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QUESTION 1

Which basic force(s) drive (s) industry competition and the ultimate profit potential of the industry?

- I. Threat of new entrants.
- II. Bargaining power of suppliers.
- III. Favorable access to raw materials and labor.
- IV.

Product differentiation

- A.
- I only
- B.
- I and II only
- C.
- III and IV only
- D.
- I, II, III, and IV

Correct Answer: B

Threat of new entrants and bargaining power of suppliers are among the five basic forces that drive industry competition and the ultimate profit potential industry. This potential is measured in terms of longterm return on invested capital. The other three forces are rivalry among existing firms, threat substitutes and threat of buyers\ bargaining power.

QUESTION 2

Of the following decisions, capital budgeting techniques would least likely be used in evaluating the

- A. Acquisition of new aircraft by a cargo company.
- B. Design and implementation of a major advertising program.
- C. Trade for a star quarterback by a football team.
- D. Adoption of a new method of allocating nontraceable costs to product lines.

Correct Answer: D

Capital budgeting is the process of planning expenditures for investments on which the returns are expected to occur over a period of more than 1 year. Thus, capital budgeting concerns the acquisition or disposal of long-term assets and the financing ramifications of such decisions. The adoption of a new method of allocating, nontraceable costs to product

lines has no effect on a company's cash flows, does not concern the acquisition of long-term asset and is not concerned with financing. Hence, capital budgeting is irrelevant to such a decision.

QUESTION 3

Lawson Company has the opportunity to increase annual sales by \$100,000 by selling to a new, riskier group of customers. Based on sales, the uncollectible expense is expected to be 15%, and collection costs will be 5%. The manufacturing and selling expenses are 70% of sales, and its effective tax rate is 40%. If Lawson accepts this opportunity, the company's after-tax profit will increase by

- A. \$4,000.
- B. \$6,000.
- C. \$10,000.
- D. \$9,000.

Correct Answer: B

The company's manufacturing and selling costs exclusive of bad debts equal 70% of sales. Hence, the gross profit on the \$100,000 increase in sales will be \$30,000 ($\$100,000 \times 30\%$). Assuming \$15,000 of bad debts and \$5,000 of collection expense, the increase in pre-tax income will be \$10,000 ($\$30,000 - \$20,000$). Consequently, after-tax income will increase by \$6,000 [$\$10,000 - (40\% \times \$10,000)$].

QUESTION 4

An analysis of a company's planned equity financing using the capital asset pricing model (or security market line) would incorporate only the

- A. Expected market earnings, the current U.S. Treasury bond yield, and the beta coefficient.
- B. Expected market earnings and the price-earnings ratio,
- C. Current U.S. Treasury bond yield, the price-earnings ratio, and the beta coefficient.
- D. Current U.S. Treasury bond yield and the dividend payout ratio.

Correct Answer: A

The capital asset pricing model adds the risk-free rate to the product of the market risk premium and the beta coefficient. The market risk premium is the amount above the risk-free rate (approximated by the

U.S. Treasury bond yield) that must be paid to induce investment in the market. The beta coefficient of an individual stock is the correlation between the price volatility of the stock market as a whole and the price volatility of the individual stock.

QUESTION 5

None of the following items are deductible in calculating taxable income except A. Estimated liabilities for product warranties expected to be incurred in the future

- B. Dividends on common stock declared but not payable until next year.
- C. Bonus accrued but not paid by the end of the year to a cash-basis 90% shareholder
- D. Vacation pay accrued on an employee-by-employee basis.

Correct Answer: D

Sec.162(a) states that a deduction is allowed for the ordinary and necessary expenses incurred during the year in any trade or business. A corporation may therefore deduct a reasonable amount for compensation Accrued vacation pay is a form of compensation that results in an allowable deduction for federal income tax purposes

QUESTION 6

For capital budgeting purposes, management would select a high hurdle rate of return for certain projects because management

- A. Wants to use equity funding exclusively.
- B. Believes too many proposals are being rejected.
- C. Believes bank loans are riskier than capital investments.
- D. Wants to factor risk into its consideration of projects.

Correct Answer: D

Risk analysis attempts to measure the likelihood of the variability of future returns from the proposed investment. Risk can be incorporated into capital budgeting decisions in a number of ways, one of which is to use a hurdle rate (desired rate of return) higher than the firm's cost of capital, that is, a risk-adjusted discount rate. This technique adjusts the interest rate used for discounting upward as an investment becomes riskier. The expected flow from the investment must be relatively larger or the increased discount rate will generate a negative net present value, and the proposed acquisition will be rejected.

QUESTION 7

How much must the stock be worth at expiration in order for a call option to break even if the exercise price is \$60 and the call premium was \$3?

- A. \$57.00
- B. \$60.00
- C. \$61.50
- D. \$63.00

Correct Answer: D

Because the call premium is \$3, the stock price must be at least \$63 (\$60 exercise price + \$3 call premium).

QUESTION 8

Garfield, Inc. is considering a 10-year capital investment project with forecasted revenues of \$40,000 per year and forecasted cash operating expenses of \$29,000 per year. The initial cost of the equipment for the project is \$23,000, and Garfield expects to sell the equipment for \$9,000 at the end of the tenth year. The equipment will be depreciated over 7 years. The project requires a working capital investment of \$7,000 at its inception and another \$5,000 at the end of Year 5. Assuming a 40% marginal tax rate, the expected net cash flow from the project in the tenth year is?

