Question block created by wizard

You have 180 minutes to complete this session.

1. Jeffrey Jones passed the Level I CFA examination in 1997 and the Level II examination in 2009. He is not currently enrolled for the Level III examination. According to the CFA Institute Standards of Professional Conduct, which of the following is the *most* appropriate way for Jones to refer to his participation in the CFA Program?

A. Jeffrey Jones, CFA (expected 2014)
B. Candidate in the CFA Institute CFA Program
C. Passed Level II of the CFA examination in 2009

Answer = C

No designation exists for someone who has passed Level I, Level II, or Level III of the CFA exam, see Standard VII(B). Persons who have passed a certain level of the exam may state that they have completed that level. A person can state he is a candidate only if he is currently enrolled in the CFA Program. It is also an improper reference to use "expected" a part of the designation.

2014 CFA Level I
"Guidance for Standards I-VII", CFA Institute
Standard VII(B)

2. Ri Lin, CFA, is a portfolio manager with Dynasty Investment Management. Lin is performing research on Titan Mining for potential inclusion in his fund. Management at Titan is interested in having a well-known fund manager such as Lin as a shareholder. Titan pays for Lin to fly to a company retreat in Tokyo, where a brief introductory meeting is followed by attendance at a sporting event and then dinner at one of the city's top restaurants. Lin participates after disclosing the activities to Dynasty's compliance department. Which standard did Lin's actions *most likely* violate?

A. Disclosures of Conflicts
B. Independence and Objectivity
C. Diligence and Reasonable Basis

Answer = B

Lin is placing himself in a situation in which his objectivity or appearance of objectivity may be compromised, which is a violation of Standard I(B). It would have been more advisable for Lin to decline having Titan pay for this trip.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard I(B), Standard V(A), Standard VI(A

3. James Woods, CFA, is a portfolio manager at ABC Securities. Woods has reasonable grounds to believe his colleague, Sandra Clarke, a CFA Level II candidate, is engaged in unethical trading activities that may also be in violation of local securities laws. Woods is not Clarke's supervisor, and her activities do not impact Woods or any of the portfolios for which he is responsible. Based on the Code and Standards, the recommended course of action is for Woods to:

A. report Sandra Clarke to the appropriate governmental or regulatory organization.
B. not take any action because he is not directly involved.
C. report Sandra Clarke to ABC's trading supervisor or compliance department.

Answer = C

Under Standard 1(A) in situations where a member or candidate is aware of employer engagement in unethical or illegal activity, it is recommended that they attempt to stop the behavior by bringing it to the attention of a supervisor or the firm's compliance department.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard I(A)

4. Albert Nyakenda, CFA, was driving to a client's office where he was expected to close a multi-million-dollar deal, when he was pulled over by a traffic policeman although he did not believe he had violated any traffic laws. When Nyakenda realized the policeman planned to wrongly ticket him for speeding, he offered to buy him "lunch" so that he could quickly get to his client's office. The lunch would cost significantly more than the ticket. The alternative was to go to the police station and file a complaint of being wrongly accused that would also involve going to court the next day to present his case. Did Nyakenda *most likely* violate the CFA Institute Code of Ethics?

A. Yes
B. No, because the cost of lunch is more than the ticket
C. No, because he was wrongly accused

Answer = A

Nyakenda was effectively trying to bribe the policeman so that he would not issue a speeding ticket. This action violates the Code of Ethics. Despite feeling he was wrongly accused, it is only his opinion, and may not be based on fact or upheld in a court of law. Nyakenda has a responsibility to act with integrity and in an ethical manner as required by the Code of Ethics.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute

5. Which of the following statements is *most likely* consistent with the CFA Institute Code of Ethics? CFA Institute members and CFA candidates must:

A. promote the integrity of and uphold the rules governing capital markets.
B. practice the highest level of personal and professional integrity and always act in the best interest of their employers.

C. maintain their professional competence and require investment professionals under their supervision to adopt the CFA Code of Ethics.

Answer = A

The Code of Ethics requires CFA Institute members and candidates for the CFA designation to promote the integrity of and uphold rules governing capital markets. Although the Code of Ethics requires members and candidates to act with integrity, and the interests of the client are paramount, not all client requests are appropriate to follow, particularly if considered unethical or illegal. The Code of Ethics does not require members and candidates to encourage others to pursue the CFA designation, only to encourage them to improve their professional competence.

2014 CFA Level I
"Ethics and Professional Standards," CFA Institute
The Code of Ethics

6. Li Chen is a CFA candidate and an equity research analyst at an independent research firm. She is contacted by Granite Technologies, Inc., to write an issuer-paid research report on the company to increase awareness of Granite's stock within the investment community. Which statement *best* represents how Chen should respond to this assignment request? She should:

A. negotiate a flat fee and disclose this relationship in her report.
B. accept long-term warrants on Granite's stock in lieu of any cash compensation.
C. decline to write the report because doing so would compromise her independence.

Answer = A

If Chen negotiates a flat fee, her independence and objectivity would not be questioned because her fee would not be based on the results of her research. In addition, by fully disclosing the relationship in her report, she allows the reader to determine whether her judgment is compromised. As a result, Chen is maintaining compliance with Standard I(B)-Independence and Objectivity.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard I(B)

7. Miranda Grafton, CFA, purchased a large block of stock at varying prices during the trading session. The stock realized a significant gain in value before the close of the trading day, so Grafton reviewed her purchase prices to determine what prices should be assigned to each specific account. According to the *Standards of Practice Handbook*, Grafton's *least* appropriate action is to allocate the execution prices:

A. across the participating client accounts pro rata on the basis of account size.
B. across the participating client accounts at the same execution price.
C. on a first-in, first-out basis with consideration of bundling orders for efficiency.

Answer = A

According to Standard III (B) best practices include allocating pro rata on the basis of order size, not account size. All clients participating in the block trade should receive the same execution price and be charged the same commission.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard III(B)

8. Amanda Covington, CFA, works for McJan Investment Management. McJan employees must receive prior clearance of their personal investments in accordance with McJan's compliance procedures. To obtain prior clearance, McJan employees must provide a written request identifying the security, the quantity of the security to be purchased, and the name of the broker through which the transaction will be made. Precleared transactions are approved only for that trading day. As indicated below, Covington received prior clearance.

Security	Quantity	Broker	Prior Clearance
A	100	Easy Trade	Yes
B	150	Easy Trade	Yes

Two days after she received prior clearance, the price of Stock B decreased, so Covington decided to purchase 250 shares of Stock B only. In her decision to purchase 250 shares of Stock B only, did Covington violate any CFA Institute Standards of Professional Conduct?

A. Yes, relating to diligence and reasonable basis
B. No
C. Yes, relating to her employer's complicance procedures

Answer = C

Prior-clearance processes guard against potential and actual conflicts of interest; members are required to abide by their employe's compliance procedures. (See Standard VI(B)).

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard V(A), Standard VI(B)

9. Delaney O'Keefe, a CFA candidate, is a portfolio manager at Bahati Management Company. The company is considering investing offshore for the first time, particularly in North America, on behalf of its clientele, who are all high-net-worth individuals. O'Keefe does not have experience in offshore investments, so she hires Mark Carlson, CFA, of Carlson Consulting, on the sole basis that he is a CFA charterholder, to undertake due diligence exercises on the top 10 portfolio managers in North America, ranked by assets under management (AUM). To avoid violating any Code and Standards, O'Keefe should *most likely* undertake:

A. the due diligence exercise on the top 10 asset managers herself.
B. a sampling of the suitability of North America for her clients.
C. a due diligence exercise on Mark Carlson and Carlson Consulting.

Answer = C

O'Keefe can delegate a due diligence exercise to a third party but must ensure the person or company hired to do so is competent and has the skills necessary to undertake a thorough and appropriate analysis. Although Carlson may be qualified to undertake this assignment, O'Keefe needs to take the necessary steps to ensure that he is indeed qualified. Just because a person is a CFA charterholder does not necessarily mean he or she is appropriate for the assignment.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard V(A)

10. Marc Davidson, CFA, works as a trust specialist for Integrity Financial. Davidson starts a part-time consulting business providing advice to trustees for a fee. He conducts this business on his own time and therefore did not notify Integrity Financial of his consulting. Davidson asks his assistant to compile a list of Integrity's clients and their contact information. The following month, Davidson is offered a similar role at Integrity's largest competitor, Legacy Trust Services, Inc. After he begins working at Legacy, his new manager arranges for him to meet with a number of prospective clients, many of whom are clients of Integrity. After meeting with Davidson, a number of former Integrity clients decide to transfer their business to Legacy. Did Davidson's action violate the Code and Standards?

A. No
B. Yes, Davidson's part-time consulting business is a violation of the Standards
C. Yes, both Davidson's part-time consulting business and his meetings with Integrity clients are violations of the Standards

Answer = B

Members and candidates are required to disclose any compensation arrangement to their employers that involves performing tasks or services that their employers can charge for. Disclosure is required even if the activities occur during non-work hours.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard IV(A) Loyalty to Employer

11. David Donnigan enrolled to take the Level II CFA examination in the current year, but he did not take the exam. Donnigan advised his employer that he passed Level II. Subsequently, he registered to take the Level II exam the next year. Which CFA Institute Standards of Professional Conduct did Donnigan *least likely* violate? The standard related to:

A. professional misconduct.
B. duty to employer.
C. referencing candidacy in the CFA Program.

Answer = C

Because he registered to take the exam in the next year, Donnigan still qualifies to state he is a candidate in the CFA Program. He would not, however, be authorized to reference that he is a Level III candidate and, if asked, would need to specifiy that he is a Level II candidate.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard I(D), Standard IV(A)

12. Justin Blake, CFA, a retired portfolio manager, owns 20,000 shares of a small public company that he would like to sell because he is worried about the company's prospects. He posts messages on several internet bulletin boards. The messages read, "This stock is going up once the pending patents are released, so now is the time to buy. The stock is a buy at anything below $3. I have done some close research on these guys." According to the *Standards of Practice Handbook*, Blake *most likely* violated the Code and Standards associated with:

A. Integrity of Capital Markets, and Conflicts of Interest.
B. Integrity of Capital Markets, but not Conflicts of Interest.
C. neither Integrity of Capital Markets nor Conflicts of Interest.

Answer = B

Blake violated Standard II(B) regarding the Integrity of Capital Markets by engaging in a practice that is likely to artificially inflate trading volume.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard II(B), Standard VI(A)

13. The Global Investment Performance Standards *least likely* require:

A. nondiscretionary portfolios to be included in composites.
B. composites to be defined according to similar investment objectives and/or strategies.
C. non-fee-paying portfolios to be excluded in the returns of appropriate composites.

Answer = A

Composites (Standard IV – Composites) must be defined according to similar investment objectives and/or strategies. Terminated portfolios must be included in the historical returns of appropriate composites, and only fee-paying portfolios are to be included in composites. Non-discretionary portfolios must not be included in a firm's composites.

2014 CFA Level I
"Introduction to the Global Investment Performance Standards (GIPS)," CFA Institute

14. Lawrence Hall, CFA, and Nancy Bishop, CFA, began a joint research report on Stamper Corporation. Bishop visited Stamper's corporate headquarters for several days and met with all company officers. Prior to the completion of the report, Bishop was reassigned to another project. Hall used his and Bishop's research to write the report but did not include Bishop's name on the report, because he did not agree with and changed Bishop's conclusion included in the final report. According to the *Standards of Practice Handbook*, did Hall *most likely* violate any CFA Institute Standards of Professional Conduct?

