CMA Q&As

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QUESTION 1

The economic order quantity for a product is 500 units. However, new orders require 4 working-days lead time during which 80 units will be used. Given this information, the correct economic order quantity\\' is

A. 420 units.

B. 500 units.

C. 509 units.

D. 580 units.

Correct Answer: B

The lead times does not affect the EOQ; it just means the order should be placed four days earlier.

QUESTION 2

A company uses portfolio theory to develop its investment portfolio. If the company wishes to obtain optimal risk reduction through the portfolio effect, it should make its next investment in an investment that

A. Correlates negatively to the current portfolio holdings.

B. Is uncorrelated to the current portfolio holdings.

C. Is highly correlated to the current portfolio holdings.

D. Is perfectly correlated to the current portfolio holdings.

Correct Answer: A

A common general definition is that risk is an investment with an unknown outcome but a known probability distribution of returns (a known mean and standard deviation). An increase in the standard deviation (variability) of returns is synonymous with an increase in the riskiness of a project. Risk is also increased when the project\\'s returns are positively (directly) correlated with other investments in the company\\'s portfolio; that is, risk increases when returns on all projects rise or fall together. Consequently, the overall risk is decreased when projects have low variability and are negatively correlated (the diversification effect).

QUESTION 3

Franklin Inc. is a medium-size manufacturer of toys that makes 25% of its sales to Mega Company, a major national discount retailing firm. Mega will be requiring Franklin and other suppliers to use Electronic Data Interchange (EDI) for inventory replenishment and trade payment transactions as opposed to the paper-based systems previously used. Franklin would consider all of the following to be advantages of using EDI in its dealings with Mega except

A. Access to Megan\\'s inventory balances of Franklin\\'s products.

B. Better status tracking of deliveries and payments.

C. Compatibility with Franklin\\'s other procedures and systems.

D. Reduction in the payment float.

Correct Answer: C

Electronic data interchange is the electronic transfer of documents between businesses. EDI was developed to enhance just-in-time (JIT) inventory management. Advantages include speed, reduction of clerical errors, and elimination of repetitive clerical tasks and their costs. Improved business relationships result because of the mutual benefits conferred by EDI. Accordingly, some organizations require EDI. However, EDI entails the exchange of common business data converted into standard message formats. Thus, two crucial requirements are that the participants agree on transaction formats and that translation software be developed to convert messages into a form understandable by other companies. Accordingly, establishing compatibility with Megan\\'s procedures and systems will require Franklin to resolve issues regarding compete ability with its other procedures and systems.

QUESTION 4

A financial manager usually prefers to issue preferred stock rather than debt because

A. Payments to preferred stockholders are not considered fixed payments

B. The cost of fixed debt is less expensive since it is tax deductible even if a sinking fund is required to retire the debt.

C. The preferred dividend is often cumulative, whereas interest payments are not.

D. In a legal sense, preferred stock is equity, therefore, dividend payments are not legal obligations

Correct Answer: D

For a financial manager, preferred stock is preferable to debt because dividends do not have to be paid on preferred stock, but failure to pay interest on debt could lead to bankruptcy. Thus, preferred stock is less risky than debt. However, debt has some advantages over preferred stock, the most notable of which is that interest payments are tax deductible. Preferred stock dividends are not.

QUESTION 5

Which one of the following statements concerning cash discounts is correct?

A. The cost of not taking a 2/10, net 30 cash discount is usually less than the prime rate.

B. With trade terms of 2/15, net 60, if the discount is not taken, the buyer receives 45 days of free credit.

C. The cost of not taking the discount is higher for terms of 2/10, net 60 than for 2/10, net 30.

D. The cost of not taking a cash discount is generally higher than the cost of a bank loan.

Correct Answer: D

Payments should be made within the discount periods if the cost of not taking discounts exceeds the firm\\'s cost of capital. For example, failing to take a discount when terms are 2/10, net 30 means that the firm is paying an effective annual interest rate exceeding 36%. Thus, the cost of not taking a discount is usually higher than the cost of a bank loan.