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QUESTION 1

The expected rate of return for the stock of Cornhusker Enterprises is 20%, with a standard deviation of 15%. The expected rate of return for the stock of Mustang Associates is 10%, with a standard deviation of 9%. The riskier stock is

- A. Cornhusker because the return is higher.
- B. Cornhusker because the standard deviation is higher.
- C. Mustang because the standard deviation is higher.
- D. Mustang because the coefficient of variation is higher.

Correct Answer: D

QUESTION 2

On January 1, Crane Company will acquire a new asset that costs \$400,000 and is anticipated to have a salvage value of \$30,000 at the end of 14 years. The new asset - Qualifies as 3-year property under the Modified Accelerated Cost Recovery System (MACRS). Will replace an old asset that currently has a tax basis of \$80,000 and can be sold now for \$60,000. Will continue to generate the same operating revenues as the old asset (\$200,000 per year). However, savings in operating costs will be experienced as follows: a total of \$120,000 in each of the first 3 years and \$90,000 in the fourth year. Crane is subject to a 40% tax rate and rounds all computations to the nearest dollar. Assume that any gain or loss affects the taxes paid at the end of the year in which it occurred. The company uses the net present value method to analyze projects using the following factors and rates:

Period	Present Value of \$1 at 14%	Present Value of \$1 Annuity at 14%	MACRS
1	.88	.88	33%
2	.77	1.65	45
3	.68	2.33	15
4	.59	2.92	7

The discounted net-of-tax amount that should be factored into Crane Company's analysis for the disposal transaction is?

- A. \$45,760.
- B. \$60,000.
- C. \$67,040.
- D. \$68,000.

Correct Answer: C

The old asset can be sold for \$60,000, producing an immediate cash inflow of that amount. This sale will result in a \$20,000 loss for tax purposes (\$80,000 -- \$60,000). At a 40% tax rate, the loss, which is deemed to affect taxes paid at the end of the first year, will provide a tax savings (cash inflow) of \$8,000. Because the \$8,000 savings is treated as occurring at the end of the first year, it must be discounted. This discounted (present) value is \$7,040 (\$8,000 x .88 PV of \$1 at 14% for one period). Combining the \$60,000 initial inflow with the \$7,040 of tax savings results in a net-of-tax amount of \$67,040.

QUESTION 3

Which one of the following is not a determinant in valuing a call option?

- A. Exercise price
- B. Expiration date.
- C. Forward contract price.
- D. Interest rate.

Correct Answer: C

The exercise price, the expiration date, and the interest rate are all determinants in valuing a call option.

QUESTION 4

The length of time required to recover the initial cash outlay of a capital project is determined by using the A. Discounted cash flow method.

- B. Payback method.
- C. Weighted net present value method.
- D. Net present value method.

Correct Answer: B

The payback method measures the number of years required to complete the return of the original investment. This measure is computed by dividing the net investment by the average expected cash inflows to be generated, resulting in the number of years required to recover the original investment. The payback method gives no consideration to the time value of money, and there is no consideration of returns after the payback period.

QUESTION 5

When a company offers credit terms of 2/101 net 301 the annual interest cost based on a 360-day year, is

- A. 24.0%.
- B. 35.3%.
- C. 35.3%.

D. 36.7%.

Correct Answer: D

Assume that the gross amount of an invoice is \$1,000. With a 2% discount, the buyer will pay only \$980 on the tenth day. Thus, the seller is forgoing \$20 to receive payment 20 days sooner than would otherwise be required. The 20-day interest rate is $\frac{\$20}{\$980} = 0.0204$. The number of 20-day periods in a year is $\frac{360}{20} = 18$. If the interest rate is 2.04% for each 20-day period, the annual interest rate (rounded to the nearest tenth) is $18 \times 2.04\% = 36.7\%$.

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