A. Yes, with respect to misrepresentation
B. No
C. Yes, with respect to diligence and reasonable basis

Answer = B

Members are in compliance with CFA Institute's Standard V(A)-Diligence and Reasonable Basis if they rely on the research of another party who exercised diligence and thoroughness. Because Bishop's opinion did not agree with the final report, disassociating her from the report is one way to handle this difference between the analysts.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard V(A

15. Several years ago, Leo Peek, CFA, co-founded an investment club. The club is fully invested but has not actively traded its account for at least a year and does not plan to resume active trading of the account. Peek's employer requires an annual disclosure of employee stock ownership. Peek discloses all of his personal trading accounts but does not disclose his holdings in the investment club. Peek's actions are *least likely* to be a violation of which of the CFA Institute Standards of Professional Conduct?

A. Misrepresentation
B. Transaction priority
C. Conflicts of interest

Answer = B

There is no indication that the investment club is trading ahead of clients. See Standard VI(B).

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard I(C), Standard VI(A), Standard VI(B)

16. Which of the following is *least likely* a requirement of the GIPS standards? Firms are required to:

A. have their performance records verified by an independent third party.
B. present a minimum of five years of annual investment performance compliant with the GIPS standards.
C. include all discretionary, fee-paying portfolios in at least one composite.

Answer = A

It is a recommendation but not a requirement that firms obtain independent third-party verification to claim GIPS compliance. Firms are required to include all discretionary, fee-paying portfolios in at least one composite. They must also present a minimum of five years of annual investment performance compliant with the GIPS standards.

2014 CFA Level I
"Global Investment Performance Standards (GIPS)," CFA Institute
GIPS Standards

17. Jimmy Lan, CFA, is a technology analyst at Pacific Securities, Inc. and is a leading authority on Japanese technology companies. Lan's clients include many leading Japanese equity managers. While still employed at Pacific, Lan makes plans during the weekends to start a new company, JL Consulting. His plans consist of contracting office space, interviewing potential employees, and purchasing office equipment. Once he feels ready to launch his new firm, Lan provides Pacific with his resignation notice. After leaving, Lan constructs earnings models of the technology companies he previously covered, using the knowledge and experience gained while at Pacific. He then contacts former clients by using public sources and encourages them to become clients of his new firm. Are Lan's actions in compliance with the Code and Standards?

A. Yes, assuming he is not in breach of any non-compete agreement signed while at Pacific Securities
B. No, because he is prohibited from engaging in activities related to starting his new business while still employed by Pacific Securities
C. No, because the names of former clients, modeling skills, and experience gained by Lan are confidential information of Pacific Securities

Answer = A

Lan's actions do not violate Standard IV (A) – Duties to Employers. Lan does not use company time to make arrangements for his new venture, nor does he misappropriate any information (financial models or client contacts) from his former employer. All of Lan's actions are permissible under Standard IV (A).

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard IV(A)

18. Alexander Newton, CFA, is the chief compliance officer for Mills Investment Limited. Newton institutes a new policy requiring the pro rata distribution of new security issues to all established discretionary accounts for which the new issues are appropriate. The policy also provides for the exclusion of newly established discretionary accounts from the distribution until they have reached their one-month anniversary date. This policy is disclosed to all existing and potential clients. Did Newton *most likely* violate any CFA Institute Standards of Professional Conduct?

A. No, because the allocation policy is not inequitable under the standards
B. Yes
C. No, because the policy has been adequately disclosed to all existing and potential clients

Answer = B

Under Standard III(B)-Fair Dealing, members and candidates should disclose to clients and prospective clients how they select accounts to participate in and how they determine the amount of securities each account will buy or sell. Trade allocation procedures must be fair and equitable, and disclosure of inequitable allocation methods does not relieve the member or candidate of this obligation. All discretionary accounts should be treated in the same manner. Treating newer accounts differently would be considered inequitable regardlessof whether this policy is disclosed.

2014 CFA Level I
"Guidance for Standards I-VII," CFA Institute
Standard III(B)

19. Which of the following statements is the *most* accurate description concerning the internal rate of return (IRR) method? IRR:

A. assumes that all cash flows from a project will be reinvested at the computed IRR.
B. is the preferred method for evaluating mutually exclusive projects.
C. is sensitive to changes in the firm's weighted average cost of capital.

Answer = A

All of the incremental cash flows arising from a project should be analyzed on an after-tax basis.

2014 CFA Level I
"Capital Budgeting," by John D. Stowe and Jacques R. Gagné
Section 3

20. An analyst gathered the following information about a company that expects to fund its capital budget without issuing any additional shares of common stock

Source of Capital	**Capital Structure Proportion**	**Marginal After-Tax Cost**
Long-term debt	50%	6%
Preferred stock	10%	10%
Common equity	40%	15%

If no significant size or timing differences exist among the project(s) and both projects have the same risk as the company's existing projects, which project(s) should be accepted?

IRR of Two Independent Projects	
Warehouse project	8%
Equipment project	12%

A. Both projects
B. The equipment project only
C. The warehouse project only

Answer = B

The company's weighted average cost of capital (WACC) is calculated as
WACC=0.5(6%)+ 0.1(10%)+ 0.4(15%)= 10%.
In this scenario, the company should accept projects that have an internal rate of return greater than

the cost of capital. The equipment project's IRR exceeds the WACC. The warehouse project does not.

2014 CFA Level I
"Capital Budgeting," by John D. Stowe and Jacques R. Gagné
Sections 4.1–4.2

"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Sections 2–2.1

21. Which of the following transactions is *most likely* to affect a company's financial leverage ratio?

A. An increase in cash dividends paid
B. Payment of a 9% stock dividend
C. Completion of a previously announced 1-for-20 reverse stock split

Answer = A

Cash dividends affect a company's capital structure and financial leverage ratios by reducing assets and shareholders' equity.

2014 CFA Level I
"Dividends and Share Repurchases: Basics," by George H. Troughton and Gregory Noronha
Section 2.4

22. A company that wants to determine its cost of equity gathers the following information

Rate of return on 3-month Treasury bills	3.0%
Rate of return on 10-year Treasury bonds	3.5%
Market risk premium	6.0%
The company's equity beta	1.6
Dividend growth rate	8.0%
Corporate tax rate	35%

Using the capital asset pricing model (CAPM) approach, the cost of equity (%) for the company is closest to:

A. 13.1%.
B. 12.6%.
C. 7.5%.

Answer = A

CAPM: Cost of equity = Risk free rate + Beta × Market risk premium = 3.5% + 1.6 × (6.0%) = 13.1%

The 10-year risk free rate is appropriate based on the long-term duration of the cash flows from the project.

2014 CFA Level I
"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Section 3.3.1

23. A firm's before-tax costs of debt, preferred stock, and equity are 12%, 17%, and 20% respectively. Assuming equal funding from each source and a marginal tax rate of 40%, the weighted average cost of capital (%) is *closest* to:

A. 13.9%.
B. 9.8%.
C. 14.7%.

Answer = C

$WACC = w_d r_d (1 - t) + w_p r_p + w_e r_e$

$$WACC = \frac{1}{3}(0.12)(1 - 0.4) + \frac{1}{3}(0.17) + \frac{1}{3}(0.20) = 14.73\%$$

2014 CFA Level I
"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Section 2

24. A class of noncallable, nonconvertible preferred stock was issued at $45.00 per share with a dividend of $5.25. The preferred stock is now trading at $60.00 per share. Earnings of the company are growing at 3.00%. The cost of preferred stock is *closest* to:

A. 5.8%.
B. 8.8%.
C. 11.7%.

Answer = B

The cost of preferred stock is:

$$r_p = \frac{D_p}{P_p}$$

where:

r_p =the cost of preferred stock

D_p =the preferred stock dividend per share

P_p =the current preferred stock price per share

The cost of preferred stock is 5.25 ÷ 60.00 = 8.75%

2014 CFA Level I
"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Section 3.

25. Which of the following sources of short-term financing is *most likely* used by smaller companies?

A. Uncommitted lines
B. Collateralized loans
C. Commercial paper

Answer = B

Smaller companies use collateralized loans, factoring, or loans from non-bank companies as their sources of short-term financing. Larger companies can take advantage of commercial paper, banker's acceptances, uncommitted lines, and revolving credit agreements.

2014 CFA Level I
"Working Capital Management," by Edgar A. Norton, Jr., Kenneth L. Parkinson, and Pamela Peterson Drake
Section 8.1-8.2

26. A firm with a marginal tax rate of 40% has a weighted average cost of capital of 7.11%. The before-tax cost of debt is 6%, and the cost of equity is 9%. The weight of equity in the firm's capital structure is *closest* to:

A. 79%.
B. 37%.
C. 65%.

Answer = C

WACC = $w_d\, r_d\,(1 - t) + w_e\, r_e$, where $w_d + w_e = 1$
$7.11 = (1 - w_e) \times 6 \times (1 - 0.4) + w_e \times 9$
$w_e = 65\%$

2014 CFA Level I
"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Section 2.1

27. The following data apply to two companies producing similar products.

	Company A	**Company B**
Number of units produced and sold	1 million	1 million
Sale price per unit	$100	$100
Variable cost per unit	$60	$50
Fixed operating costs	$20 million	$40 million
Fixed financing expenses	$10 million	$5 million
Degree of operating leverage (DOL)	?	5.0
Degree of financial leverage (DFL)	2.0	2.0

Compared with Company B, Company A has:

A. a higher degree of total leverage.
B. a lower sensitivity of operating income to changes in units sold.
C. the same sensitivity of operating income to changes in net income.

Answer = B

	Company A	**Company B**
Degree of operating leverage (DOL) $DOL = \dfrac{Q(P-V)}{Q(P-V)-F}$	$\dfrac{1\ million \times (\$100 - \$60)}{1\ million \times (\$100 - \$60) - \$20\ million} = 2.0$	=**5.0** (as given)
Degree of financial leverage (DFL) $DFL = \dfrac{Q(P-V)Q}{Q(P-V)-F-C}$	**= 2.0** (as given)	=**2.0** (as given)
Degree of total leverage (DTL) DTL = DOL × DFL	DTL = 2.0 × 2.0 = **4.0**	DTL = 5.0 × 2.0

		= **10.0**

The DOL is lower for Company A than Company B (as per the table), meaning Company A's operating income is less sensitive to a change in the units sold relative to Company B.

2014 CFA Level I
"Measures of Leverage," by Pamela Peterson Drake, Raj Aggarwal, Cynthia Harrington, and Adam Kobor
Sections 3.3–3.5

28. A publicly listed company has a 12-person board of directors. The chairman, who is the past chief executive officer of the company, was named chairman on his retirement date four years ago. Each member is elected for a two-year term and one-half of the positions stand for election every year. The three members of the audit committee are all outside directors and have relevant financial and accounting experience. Which of the following actions would provide the *greatest* improvement in the corporate governance of this company?

A. All members of the board of directors should stand for election every year.
B. The company's vice president of finance should be a member of the audit committee.
C. The chairman of the board should be an independent director.

Answer = C

If the chair of the board is a former chief executive of the company, it may hamper efforts to undo mistakes made by him or her as chief executive. It is not clear whether it is better to have all members elected annually (more flexibility to meet changes in the marketplace) or whether it is better to have staggered board terms (better continuity of board expertise). All members of the audit committee should be independent members of the board.

