



# BUSINESS-ENVIRONMENT-AND- CONCEPTS<sup>Q&As</sup>

Certified Public Accountant (Business Environment & Concept)

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**QUESTION 1**

Following the formation of a corporation, which of the following terms best describes the process by which the promoter is released from, and the corporation is made liable for, pre-incorporation contractual obligations?

- A. Assignment.
- B. Novation.
- C. Delegation.
- D. Accord and satisfaction.

Correct Answer: B

Choice "b" is correct. A promoter is personally liable for the contracts he or she enters into prior to incorporation. A corporation may become liable by adoption of the contract, and through the process of novation (an agreement among all of the parties), the promoter may be released from contractual obligations. Choice "a" is incorrect. An assignment is a transfer of a contractual duty to perform. After the transfer, both the assignor and assignee may be held liable for performance. The assignor is not, thereby, released from liability. Choice "c" is incorrect. A delegation is a transfer of a contractual duty to perform. Both the delegor and delegee are liable to perform after the assignment; it does not release the promoter from liability. Choice "d" is incorrect. An accord is an agreement to change the performance due under a contract. Once the new terms are performed or satisfied, the original contract terms are terminated. Such an agreement does not automatically result in release of a promoter.

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**QUESTION 2**

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.

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

Gunning Industries\' net cash outflow in a capital budgeting decision would be:

- A. \$190,000
- B. \$195,000
- C. \$204,525
- D. \$225,000

Correct Answer: D

Choice "d" is correct. \$225,000 net cash outflow.

Purchase price of new machine	\$ 160,000
Shipping, installation and testing cost	30,000
Required increase in working capital	35,000
Total	<u>\$ 225,000</u>

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

Note: This question is the first from a series of questions on a prior exam. The last in the series is presented for you in the regular homework questions (not the supplemental questions) for this chapter.

### QUESTION 3



Lawson Inc. is expanding its manufacturing plant, which requires an investment of \$4 million in new equipment and plant modifications. Lawson's sales are expected to increase by \$3 million per year as a result of the expansion. Cash investment in current assets averages 30 percent of sales; accounts payable and other current liabilities are 10 percent of sales. What is the estimated total investment for this expansion?

- A. \$3.4 million.
- B. \$4.3 million.
- C. \$4.6 million.
- D. \$4.9 million.

Correct Answer: C

Rule: The expansion of working capital ( $WC = CA - CL$ ) is treated as an increase in investment. Choice "c" is correct. \$4.6 million estimated total investment for this expansion.

\$4,000,000	Original investment
900,000	[(.30)(3,000,000)] expansion of current assets
(300,000)	[(.10)(3,000,000)] expansion of current liabilities
<u>\$4,600,000</u>	Total investment for expansion

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

#### QUESTION 4

Which of the following parties is liable to repay an illegal distribution to a corporation?

- A. A director not breaching his or her duty in approving the distribution and the corporation is solvent.
- B. A director not breaching his or her duty in approving the distribution and the corporation is insolvent.
- C. A shareholder not knowing of the illegality of the distribution and the corporation is solvent.
- D. A shareholder knowing of the illegality of the distribution and the corporation is insolvent.

Correct Answer: D

Choice "d" is correct. Illegal dividends from an insolvent company must be repaid to the corporation for the benefit of the creditors. A shareholder who knowingly accepts an illegal dividend is liable to return it. Choices "a" and "b" are incorrect. If a director does not breach any duties in approving a distribution, the director is protected by the business judgment rule and is not liable for the distribution whether the corporation is solvent or insolvent. Choice "c" is incorrect. A shareholder of a solvent corporation who unknowingly accepts an illegal distribution is not obligated to repay the distribution.

#### QUESTION 5

Hedgehog International owes 500,000 local currency units to its foreign supplier in 90 days. The current spot rate of the



local currency unit is \$.60. Hedgehog purchases a call option to buy the local currency unit in 90 days for \$.61 for a premium of \$.005. The exchange rate for the local currency increases to \$.63 in 90 days. What will Hedgehog do on the payables' settlement date?

- A. Hedgehog will exercise its option and settle the payables with proceeds from the option contract at a gain.
- B. Hedgehog will not exercise the option and settle the payables after purchase of the local currency unit at the spot rate.
- C. Hedgehog will be indifferent as to whether it exercises the option or not.
- D. Hedgehog will sell the option at the settlement date and use its proceeds along with local currency units purchased at the spot rate to satisfy the amount payable.

