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Question 1

Question Type: MultipleChoice

A company is considering the purchase of a new machine to replace a five-year old machine and has gathered the following information:
Purchase price of new machine \$50,000 Installation cost of new machine 4,000 Market value (selling price) of the old machine 5,000
Book value of the old machine 2,000 Increase in net working capital if new machine is installed 1,000 Effective income tax rate 40%
If the company replaces the old machine with the new machine, what is the cash flow in period 0?

Options:

- A- \$(49,000)
- B- \$(51.200)
- C- \$(51.800)
- D- \$(53.000)

Answer:

B

Explanation:

The net initial investment for a capital project consists of three components: the purchase of new equipment, the increase in working capital, and the after-tax proceeds from the disposal of old equipment. For this company, the first of these is \$54,000 (\$50,000 + \$4,000), and the second is \$1,000. The calculation of the after-tax proceeds from the disposal of the old equipment is as follows:

Question 2

Question Type: MultipleChoice

Mobile Home Manufacturing, Inc. is evaluating a proposed acquisition of a new machine at a purchase price of \$380,000 and installation charges that will amount to \$20,000. A \$15,000 increase in working capital will be required. The machine will have a useful life of four years, after which it can be sold for \$50,000. The estimated annual incremental operating revenues and cash operating expenses are \$750,000 and \$500,000, respectively, for each of the four years. Mobile Home's tax rate is 40%, and the cost of capital is 12%. Mobile Home uses straight-line depreciation for both financial reporting and income tax purposes. If Mobile Home accepts the project, the initial investment will be

Options:

A- \$350,000

B- \$365,000

C- \$385,000

D- \$415,000

Answer:

D

Explanation:

The net initial investment for a capital project consists of three components: the purchase of new equipment, the increase in working capital, and the salvage value of old equipment Mobile Home Manufacturing's calculation is thus as follows:

Question 3

Question Type: MultipleChoice

The management of Pelican, Inc. is evaluating a proposed acquisition of a new machine at a purchase price of \$180,000 and with installation costs of \$10,000. A \$9,000 increase in working capital will be required. The machine Will have a useful life of four years, after which it can be sold for \$30,000. The estimated annual incremental operating revenues and cash operating expenses are \$450,000 and \$300,000, respectively, for each of the four years. Pelican's effective income tax rate is 40%. and the cost of capital is 12%. Pelican uses straight-line depreciation for both financial reporting and income tax purposes. If the project is accepted, the estimated incremental after-

tax operating cash flows at the end of the first year will be?

Options:

A- \$99,000

B- \$106,000

C- \$108,000

D- \$150,000

Answer:

B

Explanation:

The estimated incremental after-tax operating cash flows for each year of a capital project consist of two components: the after-tax cash inflows from operations and the depreciation tax shield arising from the purchase of new equipment. The first of these for Pelican can be calculated as follows:

Pelican's total incremental after-tax operating cash flows for each year of the project's

life is thus \$106,000 (\$90,000 + \$16,000).

Question 4

Question Type: MultipleChoice

The chief financial officer of Pauley, Inc has requested an evaluation of a proposed acquisition of a new machine at a purchase price of \$60,000 and with installation costs of \$10,000. A \$3,000 increase in working capital will be required. The machine will have a useful life of four years, after which it can be sold for \$10,000. The estimated annual incremental operating revenues and cash operating expenses are \$150,000 and \$100,000, respectively, for each of the four years. Pauley's effective income tax rate is 40%, and the cost of capital is 12%. Pauley uses straight-line depreciation for both financial reporting and income tax purposes. Pauley's estimated after-tax cash flow in the fourth year, at which time the equipment will be sold, will be?

Options:

- A- \$34,000
- B- \$45,000
- C- \$46,000
- D- \$49,000

Answer:

D

Explanation:

The estimated incremental after-tax operating cash flows for each year of a capital project consist of two components: the after-tax cash inflows from operations and the depreciation tax shield arising from the purchase of new equipment. The first of these for Pauley can be calculated as follows:

Pauley's total after-tax operating cash inflow for each year of the project's life is thus \$36,000 (\$30,000 + \$6,000). In the final year of the project, two additional cash flows must be taken into account, the after-tax proceeds from the disposal of the equipment purchased for the project, and the recovery of working capital devoted to the project. These two additional cash flows can be calculated as follows:

Pauley's total after-tax cash inflow for the final year of the project's life is thus \$49,000

(\$36,000 + \$13,000).

Question 5

Question Type: MultipleChoice

The Hopkins Company has estimated that a proposed project's 10-year annual net cash benefit, received each year end, will be \$2,500 with an additional terminal benefit of \$5,000 at the end of the 10th year. Assuming that these cash inflows satisfy exactly Hopkins' required rate of return of 8%, calculate the initial cash outlay

Options:

A- \$16,775

B- \$19,090

C- \$25,000

D- \$30,000

Answer:

B

Explanation:

If the 8% return exactly equals the present value of the future flows (i.e., NPV is zero), then simply determine the present value of the future inflows. Thus, Hopkins Company's initial cash outlay is \$19,090 [(\$2,500)(PVIFA at 8% for 10 periods) + (\$5,000)(PVIF at 8% for 10 periods) (\$2,500)(6.710) + (\$5,000)(.463)].

Question 6

Question Type: MultipleChoice

Union Electric Company must clean up the water released from its generating plant. The company's cost of capital is 12 percent for average risk projects, and that rate is normally adjusted up or down by 2 percentage points for high- and low- risk projects. Clean-Up Plan A . which is of average risk, has an initial cost of \$10 million, and its operating cost will be \$1 million per year for its 10-year life. Plan B, which is a high-risk project, has an initial cost of \$5 million, and its annual operating cost over Years 1 to 10 will be \$2 million. What is the approximate PV of costs for the better project?

Options:

A- \$15,432,000

B- \$15,650,000

C- \$16,300,000

D- \$17,290,000

Answer:

B

Explanation:

The cash flows of Plan A are discounted at 12%, the company's cost of capital for average risk projects. Plan B is evaluated with a lower cost of capital that reflects a greater risk of the cash outflow of the project. Thus, the cash flows of Plan B are discounted at 10% (12% --- 2%). the company's adjusted cost of capital for high risk projects. The net present value of each plan is the initial cost plus the present

value of an annuity for 10 years at the appropriate rate multiplied times the annual operating cost.

The present value factors are found in the tools section of CMA Test Prep.

$$\text{Plan A NPV} = \$10,000,000 + (\$1,000,000 \times 5.650)$$

$$\text{Plan A NPV} = \$15,650,000$$

$$\text{Plan B NPV} = \$5,000,000 + (\$2,000,000 \times 6.145)$$

$$\text{Plan B NPV} = \$17,290,000$$

Plan A has a lower NPV and thus is the better project.

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