2014 CFA Level I
"The Corporate Governance of Listed Companies: A Manual for Investors," by Kurt Schacht, James C. Allen, and Matthew Orsagh
Section: The Board

29. Which of the following is *least likely* to be a component of a developing country's equity premium?

A. Sovereign yield spread
B. Annualized standard deviation of the developing country's equity index
C. Annualized standard deviation of the sovereign bond market in terms of the developing country's currency

Answer = C

The annualized standard deviation of the sovereign bond market in terms of the developing country's currency is not part of the equity premium calculation.	
Country equity premium	$= \text{Sovereign yield spread} \times \dfrac{\text{Annualized standard deviation of equity index}}{\text{Annualized standard deviation of the soverign bond market in terms of the developed market currency}}$

2014 CFA Level I
"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Section 4.2

30. A company extends its trade credit terms by four days to all its credit customers. The *most likely* effect of this change to the company's credit customers is a four-day:

A. decrease in the company's net operating cycle.
B. decrease in the company's operating cycle.
C. increase in the company's operating cycle.

The company's customers are receiving a four-day increase in their number of days of payables, which will reduce the company's cash conversion cycle (net operating cycle) by four days.

2014 CFA Level I
"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning

"Working Capital Management," by Edgar A. Norton, Jr., Kenneth L. Parkinson, and Pamela Peterson Drake
Section 2.2

31. In order to maintain an adequate net daily cash position, a company is *least likely* to:

A. forecast depreciation and accruals.
B. predict the business cycles and seasonal effects.
C. monitor access to borrowing facilities.

Answer = A

Accruals are paid at a later date, and depreciation is a noncash expense.

2014 CFA Level I
"Working Capital Management," by Edgar A. Norton, Jr., Kenneth L. Parkinson, and
Pamela Peterson Drake
Sections 3.1– 3.2

32. The following information is available for a company and the industry in which it competes:

	Company	**Industry**
Accounts receivable turnover	5.6 times	6.5 times
Inventory turnover	4.2 times	4.0 times
Number of days of payables	28 days	36 days
Operating cycle	?	147 days

Cash conversion cycle	124 days	?

Relative to the industry, the company's operating cycle:

A. is shorter, but its cash conversion cycle is longer.
B. and cash conversion cycle are both longer.
C. is longer, but its cash conversion cycle is shorter.

Answer = B

Operating cycle = Number of days of inventory + Number of days of receivables.
Cash conversion cycle = Operating cycle – Number of days of payables.

	Company	**Industry**
Number of days receivables	365/5.6 = 65 days	365/6.5 = 56 days
Number of days inventory	365/4.2 = 87 days	365/4.0 = 91 days
Operating cycle	65 + 87 = 152 days Longer	147 days (given)
Cash conversion cycle	124 days (given) Longer	147 – 36 = 111

Therefore, both the operating and cash conversion cycles are longer for the company.

2014 CFA Level 1
"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Sections 4.2 – 4.3

"Working Capital Management," by Edgar A. Norton, Jr., Kenneth L. Parkinson, and Pamela Peterson Drake
Section 2.2

33. The following data apply to two comparable companies that are in direct competition.

	Company A	**Company B**
Times interest earned ratio	2.50	2.50
Return on equity (ROE)	10.13%	16.88%
Return on assets (ROA)	6.75%	11.25%
Asset turnover	1.50	2.50

Which of the following statements is *most* accurate?

A. Both companies have the same amount of interest expense.
B. Company A has a higher degree of financial leverage than Company B.

C. Company A has a lower net profit margin.

Answer = A

		Company A	Company B	Comparison
Net profit margin	$\frac{\text{ROA}}{\text{Asset turnover}}$	6.75 ÷ 1.50 = 4.50%	11.25 ÷ 2.50 = 4.50%	Same
Financial leverage	$\frac{\text{ROE}}{\text{ROA}}$	10.13 ÷ 6.75 = 1.50	16.88 ÷ 11.25 = 1.50	Same

In this instance, times interest earned can be found as the correct answer by process of eliminating the other choices as potential correct answers. Keep in mind, however, that even when companies have equal times interest earned ratios, it does not mean that the amount of interest expense is the same for both because the companies may not be of equal size.

2014 CFA Level I
"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Sections 4.2–4.3

"Measures of Leverage," by Pamela Peterson Drake, Raj Aggarwal, Cynthia Harrington, and Adam Kobor
Section 3.4

34. Which of the following situations is the *least likely* reason why the marginal cost of capital schedule for a company rises as additional funds are raised?

A. The company deviates from its target capital structure because of the economies of scale associated with flotation costs and market conditions.
B. The cost of additional funds from various sources rises as higher levels of financing are achieved.
C. The company seeks to issue less senior debt because it violates the debt incurrence test of an existing debt covenant.

Answer = B

The WACC does not necessarily increase as more funds are being raised. Higher amounts of funding would not change the WACC if everything were in proportion to the old target capital structure - it is the changes in relative proportions of sources of funding that could make a difference because of interest deductibility and financial risk.

2014 CFA Level I
"Cost of Capital," by Yves Courtois, Gene C. Lai, and Pamela Peterson Drake
Section 4.3

35. Which of the following statements describes the *most* appropriate treatment of cash flows in capital budgeting?

A. A project is evaluated using its incremental cash flows on an after-tax basis.
B. Interest costs are included in the project's cash flows to reflect financing costs.
C. Sunk costs and externalities should not be included in the cash flow estimates.

Answer = A

All of the incremental cash flows arising from a project should be analyzed on an after-tax basis.

2014 CFA Level I
"Capital Budgeting," by John D. Stowe and Jacques R. Gagné
Section 3

36. A company is deciding to repurchase 5 million shares of stock that has a current price of $49.50. Below is the forecasted information of shares available for purchase. Which of the following repurchase methods will *most likely* result in the average repurchased cost being $49.80?

Price	**Number of Shares Available for Purchase (in millions)**
$50.00	9.00
$49.90	5.00
$49.80	3.00
$49.70	1.00
$49.60	0.50
$49.50	0.50

A. Dutch auction
B. Open market repurchase
C. Fixed-price tender offer

Answer = A

A Dutch auction uncovers the minimum price at which the company can buy back the desired number of shares with the company paying that price to all qualifying bids. Here the qualifying bids are from $49.50 to $49.80 to satisfy the required 5 million share requirement. Under a Dutch auction, 5 million shares can be purchased for $49.80 because at that price point, sufficient volume is available in the shares.

The fixed-price tender offer cannot be completed at the $49.80 price because there is insufficient volume available at that price.

Using an open market share repurchase process, shares are bought at prices that vary between $49.50 and $49.80. The open market share repurchase will result in the average cost per share of $49.73.

Price	**Volume**	**Price × Volume**
$49.80	3,000,000	$149,400,000
$49.70	1,000,000	$49,700,000

$49.60	500,000	$24,800,000
$49.50	500,000	$24,750,000
Total Cost		$248,650,000
Average repurchased cost per share		$49.73

2014 CFA Level I
"Dividends and Share Repurchases: Basics," by George H. Troughton and Gregory Noronha
Section 4.1

37. The post-audit performed as part of the capital budgeting process is *least likely* to include the:

A. provision of future investment ideas.
B. indication of systematic errors.
C. rescheduling and prioritizing of projects.

Answer = C

Rescheduling and prioritizing projects is part of the planning stage of the capital budgeting process, not the post-audit. The post-audit's purpose is to explain any differences between the actual and predicted results of a capital budgeting project. This process can aid in indicating systematic errors, improve business operations, and provide concrete ideas for future investment opportunities.

2014 CFA Level I
"Capital Budgeting," by John D. Stowe and Jacques R. Gagné
Section 2

38. If a central bank reduces the money supply, this move will *most likely* lead to a:

A. rise in nominal interest rates and a decline in aggregate price level.
B. decline in nominal interest rates and a rise in aggregate price level.
C. rise in nominal interest rates and a rise in aggregate price level.

Answer = A

A reduction in the money supply (leftward shift) leads to an increase in nominal rates. Furthermore, on the basis of the quantity theory of money, a reduced money supply makes money more valuable (thus a higher interest rate), which reduces aggregate price levels.

2014 CFA Level I
"Monetary and Fiscal Policy," by Andrew Clare and Stephen Thomas
Sections 2.1.6

39. With respect to the relationship between output and costs in the short run, a decline in the marginal cost per unit *most likely* occurs at what level of production?

A. Low output
B. High output
C. Profit-maximizing output

Answer = A

Marginal cost per unit, in the short run, decreases at low levels of output as a result of economies from greater specialization. At higher levels of output, however, it eventually increases because of the law of diminishing returns.

2014 CFA Level I
"Demand and Supply Analysis: The Firm," by Gary L. Arbogast and Richard V. Eastin
Section 3.1.3

40. Assume that the nominal spot exchange rate (USD/EUR) increases by 7.5%, the eurozone price level decreases by 4%, and the U.S. price level increases by 2.5%. The change in the real exchange rate (%) is *closest* to:

A. 14.8%.
B. 0.7%.
C. –6.3%.

Answer = B

Real exchange rate = Nominal spot exchange rate × CPI of the foreign country / CPI of the domestic country
Change in the real exchange rate = [(1 + Change in exchange rate) × (1 + Change in price level in foreign country)] / (1 + Change in price level in domestic country) –1

$$= \left[(1+7.5\%) \times (1-4\%) \right] / (1+2.5\%) - 1 = 0.7\%$$

2014 CFA Level I
"Currency Exchange Rates," by William A. Barker, Paul D. McNelis, and Jerry Nickelsburg
Section 2

41. If a price cut of a product increases total revenue, demand is *best* described as:

A. inelastic.
B. unit elastic.
C. elastic.

Answer = C

A product's demand is elastic if demand increases by a greater percentage than the percentage price cut when prices are cut. For example, if a 1% price cut increases the quantity sold by more than 1%, total revenue increases and demand is said to be elastic.

2014 CFA Level I
"Demand and Supply Analysis: Introduction," by Richard V. Eastin and Gary L. Arbogast
Section 4.1

42. Assume that an economy is composed of two products, X and Y, with the following details:

Product	**Quantity Produced in 2012**	**Quantity Produced in 2013**	**Product Unit Prices in 2012**	**Product Unit Prices in 2013**
X	351.0	352.0	13.3	13.8
Y	179.0	182.5	unknown	11.1

Assuming 2012 is the base year for measuring GDP and the GDP deflator for the economy in 2013 is 102.4, the unit price of Y in 2012 is *closest* to:

A. 10.8.
B. 11.2.
C. 11.5.

Answer = B

Product	**Quantity Produced in 2012 (1)**	**Quantity Produced in 2013 (2)**	**Product Unit Prices in 2012 (3)**	**Product Unit Prices in 2013 (4)**	**= (2) × (4)**
X	351.0	352.0	13.3	13.8	4,857.6
Y	179.0	182.5		11.1	2,025.8
Nominal GDP in 2013 equals the sum of the last column:					6,883.4

$$\text{Real GDP}_{2013} = \text{Nominal GDP}_{2013} \times 100 / \text{GDP deflator} = 6883.4 \times 100 / 102.4 = 6722.1$$

$$\text{Real GDP}_{2013} = P^X{}_{2012} \times Q^X{}_{2013} + P^Y{}_{2012} \times Q^Y{}_{2013}$$

$$6722.1 = (13.3 \times 352.0) + P^Y{}_{2012} \times 182.5$$

$$6722.1 = 4681.6 + P^Y{}_{2012} \times 182.5$$

$$P^Y{}_{2012} = 11.2$$

2014 CFA Level I
"Aggregate Output, Prices, and Economic Growth," by Paul R. Kutasovic and Richard G. Fritz
Section 2.1.2

43. The unemployment rate is *best* described as the ratio of unemployed to:

A. labor force minus frictionally unemployed.
B. total population of people who are of working age.
C. labor force.

Answer = C

The unemployment rate is the ratio of unemployed to labor force.

