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QUESTION 1

What return on equity do investors seem to expect for a firm with a \$50 share price, an expected dividend of \$5.50, of 9, and a constant growth rate of 4.5%?

- A. 15.05%
- B. 15.50%
- C. 15.95%
- D. 16.72%

Correct Answer: B

Dividing the \$5.50 dividend by the \$50 share price produces an 11% dividend yield. Adding the 11% yield to the 4.5% growth rate produces a total return of 15.5%.

QUESTION 2

Which one of the following capital investment evaluation methods does not take the time value of money into consideration?

- A. Net present value.
- B. Discounted payback.
- C. Internal rate of return.
- D. Accounting rate of return.

Correct Answer: D

The accounting rate of return (unadjusted rate of return or rate of return on the carrying amount) equals accounting net income divided by the required initial or average investment. The accounting rate of return ignores the time value of money.

QUESTION 3

The evaluation technique of linear programming involves all of the following except

- A. Linear equations.
- B. Scarce resources.
- C. Accurate results.
- D. Objective function.

Correct Answer: C



Linear programming is a tool for allocating scarce resources in the presence of resource constraints. The problem must be described by a system of linear equations. An objective function (usually cost or revenue) is maximized or minimized subject to constraint equations. The simultaneous solution to the system of equations maximizes profit (or minimizes cost). This description is seldom strictly accurate but provides useful approximations.

QUESTION 4

Project 1 has an expected NPV of \$120,000 and a standard deviation of \$200,000. Project 2 has an expected NPV of \$100,000 and a standard deviation of \$150,000. The correlation between these two projects is 0.80. What is the coefficient of variation for the portfolio of projects?

- A. 1.67
- B. 1.59
- C. 1.51
- D. 0.63

Correct Answer: C

The coefficient of variation is useful when the rates of return and standard deviations of two investments differ. It measures the risk per unit of return by dividing the standard deviation by the expected return. Thus, for Project 1, dividing \$200,000 by \$120,000 produces a coefficient of 1.67. For Project 2, the calculation is to divide \$150,000 by \$100,000, or 1.50. If the two projects had perfect correlation ($=1.0$), then you could combine the calculations ($\$350,000 \div \$220,000 = 1.59$). However, with a correlation of less than one, the risk will be something less than 1.59.

QUESTION 5

Post-investment audits

- A. Complete a stage in the capital budgeting process.
- B. Serve as a control mechanism.
- C. Allow the outcome of a project to be evaluated as soon as possible.
- D. Deter managers from proposing profitable investments.

Correct Answer: B

Post-investment audits should be conducted to serve as a control mechanism and to deter managers from proposing unprofitable investments. Actual-to-expected cash flow comparisons should be made, and unfavorable variances should be explained. Individuals who supplied unrealistic estimates should have to explain differences.