Correct Answer: A

Choice "a" is correct. Hedgehog will exercise its option and liquidate the payables associated with the proceeds. The exercise of the option represents a less costly alternative than acquisition of proceeds at the spot rate at the time the payables are due. The net impact of exercise of the option is computed as follows:

	Required LCU	Exchange @ Settlement	Call Price	Premium	Total	Payables Settlement
Settlement at spot	500,000	\$0.63	\$ -	\$ -	\$ -	\$315,000
Settlement with option	500,000	\$ -	\$0.61	\$0.005	\$0.615	307,500
Net effect: Gain (Loss)						<u>\$ 7,500</u>

The premium is a sunk cost and is irrelevant to the decision. Note that the premium is a factor in determining the net gain (loss) but not in deciding whether to exercise the option.

Choices "b", "c", and "d" are incorrect, per computation above.

## QUESTION 6

The CPI jumps from 131 in year 1 to 136.5 in year 2. What is annual inflation rate?

- A. 4.2%
- B. 3%
- C. 1.38%
- D. 13.8%

Correct Answer: A

Choice "a" is correct. The inflation rate is measured as:



$$\text{Inflation Rate} = \frac{\text{CPI}_{\text{this period}} - \text{CPI}_{\text{last period}}}{\text{CPI}_{\text{last period}}} \times 100$$

$$\text{Inflation Rate} = \frac{136.5 - 131}{131} \times 100 \approx 4.2\%$$

#### QUESTION 7

Handyman Inc. operates a chain of hardware stores across New England. The controller wants to determine the optimum safety stock levels for an air purifier unit. The inventory manager has compiled the following data.

- 

The annual carrying cost of inventory approximates 20 percent of the investment in inventory.

- 

The inventory investment per unit averages \$50.

- 

The stockout cost is estimated to be \$5 per unit.

- 

The company orders inventory on the average of ten times per year.

- 

Total cost = carrying cost + expected stockout cost.

- 

The probabilities of a stockout per order cycle with varying levels of safety stock are as follows.

Units		Probability
Safety Stock	Stockout	
200	0	0%
100	100	15
0	100	15
0	200	12

The total cost of safety stock on an annual basis with a safety stock level of 100 units is:





A. \$1,750

B. \$1,950

C. \$2,000

D. \$650

Correct Answer: A

Choice "a" is correct. \$1,750 total annual cost of safety stock of 100 units.

**Stockout Cost**

Stockout Units	100
Stockout Cost Per Units	$\times \$5$
	<u>\$500</u>
Probability at 100 Safety Stock Level	$\times .15$
	<u>\$ 75</u>
Orders Per Year	$\times 10$
Expected Stockout Cost	<u>\$750</u>

**Carrying Cost**

Inventory Investment	
Per Unit	\$ 50
Carrying Cost Percentage	$\times 20\%$
Carrying Cost Per Unit	<u>\$10</u>
Stockout Units	$\times 100$
Carrying Cost	<u>1,000</u>
Total Annual Cost of Safety Stock of 100 Units	<u><u>\$1,750</u></u>

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

**QUESTION 8**

Wendy's Sandwich Shop purchased an asset for \$100,000 that has no salvage value and a 10-year life. Wendy's effective income tax rate is 40 percent, and it uses the straight-line depreciation method for income tax reporting purposes. Wendy's annual depreciation tax shield from the asset would be:

A. \$10,000





- B. \$6,000
- C. \$4,000
- D. \$2,000

Correct Answer: C

Choice "c" is correct. \$4,000 annual depreciation tax shield.

$$\frac{\text{Cost of the asset}}{\text{Estimated useful life}} = \frac{\$100,000}{10} = \$10,000 \text{ annual depreciation}$$

Annual depreciation	\$10,000
X tax rate	<u>× .40</u>
Annual depreciation tax shield	<u>\$ 4,000</u>

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

#### QUESTION 9

A government price support program will:

- A. Lead to surpluses.
- B. Lead to shortages.
- C. Improve the rationing function of prices.
- D. Not influence the rationing function of prices.

Correct Answer: A

Choice "a" is correct. A government price support program acts as a subsidy that will encourage suppliers to increase supply beyond an equilibrium point (the point where supply and demand curves intersect). This excess of supply over demand will create surpluses in the market.

Choices "b", "c", and "d" are incorrect, per the above Explanation.

#### QUESTION 10

Atlas Worldwide Industries conducts business in a number of different countries and is trying to evaluate its economic exposure to exchange rate risk. Which of the following statements is not correct?

- A. Atlas will suffer an economic loss in the event it has net cash outflows of a foreign currency and the foreign currency



appreciates.

B. Atlas will enjoy an economic gain in the event it has net cash outflows of a foreign currency and the foreign currency depreciates.

C. Atlas will suffer an economic loss in the event it has net cash inflows of a foreign currency and the foreign currency appreciates.

D. Atlas will suffer an economic loss in the event it has net cash inflows of a foreign currency and the foreign currency depreciates.