2014 CFA Level I
"Understanding Business Cycles," by Michele Gambera, Milton Ezrati, and Bolong Cao
Section 4.1

44. During the last month, a food company located in the United States had the following transactions:

Transaction	**Amount (US$ millions)**
Bought raw material from Indonesia	50.0
Sold food products to France	65.0
Received royalty fees from its branch in the United Kingdom	0.5
Donated to a charitable institution in Africa	0.1
Borrowed from a bank in Singapore	2.0
Paid legal fees to its German legal consultant company	1.2
Received interest coupon from its investment in Eurobonds issued in Luxembourg	0.8

These transactions will *most likely* increase the U.S. current account by:

A. $17.0 million.
B. $15.0 million.
C. $14.5 million.

Answer = B

Note that the borrowing from a bank in Singapore is not a current account transaction.

Transaction	**Current Account (US$ millions)**
Bought raw material from Indonesia	–50.0
Sold food products to France	65
Received royalty fees from its branch in the United Kingdom	0.5
Donated to charitable institution in Africa	–0.1
Borrowed from a bank in Singapore	Omit
Paid legal fees to its German legal consultant company	–1.2

Received interest coupon from its investment in Eurobonds issued in Luxembourg	0.8
Total	**15**

2014 CFA Level I
"International Trade and Capital Flows," by Usha Nair-Reichert and Daniel Robert Witschi
Sections 4.2–4.3

45. A market structure characterized by homogeneous/standardized product differentiation is *best* described as:

A. monopolistic competition.
B. perfect competition and oligopoly.
C. monopoly.

Answer = B

Perfect competition and oligopoly are characterized by homogeneous/standardized product differentiation.

Market Structure	**Degree of Product Differentiation**
Perfect competition	Homogeneous/ standardized
Monopolistic competition	Differentiated
Oligopoly	Homogeneous/ standardized
Monopoly	Unique product

2014 CFA Level I
"The Firm and Market Structures," by Richard G. Fritz and Michele Gambera
Section 2.2

46. Assume the following consumption basket and prices over 2011 and 2012 (in U.S. dollars):

	2011		**2012**	
Item	**Price**	**Quantity**	**Price**	**Quantity**
Meat	$12/kg	30 kg	$12.2/kg	35 kg
Rice	$1/kg	55 kg	$1.1/kg	50 kg
Milk	$1.5/liter	65 liters	$1.6/liter	65 liters
Fuel	$1/liter	95 liters	$1.2/liter	85 liters

The Fisher Index is *closest* to:

A. 105.4.
B. 105.8.
C. 106.1.

Answer = B

Fisher Index = $(I_L \times I_P)^{0.5}$

	2011		**2012**		**Laspeyres Index I_L**		**Paasche Index I_P**	
Item	**Price**	**Quantity**	**Price**	**Quantity**	$P_{11} \times Q_{11}$	$P_{12} \times Q_{11}$	$P_{11} \times Q_{12}$	$P_{12} \times Q_{12}$
Meat	$12/kg	30 kg	$12.2/kg	35 kg	360	366	420	427
Rice	$1/kg	55 kg	$1.1/kg	50 kg	55	60.5	50	55
Milk	$1.5/liter	65 liters	$1.6/liter	65 liters	97.5	104	97.5	104
Fuel	$1/liter	95 liters	$1.2/liter	85 liters	95	114	85	102
				Total	607.5	644.5	652.5	688
				Index		106.1 = 644.5 ÷ 607.5		105.4 = 688 ÷ 652.5
Note: The “11” and “12” subscript refer to years 2011 and 2012 respectively								

Fisher Index = $(I_L \times I_P)^{0.5}$ = $(106.1 \times 105.4)^{0.5}$ = 105.8

2014 CFA Level I
“Understanding Business Cycles,” by Michele Gambera, Milton Ezrati, and Bolong Cao
Section 4.2.2

47. The *most likely* initial (short-run) effect of demand-pull inflation is an increase in:

A. employee wages.
B. finished good prices.
C. commodity prices.

Answer = C

The effect of demand-pull inflation is an increase in the aggregate demand, which, in turn, leads to an increase (initially) in commodity prices.

2014 CFA Level I
“Understanding Business Cycles,” by Michele Gambera, Milton Ezrati, and Bolong Cao
Sections 4.2.4–4.2.4.2

48. A research report produced by a dealer includes the following exchange rates:

	Spot Rate	Expected Spot Rate in One Year
USD/EUR	1.396	1.386
USD/CAD	1.011	1.030
EUR/GBP	1.285	1.279

The *most* accurate calculation of the expected appreciation (%) of the Canadian dollar (CAD) relative to the British pound (GBP) is:

A. 2.99%
B. 0.7%.
C. -2.04%

Answer = A

Spot Rate	Expected Spot Rate in One Year	Appreciation (Expected / Spot – 1)	
USD/EUR	1.396	1.386	–0.72%
USD/CAD	1.011	1.030	1.88%
EUR/GBP	1.285	1.279	–0.44%
CAD/GBP	=	(USD/EUR) × (EUR/GBP) / (USD/CAD)	
CAD/GBP	1.774	1.721	–2.99%

CAD/GBP = (USD/EUR) **×** (EUR/GBP)/(USD/CAD)

Spot rate of CAD/GBP = 1.396 **×** 1.285/1.011 = 1.774

Expected spot rate of CAD/GBP = 1.386 **×** 1.279/1.030 = 1.721

Previously it cost $1.774 to buy 1 GBP; it is expected to cost $1.721 to buy 1 GBP in 1 year so the Canadian dollar has appreciated by 2.99%

2014 CFA Level I
"Currency Exchange Rates," by William A. Barker, Paul D. McNelis, and Jerry Nickelsburg
Section 3.2

49. Which of the following is *least likely* to affect the growth of the economy?

A. The workforce attending an average of 20 hours of training per year
B. An increase in the labor force that is offset by a decrease in the average hours worked per worker, making the total hours worked unchanged
C. When capital depreciation exceeds gross investment within the economy

Answer = B

The total hours worked remained unchanged, and accordingly, the growth of the economy will not change.

2014 CFA Level I
"Aggregate Output, Prices, and Economic Growth," by Paul R. Kutasovic and Richard G. Fritz
Section 4.2

50. Assume economic activity is accelerating, inflation is increasing modestly, and unemployment is low. The economy is *most likely* in which phase of the business cycle?

A. Peak
B. Late expansion
C. Early expansion

Answer = B

The late expansion phase is characterized by acceleration of growth rate, decreasing of unemployment rate, and increasing of inflation rate.

2014 CFA Level I
“Understanding Business Cycles,” by Michele Gambera, Milton Ezrati, and Bolong Cao
Section 2.1

51. A power generation company is a monopoly that has very high barriers to entry. The quantity demand (Q_D) for its product is $Q_D = 800 - 0.25 \times P$ (where P is price). The slope of the marginal revenue curve is *closest* to:

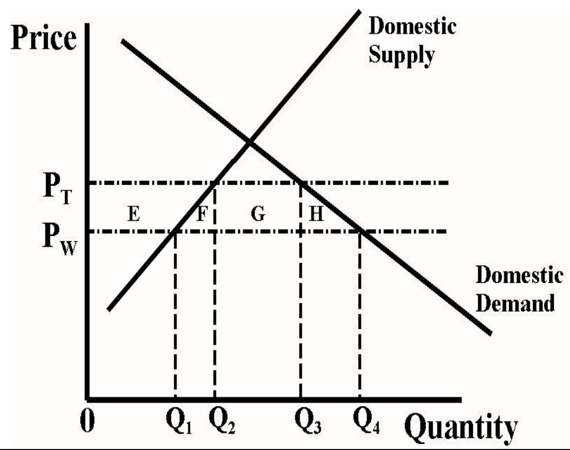
A. –8.00.
B. –0.25.
C. –4.00.

Answer = A

Solve for P from the quantity demanded:
Q = 800 - 0.25 P
P = 3200 - 4Q
TR = P × Q = 3200 Q - 4 Q^2
and Marginal Revenue = ΔTR/ΔQ = 3200 - 8 Q
Therefore the slope of the curve is -8.

2014 CFA Level I
"The Firm and Market Structures," by Richard G. Fritz and Michele Gambera
Section 6.3

52.

The diagram to the right shows the domestic demand and supply curves for a country which imports a commodity, where P_W is its world price and P_T is its domestic price after the imposition of a tariff. The reduction in the net national welfare of this country as a result of the tariff is *best* described by the area(s):	

A. E.
B. G.
C. F+H.

Answer = C

The loss in consumer surplus because of higher prices is represented by area E+F+G+H. This exceeds the gains from producer surplus (E) and government revenues on imports (G). Hence the net welfare effect to the country is a deadweight loss of [E+F+G+H] – [E] – [G] = **<u>F+H</u>**.

CFA Level 1
“Demand and Supply Analysis: Introduction,” Richard V. Eastin and Gary L. Arbogast, CFA
Sections 3.9, 3.10, 3.13

“International Trade and Capital Flows,” Usha Nair-Reichert, PhD, and Daniel Robert Witschi, PhD, CFA
Section 3.1

53. Which of the following is the *least likely* outcome when a monopolist adopts first-degree price discrimination because of customers' differing demand elasticities?

A. The monopolist shares the total surplus with consumers.
B. The price for a marginal unit decreases to less than the price for other units.
C. The output increases to the point at which price equals the marginal cost.

Answer = A

In a monopoly, perfect price discrimination results in the total surplus being kept by the producer, the monopolist.

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2014 CFA Level I
“The Firm and Market Structures,” by Richard G. Fritz and Michele Gambera
Section 6.4

54. Assume that the central bank reduces the reserve requirement. The *most likely* effect will be:

A. an increase in the money multiplier.
B. a decrease in the money supply.
C. a decrease in new deposits.

Answer = A

Reducing the reserve requirement will increase the money supply, money multiplier, and new deposits.

2014 CFA Level I
“Monetary and Fiscal Policy,” by Andrew Clare and Stephen Thomas
Section 2.1.2

55. A new technology that reduces employee illness will *most likely* decrease:

A. demand-pull inflation.
B. cost-push inflation.
C. cost-pull inflation.

Answer = B

By reducing employee illness, the new technology will increase the output per hour per worker, which will decrease the unit labor cost. As the unit labor cost decreases, cost-push inflation decreases. The technology does not affect demand and accordingly should not affect demand-pull inflation.

2014 CFA Level I
"Understanding Business Cycles," by Michele Gambera, Milton Ezrati, and Bolong Cao
Section 4.2.4

56. A company uses three types of labor—unskilled, semiskilled, and skilled—in the production of electronic components. The company's production plan allows for the substitution of one type of labor for another. The marginal product and compensation in U.S. dollars is as follows:

Type of Labor	**Marginal Product per Day**	**Compensation per Day (US$)**
Unskilled	200 units	105
Semiskilled	300 units	160
Skilled	500 units	270

Assuming that the compensation of the unskilled labor increases by 4%, what labor type should the company *most likely* hire when expanding output?

A. Semiskilled
B. Skilled
C. Unskilled

Answer = A

The company should maximize output per monetary unit of input cost. So, it should look for the labor type that has the highest ratio of marginal product to compensation cost ($MP_{input}/P_{input)}$) .

