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QUESTION 1

The Moore Corporation is considering the acquisition of a new machine. The machine can be purchased for \$90,000; it will cost \$6,000 to transport to Moore's plant and \$9,000 to install. It is estimated that the machine will last 10 years, and it is expected to have an estimated salvage value of \$5,000. Over its 10-year life, the machine is expected to produce 2,000 units per year with a selling price of \$500 and combined material and labor costs of \$450 per unit. Federal tax regulations permit machines of this type to be depreciated using the straight-line method over 5 years with no estimated salvage value. Moore has a marginal tax rate of 40 percent.

What is the net cash flow for the third year that Moore Corporation should use in a capital budgeting analysis?

- A. \$68,400
- B. \$64,200
- C. \$53,700
- D. \$47,400

Correct Answer: A

Choice "a" is correct. \$68,400 net cash flow for the third year.

$$\frac{\$90,000 + 6,000 + 9,000}{5 \text{ years}} = \frac{\$105,000 \text{ tax}}{5 \text{ years}} = \$21,000 \text{ tax DEPRN}$$

| | Unit | | | |
|---------------------------------------|-----------------|-------|------------------|------------------|
| | Qty | Value | | |
| In year 3: | | | | |
| Cash inflow from sales | (2,000 × \$500) | = | \$1,000,000 | 1,000,000 |
| Cash outflow For mat'l & labor | (2,000 × \$450) | = | <u>(900,000)</u> | <u>(900,000)</u> |
| Cash inflow from operations in year 3 | | | 100,000 | 100,000 |
| Less tax | | | | |
| Depreciation expense | | | <u>(21,000)</u> | |
| Taxable income | | | 79,000 | |
| Marginal tax rate | | | × 40% | |
| Tax to be paid | | | <u>31,600</u> | <u>31,600</u> |
| Net cash flow in year 3 after taxes | | | | <u>\$ 68,400</u> |

**Alternate Computation:**

In year 3, Moore will generate a \$100,000 profit from the incremental sales (2000 units \times (\$500 - \$450)). This profit will be taxed at 40%, so the net after-tax increase in cash flow is \$60,000 BEFORE the depreciation tax shield is considered. Depreciation is not a cash outflow, but it will reduce the amount of tax the company has to pay (by 40% of the depreciation), and this has an effect on the cash-flow for the company. Depreciation, as calculated above, is \$21,000 per year (\$105,000 cost of the machine divided by 5 years). The depreciation tax shield is \$8,400 (\$21,000 \times 40%), so the total after-tax cash flows in year 3 for the new machine is \$60,000 + \$8,400 = \$68,400.

QUESTION 2

Which one of the following would cause the demand curve for a commodity to shift to the left?

- A. A rise in the price of a substitute product.
- B. A rise in average household income.
- C. A rise in the price of a complementary commodity.
- D. A rise in the population.

Correct Answer: C

Choice "c" is correct. A rise in the price of a complementary commodity would cause a shift to the left in any demand curve (representing decrease in demand, at all price levels, for that product). With respect to complementary goods, the demand for the primary product is directly impacted by the demand (and hence the price changes) for the complementary goods. For instance, if the price of gasoline goes up, the demand for cars will decrease, causing the demand curve for cars to shift left. Choice "a" is incorrect. A rise in the price of a substitute product will make the demand curve shift to the right. Choice "b" is incorrect. A rise in average household income would make the demand curve shift to the right, representing an increase in demand. Choice "d" is incorrect. A rise in population, or a change in consumers' tastes in favor of the commodity are also changes that may cause an increase in demand, making the demand curve shift to the right.

QUESTION 3

Which of the following statements is(are) correct regarding the methods a target corporation may use to ward off a takeover attempt?

- I. The target corporation may make an offer ("self-tender") to acquire stock from its own shareholders.
- II.

The target corporation may seek an injunction against the acquiring corporation on the grounds that the attempted takeover violates federal antitrust law.

- A.
- I only.
- B.
- II only.



C.

Both I and II.

D.

Neither I nor II.

Correct Answer: C

Choice "c" is correct.

Rule: A tender offer is a general invitation by a bidder to the shareholders of a target company to tender their shares to the bidder at a specified price during a specified time. A target of a takeover may ward off a tender offer by offering to repurchase shares from its shareholders. If a takeover will violate federal antitrust law, a court will enjoin the takeover.

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

QUESTION 4

Micro Manufacturers uses a performance reporting system that combines both financial and nonfinancial measures to evaluate division performance. All of the following measure operational efficiency, except:

A. Operating leverage.

B. Days\ sales in accounts receivables.

C. Inventory turnover.

D. Residual income.

Correct Answer: D

Choice "d" is correct. Residual income measures profitability in excess of a target rate of return.

Operational efficiency is not considered.

Choices "a", "b", and "c" are incorrect. Operating leverage, days\ sales in accounts receivable, and inventory are all measures of operational efficiency, specifically, efficiency in managing working capital.

QUESTION 5

By using the discounted cash flow model, estimate the cost of equity capital for a firm with a stock price of \$30.00, an estimated dividend at the end of the first year of \$3.00 per share, and an expected growth rate of 10 percent.

A. 21.1 percent.

B. 12.2 percent.



C. 11.0 percent.

D. 20.0 percent.

Correct Answer: D

$$\begin{aligned} K &= \frac{D}{P} + G = \frac{\$3 \text{ Div'd next period}}{\$30 \text{ stock price}} + 10\% \text{ Growth} \\ &= 10\% + 10\% \\ &= 20\% \text{ Cost of Equity Capital} \end{aligned}$$

Choice "d" is correct. 20.0 percent cost of equity capital by using the discounted cash flow model.

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