Correct Answer: C

<u>Domestic Currency</u>	<u>Foreign Currency</u>	
	<u>Net inflows</u>	<u>Net outflows</u>
Appreciation	Loss	Gain
Depreciation	Gain	Loss

Choice "c" is correct. Atlas will benefit from an economic gain in the event that it has net cash inflows of a foreign currency and the foreign currency appreciates (the domestic currency depreciates). Atlas will collect a more valuable currency that can buy more of its domestic currency.

Choices "a", "b", and "d" are incorrect because they are correct statements.

#### QUESTION 11

Under the Revised Model Business Corporation Act, when a corporation's bylaws grant stockholders preemptive rights, which of the following rights is(are) included in that grant?

	<u>The right to a proportionate share of corporate assets remaining on corporate dissolution</u>	<u>The right to purchase a proportionate share of newly issued stock</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

Rule: Preemptive rights provide a shareholder with a right of first refusal to buy a share of newly issued shares sufficient to maintain the shareholder's proportionate share of rights in any newly issued shares.

Rule: Preemptive rights do not provide a shareholder with the right to a proportionate share of corporate assets on dissolution.

Choice "c" is correct. "No - Yes."

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

## QUESTION 12

When a partner in a general partnership lacks actual or apparent authority to contract on behalf of the partnership, and the party contracted with is aware of this fact, the partnership will be bound by the contract if the other partners:

	<u>Ratify the contract</u>	<u>Amend the partnership agreement</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: B

Choice "b" is correct. "Yes - No." Rule: The authority of partners is governed by agency law. Under agency law, a principal is not bound to the third party unless the agent had actual authority or apparent authority. When the agent has no actual authority and no apparent authority, the principal (in this case the partnership) will only be liable if it chooses to adopt the agreement (i.e., ratify). Rule: Amending the partnership agreement (presumably to grant authority) will not cause the partnership to be bound because authority must exist at the time the contract is made or the partnership must ratify the contract. Choices "a", "c", and "d" are incorrect, per the above rules.

**QUESTION 13**

All of the following are inventory carrying costs, except:

- A. Insurance.
- B. Opportunity cost on inventory investment.
- C. Obsolescence and spoilage.
- D. Inspections.

Correct Answer: D

Choice "d" is correct. Inspections. Inspections are part of order costs, not carrying costs. Choices "a" and "c" are incorrect. Inventory carrying costs include all costs associated with warehousing (storing) inventory (e.g., storage, insurance, obsolescence, and spoilage associated with holding inventory). Choice "b" is incorrect. The economic cost of holding inventory includes the implicit (opportunity) cost of foregoing a return on the money invested in inventory.

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**QUESTION 14**

Jones, Smith, and Bay wanted to form a company called JSB Co. but were unsure about which type of entity would be most beneficial based on their concerns. They all desired the opportunity to make taxfree contributions and distributions where appropriate. They wanted earnings to accumulate tax-free. They did not want to be subject to personal holding tax and did not want double taxation of income. Bay was going to be the only individual giving management advice to the company and wanted to be a member of JSB through his current company, Channel, InC. Which of the following would be the most appropriate business structure to meet all of their concerns?

- A. Proprietorship.
- B. S corporation.
- C. C corporation.
- D. Limited liability partnership.

Correct Answer: D

Choice "d" is correct. An LLP does not pay taxes on its earnings. Instead, the profits and losses flow through to the partners as in a general partnership. The LLP files an informational tax return like that of a general partnership. The partners may agree to have the entity managed by one or more of the partners. A partner may be another entity. Choice "a" is incorrect. A proprietorship by definition has only one owner, not three owners. Choice "b" is incorrect. While an S corporation allows for the same treatment of its earnings and distributions as in the facts, it is prohibited from having another company as an owner. Choice "c" is incorrect. A C corporation pays its own taxes on its earnings, and any distributions to its shareholders are again taxed at the shareholder level (known as "double taxation").

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**QUESTION 15**

Lisa is a limited partner in a limited partnership. Jen, one of the other limited partners, is seeking to sell her interest in the partnership to Karen and allow Karen to become a new limited partner. Which of the following statements is true?



- A. Lisa may engage in the management of the limited partnership without losing her limited liability.
- B. Jen may transfer her interest and make Karen a new limited partner without the approval of the other partners.
- C. Jen may withdraw from the limited partnership without giving notice to the partnership.
- D. Lisa has a right to vote on the transferring of interest to and admission of Karen as a limited partner.

Correct Answer: D

Choice "d" is correct. Limited partners have the right to vote on the transfer of interest and admission of a new partner. Admission of a new partner requires unanimous consent. Choice "a" is incorrect. A limited partner who acts as a general partner loses her limited liability status to those she acted as a general partner towards. Choice "b" is incorrect. Partners can freely transfer their interests in profits and losses to third parties, but the third party cannot become a limited partner without the unanimous consent of the other partners. Choice "c" is incorrect. Limited partners must give 6 months notice of withdrawal in absence of an agreement to the contrary.

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