Type of Labor	**Marginal Product (MP) per Day**	**Compensatiom per Day**	**MP_{input}/P_{input}**
Unskilled	200 units	105 × 1.04 = 109.2	200/109.2 = 1.83
Semiskilled	300 units	160	300/160 = 1.88
Skilled	500 units	270	500/270 = 1.85

The company minimizes costs and enhances profitability by adding semiskilled labor rather than the other two types because it has the highest ratio of MP to input price.

2014 CFA Level I
"Demand and Supply Analysis: The Firm," by Gary L. Arbogast and Richard V. Eastin
Section 3.2.2

57. Assume the following:

An individual consumer's demand for tea	$Q^d_t = 1{,}800 - 40P_t + 0.5I + 150P_c$	
Seller's supply of tea	$Q^s_t = -516 + 350P_t - 120W$	
Legend and Initial Values		**Assumed Values**
Q^d_t	Quantity of tea	
P_t	Price of tea per 100 grams	
I	Household income	£2,400
W	Hourly wage rate for labor	
P_c	Price of coffee per 100 grams	£22.4
	Equilibrium price of tea	£30.6

If the household income increases by 2.5% while *Pc* and *W* do not change, the new equilibrium quantity will be *closest* to:

A. 5,163.
B. 5,166.
C. 5,136.

Answer = A

$Q^d_t = 1{,}800 - 40P_t + 0.5I + 150P_c$
$= 1{,}800 - 40 \times 30.6 + (0.5 \times 2400) + (150 \times 22.4) = 5{,}136 = Q^s_t$ (equilibrium)
$Q^s_t = -516 + 350P_t - 120W = 5{,}136$
Solve for $W = [5{,}136 + 516 - (350 \times 30.6)]/(-120) = 42.15$
I increased by 2.5%; $I = 2{,}400 \times 1.025 = 2{,}460$.
Set $Q^d_t = Q^s_t$ and solve for new P_t:
$P_t = [1{,}800 + (0.5 \times 2{,}460) + (150 \times 22.4) + 516 + (120 \times 42.15)]/390 = 30.68$
$Q^d = 1{,}800 - (40 \times 30.68) + (0.5 \times 2{,}460) + (150 \times 22.4) = 5{,}162.8$

2014 CFA Level I
"Demand and Supply Analysis: Introduction," by Richard V. Eastin and Gary L. Arbogast
Section 3.6

58. Three countries produce tables and chairs, and the output per worker per day in each country as follows:

Country	Tables	Chairs
A	60	80
B	40	60

Assume that Country C produces 10% more tables than Country B and 10% fewer chairs than Country A. Which country *most likely* has the greatest comparative advantage for producing tables? Country

A. A
B. C
C. B

Answer = A

A country has a comparative advantage if its opportunity cost for producing a product is less than the opportunity costs of its trading partners. Notice the cost of a table in units of chairs is lowest for Country A.

Country	Tables	Chairs	Comparative Advantage (Chairs/Tables)
A	60	80	1.33

B	40	60	1.50
C	40 × 1.1 = 44	80 × 0.9 = 72	1.64

2014 CFA Level I
"International Trade and Capital Flows," by Usha Nair-Reichert and Daniel Robert Witschi
Section 2.4.1

59. An expansionary fiscal policy is *least likely* to include an increase in:

A. budget deficit.
B. tax rates.
C. government expenditures.

Answer = B

An expansionary fiscal policy means that the government increases its purchases of goods and services and/or cuts tax rates to increase aggregate demand. Furthermore, an increase in the budget deficit would be associated with an expansionary fiscal policy.

2014 CFA Level I
“Monetary and Fiscal Policy,” by Andrew Clare and Stephen Thomas
Sections 3.1.1–3.1.2

60. Under conditions of perfect competition, in the long run companies will *most likely* earn:

A. positive accounting profit and negative economic profit.
B. zero accounting profit and positive economic profit.
C. normal profit and zero economic profit.

Answer = C

In highly competitive market situations, companies tend to earn the normal profit level over time because the ease of market entry allows for other competing companies to compete away any economic profit over the long run. When accounting profit equals normal profit, economic profit is zero.

2014 CFA Level I
"Demand and Supply Analysis: The Firm," by Gary L. Arbogastand Richard V. Eastin
Sections 2.1.1–2.1.2

61. If the prices of substitute resources decrease, the demand for a given resource will *most likely*:

A. increase.
B. decrease.
C. remain unchanged.

Answer = B

A decrease in the price of a substitute resource would encourage producers to use the substitute resource thus reducing demand for the resource in question.

2014 CFA Level I
“Demand and Supply Analysis: Introduction,” by Richard V. Eastin and Gary L. Arbogast
Section 4.1

62. During the process data phase of financial statement analysis, an analyst will *most likely* develop a:

A. statement of cash flows.
B. statement of purpose.
C. common-size balance sheet.

Answer = C

During the process data phase, an analyst will produce a variety of reports and documents based on the information collected. These may include common-size statements, ratios and graphs, forecasts, adjusted statements, and analytical results.

2014 CFA Level I
“Financial Statement Analysis: An Introduction,” by Elaine Henry and Thomas R. Robinson
Section 4

63. A company's balance sheet shows the following values (€):

Cash	12,000
Marketable securities	3,000
Accounts receivable	16,500
Inventory	8,745
Prepaid expenses	2,305
Current liabilities	32,580

The company’s cash ratio is *closest* to:

A. 0.46.
B. 0.97.
C. 0.37.

Answer = A

The cash ratio is

$$\frac{Cash + Marketable\ Securities}{Current\ Liabilities} = \frac{12{,}000 + 3{,}000}{32{,}580} = 0.460$$

2014 CFA Level I
"Understanding Balance Sheets," by Elaine Henry and Thomas R. Robinson
Section 7.2

"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Section 4.3.1

64. A company with a tax rate of 40% sold a capital asset with a net book value of $500,000 for $570,000 during the year. Which of the following amounts related to the asset sale will *most likely* be reported as a line item on its income statement for the year?

A. $570,000
B. $70,000
C. $42,000

Answer = B

The disposition of a capital asset is reported as a net gain or loss ($570,000 – $500,000 = $70,000) on the income statement before tax effects.

2014 CFA Level 1
"Understanding Income Statements," by Elaine Henry and Thomas R. Robinson
Section 5.3

"Understanding Cash Flow Statements," by Elaine Henry, Thomas R. Robinson, Jan Hendrik van Greuning and Michael A. Broihahn
Section 3.2.2

"Long-Lived Assets," by Elaine Henry and Elizabeth Gordon
Section 6.1

65. All else being equal and ignoring tax effects, compared with using the straight-line method of depreciation, the use of an accelerated method of depreciation in the early years of an asset's life would *most likely* result in a decrease in the firm's:

A. cash flow from operations.
B. asset turnover ratio.
C. shareholders' equity.

Answer = C

An accelerated method of deprecation produces greater expenses in the early years and lowers net income, which in turn lowers the retained earnings resulting in a decrease in shareholders' equity.

2014 CFA Level I
"Long-Lived Assets," by Elaine Henry and Elizabeth A. Gordon
Section 3.1

66. The following information is available about a company ($ millions):

Year ended 31 December	**2012**	**2011**
Sales	322.8	320.1
Net income	27.2	26.8
Cash flow from operations	15.3	38.1

During 2012, the company *most likely* experienced a significant decrease in:

A. the proportion of sales made on a cash basis.
B. inventory, anticipating lower demand for its products in 2013.
C. the proportion of interest-bearing debt relative to trade accounts payable.

Answer = A

Sales are nearly the same for the two years. A decrease in the proportion of cash sales implies an increase in the proportion of credit sales, which would increase accounts receivable and decrease cash flow from operations.

2014 CFA Level I
“Understanding Cash Flow Statements,” by Elaine Henry, Thomas R. Robinson, Jan Hendrik van Greuning, and Michael A. Broihahn
Sections 2.3.1, 3.2.5

67. According to International Financial Reporting Standards, which of the following is a condition that *must* be met for revenue recognition to occur?

A. Costs can be reliably measured.
B. Payment has been partially received.
C. Goods have been delivered to the customer.

Answer = A

The IFRS's conditions that must be met include that the costs incurred can be reliably measured, the seller knows what it expects to collect and is reasonably certain of collection, and the significant risks and rewards of ownership have been transferred, which is normally (but not always) when the goods have been delivered.

2014 CFA Level I
"Understanding Income Statements," by Elaine Henry and Thomas R. Robinson
Section 3.1

68. A company sells a product with a three-year warranty included in the price. According to IFRS, which of the following is the *most* appropriate accounting treatment for the warranty?

A. Fully recognizing the revenue and estimated warranty expense at the time of the sale and updating the expense as indicated by experience over the life of the warranty.
B. Fully recognizing the revenue at the time of the sale but waiting until the actual warranty costs are incurred to recognize the expense.
C. Deferring all of the revenue and recognizing it over the life of the warranty period.

Answer = A

Under the matching principle, a company is required to estimate the amount of future expenses resulting from its warranties, and to update the expense as indicated by experience over the life of the warranty. Waiting until actual costs are incurred will not match the expense with the associated revenue.

2014 CFA Level I
"Understanding Income Statements," by Elaine Henry and Thomas R. Robinson
Section 4.2.2

69. Which of the following is *least* consistent with the goals of accounting standards developed under the joint conceptual framework project of the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB)? Accounting standards should be:

A. developed independently.
B. internally consistent.
C. principles based.

Answer = A

Under the joint conceptual framework project of the IASB and the FASB, accounting standards should be principles based, internally consistent and converged. The goal of the joint framework is to move away from the independent development of accounting standards.

2014 CFA Level I
"Financial Reporting Standards," by Elaine Henry, Jan Hendrik van Greuning, and Thomas R. Robinson
Section 2

70. A company has reported annual revenue for the past five years as follows (£ millions):

2008	**2009**	**2010**	**2011**	**2012**

250,738	279,347	316,480	355,589	392,008

The company's compound annual growth rate in revenue is *closest* to:

A. 11.8%.
B. 9.4%.
C. 14.1%.

Answer = A

Compound growth rate can be calculated as

$$\left[\left(\frac{\text{Ending value}}{\text{Beginning value}}\right)^{1/\text{number of periods}}\right]-1=\left[\left(\frac{392{,}008}{250{,}738}\right)^{1/4}-1\right]=11.8\%$$

2014 CFA Level I
"The Time Value of Money," by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 7.1

"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Section 3

71. During a period of declining prices, a company using the last-in, first-out (LIFO) inventory method instead of first-in, first-out (FIFO) method will *most likely* report a lower value for:

A. gross profit.
B. cost of goods sold.
C. ending inventory.

Answer = B

If prices are declining, using LIFO would match the lower (most recent) costs with current sales. Cost of goods sold would be lower with LIFO and gross profit (income) would be higher compared with using FIFO. Lower cost of goods sold means inventory balances, consisting of older, higher-priced items, would be higher using LIFO, increasing current assets relative to FIFO.

2014 CFA Level I
"Inventories," by Michael A. Broihahn
Section 3.5

72. Under International Financial Reporting Standards (IFRS), the statement of comprehensive income should *most* appropriately begin with:

A. gross revenue.
B. the ending total comprehensive income from the prior year.
C. the profit or loss from the income statement.

Answer = C

Under IFRS, the statement of comprehensive income begins with the profit or loss from the income statement.

