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

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### QUESTION 1

All of the following items are included in discounted cash flow analysis, except:

- A. Future operating cash savings.
- B. The current asset disposal price.
- C. The future asset depreciation expense.
- D. The tax effects of future asset depreciation.

Correct Answer: C

Choice "c" is correct. The future asset depreciation expense is not included in discounted cash flow analysis.

Choices "a", "b", and "d" are incorrect. All of these are included in discounted cash flow analysis:

?Future operating cash savings

?Current asset disposal price ?Tax effects of future asset depreciation ?Future asset disposal price

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### QUESTION 2

Under which of the following conditions is the supplier most able to influence or control buyers?

- A. When the supplier's products are not differentiated.
- B. When the supplier does not face the threat of substitute products.
- C. When the industry is controlled by a large number of companies.
- D. When the purchasing industry is an important customer to the supplying industry.

Correct Answer: B

Choice "b" is correct. When there are few good substitutes for a supplier's product, the supplier has market power (think of a monopoly). As a result, the supplier is better able to control buyers and act as a price setter rather than a price taker. Choice "a" is incorrect. When supplier's products are not differentiated, buyers will be indifferent about which supplier they purchase from. In other words, if firms sell identical products (think of perfect competition) the product of one firm is a perfect substitute for the product of another firm. In this case, firms are price takers, not price setters. Choice "c" is incorrect. When there are a large number of firms, no one firm has much market power. This is the case of either perfect competition (if all firms sell identical products) or monopolistic competition (if all firms sell slightly differentiated products). Choice "d" is incorrect. If the purchasing industry is an important customer of the supplier, the purchasing industry (i.e. the buyer) will have some market power. This will diminish the ability of the supplier to influence or control the buyer.

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### QUESTION 3



An industry that is oligopolistic would be best characterized by:

- A. One firm selling a product with no close substitutes.
- B. Significant barriers to entry.
- C. Horizontal or flat demand curves for the output of individual firms.
- D. The absence of significant economies of scale.

Correct Answer: B

Choice "b" is correct. Oligopoly market conditions are characterized by:

?Few firms in the market ?Significant barriers to entry ?Differentiated products ?Fixed (or semi fixed) prices ?Kinked demand curves

Choice "a" is incorrect. This is an example of monopoly. Choice "c" is incorrect. Horizontal demand curves represent demand that is perfectly price elastic (buyers will only pay one price for any quantity of a product). This occurs in perfectly competitive markets. Choice "d" is incorrect. This is characteristic of perfect competition, as there are no barriers to entry ("size doesn't matter") in perfect competition.

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#### QUESTION 4

The imputed interest rate used in the residual income approach for performance measurement and evaluation can best be characterized as the:

- A. Historical weighted average cost of capital for the company.
- B. Average return on investment that has been earned by the company over a particular time period.
- C. Average return on assets employed over a particular time period.
- D. Average prime lending rate for the year being evaluated.

Correct Answer: A

Choice "a" is correct. Historical weighted average cost of capital is usually used as the target or hurdle rate in the residual income approach.

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

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#### QUESTION 5

If Brewer Corporation's bonds are currently yielding 8 percent in the marketplace, why would the firm's cost of debt be lower?

- A. Market interest rates have increased.
- B. Additional debt can be issued more cheaply than the original debt.
- C. Interest is deductible for tax purposes.



D. There is a mixture of old and new debt.

Correct Answer: C

Choice "c" is correct. Because interest expense is a tax deduction, the cost to Brewer is lower than the market yield rate on debt. Choice "a" is incorrect. If market interest rates increase, then Brewer's bonds would have to be offered at a discount to stay competitive with the market. This discount would increase (not lower) Brewer's cost of debt. Choice "b" is incorrect. Issuance of cheaper additional debt will lower future cost of debt, but have no impact on current cost of debt. Choice "d" is incorrect. Presumably, the 8% yield already includes new and old debt.

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