. This answer is backwards.

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