2014 CFA Level I
“Financial Statement Analysis: An Introduction,” by Elaine Henry and Thomas R. Robinson
Section 3.1.2.2

73. An analyst has assembled the following information with respect to a production facility:

	£ thousands
Carrying amount	132
Undiscounted expected future cash flows	120
Present value of expected future cash flows	100
Fair value if sold	105
Costs to sell	1

Under IFRS, the impairment loss on this production facility (in £ thousands) will be *closest* to:

A. 28.
B. 27.
C. 32.

Answer = A

Under IFRS, the carrying amount (£132 thousand) is compared with the higher of fair value minus costs to sell (£104 thousand = £105 - £1) and present value of expected future cash flows (£100 thousand). The higher of the two amounts, the recoverable amount, is £104 thousand; therefore, the asset is impaired and written down to that amount. The impairment loss is = £132 – £104 = £28 thousand.

2014 CFA Level I
"Long-Lived Assets," by Elaine Henry and Elizabeth A. Gordon
Section 5.1

74. The following information is available for a company ($):

December 31, 2011:		
	Total assets	100,000
	Net income for the year	4,000
	Dividends paid	0
	Assets are equally financed with debt and equity	
	50% of the equity comes from contributed capital	
December 31, 2012:		
	Total assets	92,000
	Net income (loss) for the year	(3,000)
	No new debt or equity issued or repurchased	

In 2012, the company *most likely*:

A. did not pay a dividend because it incurred a loss.
B. paid a dividend of $5,000.
C. paid a dividend of $1,000.

Answer = B

	2011 ($)	**2012 ($)**
Total assets (given)	100,000	92,000
Total debt (50% in 2011, no change in 2012)	50,000	50,000
Total equity (Total assets – Total debt)	50,000	42,000
Equity Components		
Contributed capital (50% of Equity in 2011, no change in 2012)	25,000	25,000
Retained earnings (solved for) (Total equity – Contributed capital)	25,000	17,000
Retained earnings = Opening RE + Net income – Dividends 2012 Retained earnings = 17,000 = 25,000 – 3,000 – Dividends **Dividends = 5,000**		

2014 CFA Level 1
"Financial Reporting Mechanics," by Thomas R. Robinson, Jan Hendrik van Greuning, Karen O'Connor Rubsam, Elaine Henry, and Michael A. Broihahn
Section 3.2

75. The following information is available about a company (in $ thousands).

Year	**Reported Earnings**	**Operating Cash Flow**	**Accounts Receivables**	**Ending Inventory**
2011	1,500	1,200	500	1,300
2012	1,800	1,300	1,400	1,600
2013	2,500	1,400	3,500	2,200

Which of the following would *least likely* be an accounting warning sign for this company? The relationship between reported earnings and:

A. ending inventory.
B. operating cash flow.
C. accounts receivables.

Answer = A

The relationship between reported earnings and inventory appears consistent over the three years and thus is not likely to be considered an accounting warning sign. Operating cash flow is increasing at a much slower growth rate than reported earnings and thus is likely an accounting warning sign. Accounts receivables are increasing much more rapidly than reported earnings, a potential sign of early revenue recognition.

2014 CFA Level I
"Financial Reporting Quality: Red Flags and Accounting Warning Signs," by Thomas R. Robinson and Paul Munter
Section 3

76. Company A owns 60% of Company B. Company A's consolidated income statement *most likely* includes 100% of Company A's revenues and expenses and what portion of Company B's?

A. 0%
B. 100%
C. 60%

Answer = B

Because Company A owns more than 50% of the shares in Company B it must present consolidated financial statements, which will include 100% of Company B's revenues and expenses.

2014 CFA Level I
“Understanding Income Statements,” by Elaine Henry and Thomas R. Robinson
Section 2

77. Which of the following events will *most likely* result in a decrease in a valuation allowance for a deferred tax asset under U.S. GAAP? A(n):

A. reduction in tax rates
B. extension in the tax loss carry-forward period
C. decrease in interest rates

Answer = B

Under U.S. GAAP, deferred tax assets must be assessed at each balance sheet date. If there is any doubt whether the deferral will be recovered, the carrying amount should be reduced to the expected recoverable amount. The asset is reduced by increasing the valuation allowance. Should circumstances change so that it is more probable that the deferred tax benefits will be recovered, the deferred asset account will be increased (and the valuation allowance decreased). An increase in the carry-forward period for tax losses extends the possibility that benefits will be realized from the deferred tax asset and would likely result in a decrease in the valuation allowance and an increase in the deferred tax asset.

2014 CFA Level I
"Income Taxes," by Elbie Antonites and Michael A. Broihahn
Sections 3.3, 6.1

78. Issuance of common stock is *most* accurately classified as a(n):

A. financing activity.
B. investing activity.
C. operating activity.

Answer = A

Financing activities are those activities related to obtaining or repaying capital. Examples include issuing common shares, taking out a bank loan, and issuing bonds.

2014 CFA Level I
“Financial Reporting Mechanics,” by Thomas R. Robinson, Jan Hendrik van Greuning, Karen O'Connor Rubsam, Elaine Henry, and Michael A. Broihahn
Section 2

79. In the statement of cash flows, interest paid by a company is *most likely* included in:

A. only the financing section under both IFRS and U.S. GAAP.
B. either the operating or financing section under U.S. GAAP.
C. either the operating or financing section under IFRS.

Answer = C

U.S. GAAP requires that interest paid be classified as an operating cash flow; IFRS allows interest paid to be classified as either an operating or financing activity.

2014 CFA Level I
"Understanding Cash Flow Statements," by Elaine Henry, Thomas R. Robinson, Jan Hendrik van Greuning, and Michael A. Broihahn
Sections 2.1, 2.2

80. According to the International Financial Reporting Standards framework, which of the following qualities of financial information is *least likely* cited as one of the two fundamental characteristics that make financial information useful?

A. Relevance
B. Faithful representation
C. Accrual accounting

Answer = C

The two fundamental characteristics that contribute to the usefulness of financial information in decision making are relevance and faithful representation. Accrual accounting is not a qualitative characteristic; it is an underlying assumption.

2014 CFA Level I
"Financial Reporting Standards," by Elaine Henry, Jan Hendrik van Greuning, and Thomas R. Robinson
Sections 5.2, 5.4.1

81. The following table shows changes to the number of common shares outstanding for a company during 2012:

1 January	180,000 shares outstanding
1 June	60,000 shares issued
1 August	2-for-1 stock split
31 December	480,000 shares outstanding

To calculate earnings per share for 2012, the company's weighted average number of shares outstanding is *closest* to:

A. 215,000.
B. 315,000.
C. 430,000.

Answer = C

The weighted average number of shares outstanding is time weighted:

1 January to 1 June	5/12 × 180,000	75,000
1 June to December 31	7/12 × (180,000 + 60,000)	140,000
Weighted average before considering stock split		215,000
Stock split is treated retroactively to the start of the year	215,000 × 2	430,000

2014 CFA Level I
“Understanding Income Statements,” by Elaine Henry and Thomas R. Robinson
Section 6.2

82. Under IFRS, the costs incurred in the issuance of bonds are *most likely*:

A. expensed when incurred.
B. included in the measurement of the bond liability.
C. deferred as an asset and amortized on a straight-line basis.

Answer = B

Under IFRS, debt issuance costs are included in the measurement of the bond liability.

2014 CFA Level I
"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 2.1

83. The following tables present excerpts from financial statements for two merchandising companies following the format found in each of their annual reports.

Company A (US$ millions)			**Company B (¥ millions)**	
Assets			**Assets**	
Noncurrent assets	9,640		Current assets	4,333
Current assets	2,096		Noncurrent assets	19,923
Total assets	11,736		Total assets	24,256

Which of the companies *most likely* prepares its financial statements in accordance with U.S. GAAP?

A. Both companies
B. Only Company A
C. Only Company B

Answer = C

Company A prepares its financial statements under IFRS whereas company B uses U.S. GAAP. IFRS does not specify the order of presentation of current and noncurrent assets. Under U.S. GAAP, current assets are presented before long-term assets and current liabilities before long-term ones.

2014 CFA Level 1
"Understanding Balance Sheets," by Elaine Henry and Thomas R. Robinson
Section 2.1

84. A company is buying back its common shares to offset the dilution of earnings from its stock option program. Which of the following statements *best* describes the effect on the financial statements of the amount spent to buy back the stocks? The amount spent reduces:

A. cash from operating activities.
B. net income.
C. cash from financing activities.

Answer = C

The amount spent to buy back stocks to offset dilution is classified as a financing activity on the cash flow statement, and therefore cash from financing decreases.

2014 CFA Level 1
"Understanding the Cash Flow Statement," by Elaine Henry, Thomas R. Robinson, Jan Hendrik van Greuning and Michael A. Broihahn
Section 2.1

"Accounting Shenanigans on the Cash Flow Statement," by Marc A. Siegel
Section 7

85. Which of the following ratios is *most likely* to be used as a measure of operating performance?

A. Cash ratio
B. Working capital turnover ratio
C. Defensive interval ratio

Answer = B

Activity ratios are typically used to measure operating performance. Working capital turnover is an example of an activity ratio, whereas the defensive interval ratio and cash ratio are liquidity ratios used to measure a company's ability to meet its short-term obligations.

2014 CFA Level I
“Financial Analysis Techniques,” by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Sections 4.2.1, 4.3.1

86. Which of the following is *most likely* a benefit of debt covenants for the borrower?

A. Restrictions on how the borrowed money may be invested
B. Reduction in the cost of borrowing
C. Limitations on the company's ability to pay dividends

Answer = B

The reduction in the cost of borrowing is a benefit of covenants to the borrower.

2014 CFA Level I
"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 2.5

87. The following information is available for a company that prepares its financial statements in accordance with U.S. GAAP:

- It has production facilities with a net book value of $28.4 million.
- Recently, several other companies have entered the market, and the company now estimates that it will be able to generate cash flows of only $3 million per year for the next seven years with its facilities.
- The firm has a cost of capital of 10%.

The impairment loss (in $ millions) on the production facilities will *most likely* be reported in the company's financial statements as a:

A. 7.4 reduction in the balance sheet carrying amount.
B. 13.8 reduction in operating cash flows.
C. 13.8 impairment loss on the income statement.

Answer = C

The company will report an impairment loss of $13.8 million on its income statement.Under U.S. GAAP the facilities fail the recoverability test–the net book value cannot be recovered from undiscounted cash flows: 7 years × $3 = $21 < $28.4. Therefore, the asset is impaired and should be written down to its fair value.

Fair Value: is the present value (PV) of future benefits: (*N*=7; *i*=10; PMT=3): PV = 14.6

Impairment Loss is Carrying value – Fair value: 28.4 – 14.6 = 13.8 to be reported on the income statement.

2014 CFA Level I
"Long-Lived Assets," by Elaine Henry and Elizabeth A. Gordon
Section 5.1

88. For a company issuing securities in the United States to meet its obligations under the Sarbanes–Oxley Act, which of the following is management required to attest to?

A. The adequacy of internal control over financial reporting
B. The accuracy of estimates and assumptions used in preparing the financial statements
C. The suitability of management and director compensation agreements

Answer = A

To be in compliance with Sarbanes–Oxley, it is mandatory that management's Report to Shareholders discuss internal financial controls and their effectiveness, as well as the company's auditor's opinion of these internal controls.