- A. \$32,000
- B. \$24,000
- C. \$20,000
- D. \$11,000

Correct Answer: B

The project will have an \$11,000 before-tax cash inflow from operations in the tenth year (\$40,000 - \$29,000). Also, \$9,000 will be generated from the sale of the equipment. The entire \$9,000 will be taxable because the basis of the asset was reduced to zero in the 7th year. Thus, taxable income will be \$20,000 (\$11,000 + \$9,000), leaving a net after-tax cash inflow of \$12,000 [$\$20,000 \times (1 - 0.4)$]. To this \$12,000 must be added the \$12,000 tied up in working capital (\$7,000 + \$5,000). The total net cash flow in the 10th year will therefore be \$24,000.

QUESTION 9

N-Air Corporation uses a joint process to produce three products: A, B, and C, all derived from one input. The company can sell these products at the point of split-off (end of the joint process) or process them further. The joint production costs during October were \$10,000. N-Air allocates joint costs to the products in proportion to the relative physical volume of output. Additional information is presented in the opposite column.

Product	Units Produced	Unit Sales Price at Split-off	If Processed Further	
			Unit Sales Price	Unit Additional Cost
A	1,000	\$4.00	\$5.00	\$.75
B	2,000	2.25	4.00	1.20
C	1,500	3.00	3.75	.90

Assuming sufficient demand exists, N-Air could sell all the products at the prices previously mentioned at either the split-

off point or after further processing. To maximize its profits, N-Air Corporation should

- A. Sell product A at split-off and perform additional processing on products B and C.
- B. Sell product B at split-off and perform additional processing on products C and A.
- C. Sell product C at split-off and perform additional processing on products A and B.
- D. Sell products A, B, and C at split-off.

Correct Answer: C

QUESTION 10

The maximum capital expansion that FLF Corporation can support in the coming year without resorting to external equity financing is

- A. \$2 million.
- B. \$3 million.
- C. \$5 million.
- D. Cannot determine from the information given.

Correct Answer: C

QUESTION 11

A firm has \$3 million in total assets and \$1.65 million in equity. How much of its \$500,000 capital budget should be debt-financed to retain the same debt-equity ratio?

- A. \$50,000
- B. \$225,000
- C. \$275,000
- D. \$450,000

Correct Answer: B

The firm's total assets are \$3 million and total equity is \$1.65 million. Thus, liabilities are \$1.35 million (\$3 million - \$1.65 million). The current debt-equity ratio is 1.35 to 1.65, or 45% (\$1.35 million ÷ \$3 million) to 55% (\$1.65 million ÷ \$3 million). Thus, to maintain this ratio, 45% of all new investment should come from debt financing. Multiplying 45% times the \$500,000 capital budget results in a need for \$225,000 in debt financing.

QUESTION 12

Falcon AG, a German heavy machinery manufacturer, is planning to expand its manifesting base in the US. and has been offered a special loan of \$25 million by the state of Georgia. The loan is for a term of 5 years and carries an interest of 4% to be paid annually Falcons normal borrowing rate for 5-year borrowing is 6%. What is the value of this special loan to Falcon?

- A. \$4.212 million.
- B. \$2113 million.
- C. \$6325 million,
- D. \$20.788 million.

Correct Answer: B

The value of the special loan can be calculated by computing the NPV of the loan using Falcon's normal borrowing rate of 6% for 5 periods. NPV equals \$25 million minus PV of interest payments minus PV of principal. Thus, the NPV is \$2.1 13 million $(\$25 \text{ million} - [(\$25 \text{ million} \times .04 \text{ annual interest}) \times 4.212 \text{ PV of an annuity for 5 years at 6\%}] - (\$25 \text{ million} \times 0.747 \text{ PV of } \$1 \text{ in 5 yrs. at 6\%}])$.

QUESTION 13

If two projects are completely and positively linearly dependent (or positively related), the measure of correlation between them is

- A. 0
- B. + 0.5
- C. +1
- D. 1

Correct Answer: C

The measure of correlation when two projects are linearly dependent in a positive way will be +1.0.

QUESTION 14

A feasible portfolio that offers the highest expected return for a given risk or the least risk for a given expected return is a (n)

- A. Optimal portfolio
- B. Desirable portfolio
- C. Efficient portfolio D. Effective portfolio

Correct Answer: C

A feasible portfolio that offers the highest expected return for a given risk or the least risk for a given expected return is

called an efficient portfolio.

QUESTION 15

The equity section of Smith Corporation's Statement of Financial Position is presented below.

Preferred stock, \$100 par	\$12,000,000
Common stock, \$5 par	10,000,000
Paid-in capital in excess of par	18,000,000
Retained earnings	9,000,000
Net worth	<u>\$49,000,000</u>

The book value per share of Smith Corporation's common stock is

- A. \$18.50
- B. \$5.00
- C. \$14.00
- D. \$100

Correct Answer: A

The book value per common share equals the net assets (equity) attributable to common shareholders divided by the common shares outstanding, or \$18.50 [(\$10,000,000 common stock + \$18,000,000 additional paid-in capital + \$9,000,000 RE) ÷ (\$10,000,000 ÷ \$5 par)]

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