2014 CFA Level 1
"Financial Statement Analysis: An Introduction," by Elaine Henry and Thomas R. Robinson
Section 3.1.7

89. A company issued a $50,000 seven-year bond for $47,565. The bonds pay 9% per annum, and the yield to maturity at issue was 10%. The company uses the effective interest rate method to amortize any discounts or premiums on bonds. After the first year, the yield to maturity on bonds equivalent in risk and maturity to these bonds is 9%. The amount of the bond discount amortization recorded in the first year is *closest* to:

A. $0.
B. $348.
C. $257.

Answer = C

Interest paid = Coupon rate at issue × Issued amount of bonds = 9% × $50,000 = 4,500				
Interest expense = Market rate at issue × Carrying (book value) of bonds Amortization of discount = Interest expense – Interest paid				
	Interest	**Interest**	**Amortization**	**Carrying**
Year	**Paid (9%)**	**Expense (10%)**	**of Discount**	**Value**
0				47,565
1	4,500	4,757	257	47,822
Amortization of the bond discount in the first year is $257.				

2014 CFA Level I
"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 2.2

2014 CFA Level I
"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 2.2

90. A portion of a company's balance sheet appears in the following table (euros in millions):

Cash	4,000
Marketable securities	17,000
Accounts receivable	225,000
Inventory	229,000
Total current assets	475,000
Current liabilities	339,000

The company's quick ratio is *closest* to:

A. 1.40.
B. 0.06.
C. 0.73.

Answer = C

The quick ratio is

$$\frac{cash + marketable\ securities + accts\ receivable}{current\ liabilities} = \frac{4{,}000 + 17{,}000 + 225{,}000}{339{,}000} = 0.73.$$

2014 CFA Level I
"Understanding Balance Sheets," by Elaine Henry and Thomas R. Robinson
Section 7.2

91. A company's most recent balance sheet shows the following values (NZ$ thousands):

Accounts payable	3,800
Long-term debt	5,590
Other long-term liabilities	800
Common stock	1,200
Retained earnings	1,810

The company's debt-to-capital ratio is *closest* to:

A. 1.86.
B. 0.65.
C. 0.77.

Answer = B

The debt-to-capital ratio is

$$\frac{\textit{Total Debt}}{\textit{Total Debt} + \textit{Total Shareholders' Equity}} = \frac{5{,}590}{5{,}590 + 1{,}200 + 1{,}810} = 0.650,$$

where Total Debt includes only interest-bearing debt.

2014 CFA Level I
"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Sections 4.4.1

92. A firm reports sales of €50,000 for the year ended 31 December 2012. Its accounts receivable balances were €6,000 at 1 January 2012, and €7,500 at 31 December 2012. The company's cash collections from sales for 2012 is *closest* to:

A. €51,500.
B. €48,500.
C. €42,500.

Answer = B

Cash collections from sales equals beginning receivables plus sales less ending receivables:

$$€6{,}000 + €50{,}000 - €7{,}500 = €48{,}500.$$

2014 CFA Level I
"Understanding Cash Flow Statements," by Elaine Henry, Thomas R. Robinson, Jan Hendrik van

Greuning, and Michael A. Broihahn
Sections 3.1, 3.2.1.1

93. A retailer that prepares its financial statements in accordance with IFRS has 100 office chairs in its inventory with a suggested retail price of $240 each.
• It paid on average $200 each to a supplier for these chairs.

• Demand for office chairs has been low for quite a while and the retailer estimates it can sell those chairs for $180 each if it offers free shipping to its customers at an average cost of $10 per chair.

• The supplier has also lowered its price to $160 in response to the low demand.
The total carrying amount of these 100 office chairs on the retailer's balance sheet would be *closest* to:

A. $16,000.
B. $17,000.
C. $18,000.

Answer = B

IFRS measures inventory at the lower of cost and net realizable value.

Under IFRS, net realizable value (NRV) is defined as the estimated selling price less the estimated costs necessary to get the inventory ready for sale and make the sale:

Selling price	$180	
Costs to get ready to sell	<u>$10</u>	*(Free shipping is required to sell the chairs at $180.)*
NRV per chair	$170	
For 100 chairs	$17,000	

2014 CFA Level I
"Inventories," by Michael A. Broihahn
Section 4

94. An analyst's examination of the performance of a company is *least likely* to include an assessment of a company's:

A. assets relative to its liabilities.
B. profitability.
C. cash flow generating ability.

Answer = A

Assessment of performance includes analysis of profitability and cash flow generating ability. The relationship between assets and liabilities is used to assess a company's financial position, not its performance.

2014 CFA Level I
“Financial Statement Analysis: An Introduction,” by Elaine Henry and Thomas R. Robinson
Section 2

95. If a company that leases assets for its own use classifies its leases as finance leases instead of as operating leases, its financial statements in the first year would *most likely* report:

A. higher equity.
B. higher debt.
C. lower cash from operations.

Answer = B

Classifying leases as finance leases rather than operating leases for a lessee would increase the amount of total debt reported because the present value of the total lease payments is recognized as a liability.

2014 CFA Level 1
"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 3.2.1

96. A company issued bonds in 2012 that mature in 2022. The measurement basis that will *most likely* be used on the 2012 balance sheet for the bonds is:

A. historical cost.
B. amortized cost.
C. market value.

Answer = B

Bonds payable issued by a company are financial liabilities that are usually measured at amortized cost.

2014 CFA Level 1
"Understanding Balance Sheets," by Elaine Henry and Thomas R. Robinson
Section 5.1

"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 2.2

97. A company owns its own office building which it purchased in 2011 for $1,000,000. The real estate market has been volatile in the last few years. The company uses the revaluation model as allowed by IFRS and the following table shows the fair market values since 2011:

Year	**Year-End Fair Market Value ($ thousands)**
2011	1,000
2012	600

2013	800
2014	1,300

The impact (in $ thousands) on the income statement in 2014 will *most likely* be a gain of:

A. 500.
B. 200.
C. 300.

Answer = B

The revaluation model per IFRS allows the asset to be carried at fair value. If the revaluation decreases the value, as it does here from 2011 to 2012, then later increases the value to the extent that the losses are reversed, it is recognized in profit and loss, so from $800 to $1,000 = $200.

Any increase in excess of the reversal will be recorded directly in equity in a revaluation surplus account and not on the income statement: $1,300 – $1,000 = $300.

2014 CFA Level 1
"Long-Lived Assets," by Elaine Henry and Elizabeth A. Gordon
Section 4

98. Which of the following is *most likely* considered an example of high-quality financial reporting?

A. The selection of a depreciation method that results in lower earnings than would have arisen from using the economic depreciation
B. The selection of the longest reasonable depreciable life for an asset
C. Decreasing the percent of sales ratio used to estimate bad debt expenses when collection difficulties have increased

Answer = A

Choosing a depreciation method that depreciates the asset at a higher rate than the economic depreciation (and hence results in lower earnings) is considered to be a more conservative depreciation policy, and this choice implies higher earning quality.

2014 CFA Level 1
"Financial Reporting Quality: Red Flags and Accounting Warning Signs," by Thomas R. Robinson and Paul Munter
Section 2

99. A company pays its workers on the 1st and the 15th of each month. Employee wages earned from the 15th to the 30th of September are *best* described as a(n):

A. accrued expense.
B. prepaid expense.
C. unearned expense.

Answer = A

Wage expenses that have been incurred but not yet paid are an example of an accrued expense: a liability that has not yet resulted in a cash payment.

2014 CFA Level I
"Financial Reporting Mechanics," by Thomas R. Robinson, Jan Hendrik van Greuning, Karen O'Connor Rubsam, Elaine Henry, and Michael A. Broihahn
Section 5.1

100. Which of the following statements is *least* accurate?

A. The IASB is monitored by a board that includes the U.S. SEC.
B. IFRS Foundation trustees appoint members of the IASB.
C. IFRS Foundation trustees oversee the policy decisions of the FASB.

Answer = C

The Financial Accounting Foundation, not the IFRS, oversees FASB.

2014 CFA Level I
"Financial Reporting Standards," by Elaine Henry, Jan Hendrik van Greuning, and Thomas R. Robinson
Sections 3.1.1–3.1.2

101. According to U.S. GAAP, the payment of cash dividends during the year will *most likely* affect the cash flow from which type of activity?

A. Financing
B. Investing
C. Operating

Answer = A

For a company that prepares its financial statements under U.S. GAAP, cash dividends paid are reported as a cash outflow in the cash flow from financing activities section on the statement of cash flows.

2014 CFA Level I
"Understanding Cash Flow Statements," by Elaine Henry, Thomas R. Robinson, Jan Hendrik van Greuning, and Michael A. Broihahn
Sections 2.1, 2.2

102. A company purchased a €2,000 million long-term asset in 2012 when the corporate tax rate was 30%.

Asset's Year-End Value for	**2013**	**2012**

	(€ millions)	**(€ millions)**
Accounting purposes	1,800	1,900
Tax purposes	1,280	1,600

On 15 January 2013, the government lowered the corporate tax rate to 25% for 2013 and beyond. The deferred tax liability (€ millions) as of 31 December 2013, is *closest* to:

A. 130.
B. 156.
C. 231.

Answer = A

The deferred tax liability equals the difference between the value for accounting purposes and the value for tax purposes times the current tax rate in effect.

(€1,800 – €1,280) × 0.25 = €520 × 0.25 = €130 million

2014 CFA Level I
"Income Taxes," by Elbie Antonites and Michael A. Broihahn
Section 3.3

103. An analyst is making the necessary adjustments to convert operating leases to capital leases for comparison with other companies. The *most likely* effect of the adjustments will be that the:

A. current ratio will increase.
B. interest coverage ratio will not be affected.
C. debt-to-capital ratio will increase.

Answer = C

Converting an operating lease to a capital lease will increase the total debt by the present value of the lease payments. This change will increase both debt and the total capital, but because the debt/total capital must be less than 1, equal additions to the numerator and denominator increase the ratio.

2014 CFA Level 1
"Non-Current (Long-Term) Liabilities," by Elizabeth A. Gordon and Elaine Henry
Section 3.2.1

"Financial Statement Analysis: Applications," by Thomas R. Robinson, Jan Hendrik van Greuning, Elaine Henry and Michael A. Broihahn
Section 6.6

104. Consider the following information available for a company for last year:

ROE	4.74%

Net profit margin	2.6%
Revenue	$400,000
Average total assets	$300,000

The average shareholder's equity is *closest* to:

A. $123,418.
B. $164,557.
C. $219,409.

Answer = C

The DuPont equation is

$$\frac{\text{Net Income}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Average Total Assets}} \times \frac{\text{Average Total Assets}}{\text{Average Shareholders Equity}}.$$

$$4.75\ \% = 2.6\ \% \times \frac{\$400,000}{\$300,000} \times \frac{\$300,000}{\text{Average Shareholders Equity}}$$

Average shareholders' equity = $219,409

2014 CFA Level I
"Financial Analysis Techniques," by Elaine Henry, Thomas R. Robinson, and Jan Hendrik van Greuning
Section 4.6.2

105. Which of the following statements regarding inventory valuation is *most* accurate?

A. IFRS defines market value as net realizable value less a normal profit margin.
B. Both IFRS and U.S. GAAP allow the reversal of write-downs back to the original cost.
C. Both IFRS and U.S. GAAP allow agricultural inventories to be valued at net realizable value.

Answer = C

Both IFRS and U.S. GAAP allow agricultural to be valued at net realizable value.

2014 CFA Level I
"Inventories," by Michael A. Broihahn
Section 4

106. A company acquired a customer list for $300,000 and a trademark for $5,000,000. Management expects the customer list to be useful for three years, and it expects to use the trademark for the foreseeable future. The trademark must be renewed every 10 years with the Patent and Trademark office for a nominal amount; otherwise it expires. If the company uses straight-line depreciation for all its intangible assets, the annual amortization expense for these two assets will be *closest* to:

A. $0.
B. $100,000.
C. $600,000.

Answer = B

The trademark can be renewed at a minimal cost; therefore, it is considered to have an indefinite life, and amortization expense is not required.

Annual amortization expense on the customer list = $300,000 / 3 = $100,000.

2014 CFA Level 1
"Long-Lived Assets," by Elaine Henry and Elizabeth A. Gordon
Section 3.2

107. When a company issues common stock as part of the conversion of a convertible bond, the cash flow statement will *most likely*:

A. omit the transaction but disclose it in a separate note or supplementary statement.
B. include the transaction because it materially affects the company's financial position.
C. omit the transaction without disclosure.

Answer = A

Significant non-cash transactions, such as the exchange of non-monetary assets or issuance of stock as part of a stock dividend or conversion are not incorporated in the cash flow statement. They are required to be disclosed, however, in either a separate note or a supplementary schedule to the cash flow statement.

2014 CFA Level I
“Understanding Cash Flow Statements,” by Elaine Henry, Thomas R. Robinson, Jan Hendrik van Greuning, and Michael A. Broihahn
Section 2.1

108. A firm incurred the following costs related to production during the past year:

	$ millions
Fixed production overhead costs	3.0

Raw materials costs	6.0
Labor costs	4.0
Freight-in costs for raw materials	1.0
Warehousing costs for finished goods	2.0

The total capitalized inventory cost (in US$ millions) for the year is *closest* to:

A. 16.0.
B. 13.0.
C. 14.0.

Answer = C

Total Capitalized Inventory Cost	**$ millions**
Fixed production costs	3.0
Raw materials	6.0
Labor costs	4.0
Freight-in	1.0
Total capitalized inventory cost	14.0

2014 CFA Level I
"Inventories," by Michael A. Broihahn
Section 2

109. An entry made to record an accrual, such as bad debt expense, that is not yet reflected in the accounting system is *best* described as a(n):

A. adjusting entry.
B. trial balance entry.
C. ledger entry.

Answer = A

Adjusting entries are a type of journal entries typically made at the end of the accounting period to record such items as accruals that are not yet reflected in the accounting system.

2014 CFA Level I
“Financial Reporting Mechanics,” by Thomas R. Robinson, Jan Hendrik van Greuning, Karen O'Connor Rubsam, Elaine Henry, and Michael A. Broihahn
Section 5.1

110. A random variable with a finite number of equally likely outcomes is *best* described by a:

A. continuous uniform distribution.
B. discrete uniform distribution.
C. binomial distribution.

Answer = B

A random variable has a discrete uniform distribution when there are a finite number of equally likely specified outcomes.

2014 CFA Level I
“Common Probability Distributions,” by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 2.1

111. A bank offers an effective annual rate (EAR) of 12%. Assuming quarterly compounding, the stated annual interest rate is *closest* to:

A. 11.66%.
B. 12.55%.
C. 11.49%.

Answer = C

EAR=(1+ Periodic interest rate)^m-1

12.00% = (1+ Periodic interest rate)^4 - 1

$$\textit{Periodic interest rate} = \sqrt[4]{(12.00\% + 1)} - 1 = 2.873734\%$$

Stated annual interest rate = Periodic interest rate × *m* = 2.873734% × 4 = 11.49%.

2014 CFA Level I
“The Time Value of Money,” by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 3.2

112. The joint probability of events A and B is 32%, with the probability of event A being 60% and the probability of event B being 50%. On the basis of this information, the conditional probability of event A given that event B occurs is *closest to*:

A. 64.0%.

B. 53.3%.
C. 30.0%.

Answer = A

The conditional probability of A given that B has occurred is equal to the joint probability of A and B divided by the probability of B. In this case, $P(A|B) = \frac{P(AB)}{P(B)} (Equation\ 1) = \frac{32.0\%}{50.0\%} = 64.0\%$.

2014 CFA Level I
"Probability Concepts," by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 2

113. An analyst collects the following set of 10 returns from the past:

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Return (%)	2.2	6.2	8.9	9.3	10.5	11.7	12.3	14.1	15.3	18.4

The geometric mean return is *closest* to:

A. 10.89%.
B. 9.62%.
C. 10.80%.

Answer = C

The geometric mean return is calculated as the *T*th root of the product of *T* terms, where the terms are one plus the returns and *T* is the number of returns. After taking the *T*th root, subtract one:

$$R_G = \left[\prod_{t=1}^{T}(1 + R_t)\right]^{\frac{1}{T}} - 1\,(Equation 6),$$

where *RG* is the geometric mean return,

T is the number of returns, and

R_t is the return in year *t.*

$$R_G = \sqrt[10]{1.022 \times 1.062 \times 1.089 \times 1.093 \times 1.105 \times 1.117 \times 1.123 \times 1.141 \times 1.153 \times 1.184} - 1 = 10.80\%$$

2014 CFA Level I
"Statistical Concepts and Market Returns," by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 5.4

114. The relative strength index for a stock stands at 75. This reading is *best* described as an indication that the stock is

A. overbought.
B. oversold.
C. neutral.

Answer = A

The relative strength index (RSI) is a momentum oscillator and provides information on whether or not an asset is overbought or oversold. An RSI greater than 70 indicates that a stock is overbought; an RSI lower than 30 suggests that a stock is oversold.

2014 CFA Level I
"Technical Analysis," by Barry M. Sine and Robert A. Strong
Section 3.4.2.2

115. When considering two mutually exclusive capital budgeting projects with conflicting rankings, the *most* appropriate conclusion is to choose the project with the:

A. higher net present value (NPV).
B. shorter payback.
C. higher internal rate of return (IRR).

Answer = A

The project with the higher NPV should be undertaken because it measures the increase in wealth as a result of taking the project. For mutually exclusive projects, IRR may give incorrect decisions as a result of scale and/or cash flow timing effects. Payback is not an economically sound method for evaluation of capital projects.

2014 CFA Level I
"Discounted Cash Flow Applications," by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 2.3

"Capital Budgeting," by John D. Stowe and Jacques R. Gagné
Section 4

116. The null hypothesis is *most* appropriately rejected when the *p*-value is:

A. close to one.
B. close to zero.
C. negative.

Answer = B

The *p*-value is the smallest level of significance at which the null hypothesis can be rejected. The smaller the *p*-value, the stronger the evidence against the null hypothesis. *P*-values close to zero strongly suggest that the null hypothesis should be rejected.

2014 CFA Level I

“Hypothesis Testing,” by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 2

117. A mutual fund manager wants to create a fund based on a high-grade corporate bond index. She first distinguishes between utility bonds and industrial bonds; she then, for each segment, defines maturity intervals of less than 5 years, 5 to 10 years, and greater than 10 years. For each segment and maturity level, she classifies the bonds as callable or noncallable. She then randomly selects bonds from each of the subpopulations she has created. For the manager’s sample, which of the following *best* describes the sampling approach?

A. Systematic
B. Stratified random
C. Simple random

Answer = B

In stratified random sampling, one divides the population into subpopulations and randomly samples from within the subpopulations.

2014 CFA Level I
“Sampling and Estimation,” by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 2.2

118. The joint probability of returns, for securities A and B, are as follows:
Joint Probability Function of Security A and Security B Returns
(Entries Are Joint Probabilities)

	Return on Security B=30%	Return on Security B=20%
Return on Security A= 25%	0.60	0
Return on Security A= 20%	0	0.40

The covariance of the returns between Securities A and B is *closest* to:

A. 13.
B. 14.
C. 12.

Answer = C

First calculate the expected returns on Securities A and B with the following formula: $$E(X) = \sum_{i=1}^{n} P(X_i) X_i$$

Expected return on Security $A = 0.6 \times 25\% + 0.4 \times 20\% = 15\% + 8\% = 23\%$

Expected return on Security $B = 0.6 \times 30\% + 0.4 \times 20\% = 18\% + 8\% = 26\%$

Then calculate the covariance of returns between securities A and B with the following formula

$$Cov(R_A, R_B) = \sum_i \sum_j P(R_{Ai} R_{B,j})(R_{Ai} - ER_A)(R_{B,j} - ER_B)$$

where R_A and R_B are the returns on Security A and B, respectively,

P is the joint probability,

ER_A, ER_B are the Expected Returns of Security A and B, respectively, and

i and *j* refer to the line and column of the joint probability function table in the question.

$$Cov(R_A, R_B) = 0.6[(25 - 23)(30 - 26)] + 0.4[(20 - 23)(20 - 26)] = 0.6[2 \times 4] + 0.4[(-3)(-6)]$$
$$= 0.6 \times 8 + 0.4 \times 18 = 4.8 + 7.2 = 12$$

2014 CFA Level I
“Probability Concepts,” by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 3

119. An investor currently has a portfolio valued at $700,000. The investor’s objective is long-term growth, but she will need $30,000 by the end of the year to pay her son’s college tuition and another $10,000 by year-end for her annual vacation. The investor is considering three alternative portfolios:

Portfolio	**Expected Return**	**Standard Deviation of Returns**	**Safety-First Ratio**
1			0.2290
2			0.3300
3	14%	22%	

Using Roy’s safety-first criterion, which of the alternative portfolios *most likely* minimizes the probability that the investor’s portfolio will have a value lower than $700,000 at year-end?

A. Portfolio 2
B. Portfolio 3
C. Portfolio 1

Answer = B

The investor requires a minimum return of ($30,000 + $10,000)/$700,000, or 5.71%. Roy's safety-first model uses the excess portfolio's expected return over the minimum return and divides that excess by the standard deviation for that portfolio:

$$Safety - first\ ratio = \left[E(R_P) - R_L\right] / \sigma_P,$$

where $E(R_P)$ is the expected return of portfolio P,

R_L is the minimum return required by the investor, and

σ_P is the standard deviation of returns of portfolio P.

Portfolio	Safety-First Ratio
1	0.2290
2	0.3300
3	(14% – 5.71%)/22% = 0.3768

The portfolio with the highest safety-first ratio minimizes the probability that the investor's portfolio will have a value lower than $700,000 at year end. The highest safety-first ratio is associated with Portfolio 3: 0.3768.

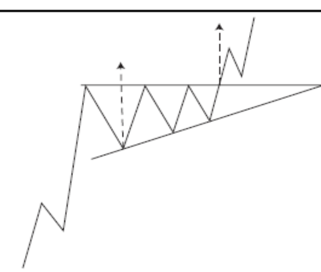
2014 CFA Level I
"Common Probability Distributions," by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle
Section 3.3

120. A trader determines that a stock price formed a pattern with a horizontal trendline that connects the high prices and a trendline with positive slope that connects the low prices. Given the pattern formed by the stock price, the trader will *most likely*:

A. purchase the stock because the pattern indicates a bullish signal.
B. avoid trading the stock because the pattern indicates a sideways trend.
C. sell the stock because the pattern indicates a bearish signal.

Answer = A

The pattern described is an ascending triangle, as shown in the diagram to the right. In an ascending triangle, the trendline connecting the high prices is horizontal and the trendline connecting the low prices forms an uptrend (it has positive slope). The fact that the rally continues beyond the triangle may be a bullish signal; it means that another set of investors is presumably willing to buy at an even higher price because their analysis suggests the intrinsic value of the security is higher. Alternatively, the fundamental facts themselves may have changed; that is, the security's fundamental value may be increasing over time.



2014 CFA Level I
"Technical Analysis," by Barry M. Sine and Robert A. Strong

Section 3.3.2.1