

## 2009 Sample Exam 3 Questions

### SS1-Ethics and Professional Standards

1. 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 provides for the distribution of new issues to newly established discretionary accounts after the one-month anniversary date. This policy is disclosed to all existing and potential clients. Did Newton violate any CFA Institute Standards of Professional Conduct?
  - A. No.
  - B. Yes, because the distribution policy fails to treat all discretionary accounts equally.
  - C. Yes, because disclosure of inequitable allocation methods does not fulfill the duty for fair and equitable trade allocation procedures.
  
2. When Jefferson Piedmont, CFA, joined Branch Investing, Branch began using a quantitative stock selection model that Piedmont had developed on his own personal time prior to his employment with Branch. One year later when Piedmont left the firm, he found the original copy of the model that he had developed in a file at his home and presented it to his new employer, who immediately began using the model. According to the Standards of Practice Handbook, did Piedmont violate any CFA Institute Standards of Professional Conduct?
  - A. No.
  - B. Yes, because he misappropriated property that now belonged to Branch.
  - C. Yes, because he failed to inform his new employer that the model was the same one used by his previous employer.
  
3. Lawrence Hall, CFA, and Nancy Bishop, CFA, began a joint research report on Stamper Corporation. Bishop spent several days visiting Stamper's corporate headquarters and meeting with all company officer. Prior to the completion of the report, Bishop was reassigned to another project. Hall utilized his and Bishop's research to write the report. According to the CFA Institute Standards of Practice Handbook, did Hall violate any CFA Institute Standards of Professional Conduct?
  - A. No.
  - B. Yes, with respect to Misrepresentation.
  - C. Yes, with respect to Diligence and Reasonable Basis.

4. According to the Global Investment Performance Standards (GIPS), which of the following is not a part of the verification process?
- A. Verification to be undertaken by the firm's compliance department.
  - B. To test whether the firm has complied with all the composite construction requirements.
  - C. To test whether the firm's processes and procedures are designed to calculate results in compliance with GIPS standards.
5. Umi Grabbo, CFA, is a highly regarded portfolio manager for Atlantic Advisors (AA), a mid-sized mutual fund firm investing in domestic securities. She has watched the hedge fund boom and on numerous occasions suggested her firm create such a fund. Senior management has refused to commit resources to the area. Frustrated by the inaction, and attracted by the higher fees associated with hedge funds, Grabbo and several other employees organize a hedge fund to invest in international securities during their nonwork hours. Grabbo is careful to work on the fund only on her own time. Because AA management thinks that hedge funds are a fad, she does not inform her supervisor about the hedge fund. According to the Standards of Practice Handbook, Grabbo least likely violated the Standard relating to:
- A. Disclosure of Conflicts.
  - B. Priority of Transactions.
  - C. Additional Compensation Arrangements.
6. David Donnigan enrolled to take the Level II CFA examination in the current year; however, he did not take the exam. Subsequently, he registered to take the Level II exam the next year. Donnigan advised his employer that he passed Level II. Which CFA Institute Standard of Professional Conduct did Donnigan most likely violate?
- A. Duties to employer.
  - B. Professional misconduct.
  - C. Referencing candidacy in the CFA program.
7. Jeffrey Jones passed the Level I CFA examination in 1997 and the Level II examination in 1999. 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 Level II.
  - B. Candidate in the CFA Institute CFA Program.
  - C. Passed Level II of the CFA examination in 1999.
8. Winnie Wong and William Leung are enrolled to take the Level I CFA examination.

Wong and Leung jointly purchased study materials from a well-known CFA review program. Wong made a photocopy of the copyrighted materials and gave the copied materials to Leung. Wong studied from the original materials. Who violated the CFA Institute Code of Ethics or any Standards of Professional Conduct?

- A. Both violated.
  - B. Only Wong violated.
  - C. Only Leung violated.
9. Nicholas Bennett, CFA, is a trader at a stock exchange. Another trader approached Bennett on the floor of the exchange and verbally harassed him about a poorly executed trade. Bennett pushed the trader and knocked him to the ground. Which of the following best describes Bennett's conduct? Bennett:
- A. Did not violate either the CFA Institute Code of Ethics or any Standards of Professional Conduct.
  - B. Violated the CFA Institute Code of Ethics and the Standard of Professional Conduct that relates to professional Misconduct.
  - C. Violated the CFA Institute Code of Ethics and the Standards of Professional Conduct that relate to professional Misconduct and Integrity of Capital Markets.

### SS2/3-Quantitative Methods

10. An analyst collects the following set of ten returns from the past: 2.2 percent, 6.2 percent, 8.9 percent, 9.3 percent, 10.5 percent, 11.7 percent, 12.3 percent, 14.1 percent, 15.3 percent, and 18.4 percent. What value is closest to the geometric mean return?
- A. 9.62%
  - B. 10.80%
  - C. 10.89%
11. An analyst gathers the following information (\$ millions) about the performance of a portfolio:

| Quarter | Value at Beginning of Quarter<br>(prior to inflow or outflow) | Cash Inflow (Outflow) At<br>Beginning of Quarter | Value at End of<br>Quarter |
|---------|---|--|----------------------------|
| 1       | 2.0   | 0.2  | 2.4                        |
| 2       | 2.4   | 0.4  | 2.6                        |
| 3       | 2.6   | (0.2)  | 3.2                        |
| 4       | 3.2   | 1.0  | 4.1                        |

The portfolio's annual time-weighted rate of return is closest to:

- A. 8%.
- B. 27%.
- C. 32%.

12. An investor currently has a portfolio valued at \$700,000. The investor's objective is long-term growth, but the investor 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 |
|-----------|-----------------|-------------------------------|
| 1         | 8%              | 10%                           |
| 2         | 10%             | 13%                           |
| 3         | 14%             | 22%                           |

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

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

13. 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 year, 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 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 sampling
- B. Simple random sampling
- C. Stratified random sampling

14. For an investment portfolio, the coefficient of variation of the returns on the portfolio is best described as measuring:

- A. Risk per unit of mean return.
- B. Mean return per unit of risk.
- C. Mean excess return per unit of risk.

15. An analyst conducts a significance test to determine if the relationship between two variables is real or the result of chance. His null hypothesis is that the population correlation coefficient is equal to zero and his alternative hypothesis is that the

population correlation coefficient is different from zero. He gathers the following information:

|   |        |
|---|--------|
| Value of the test statistic                   | 2.8092 |
| Critical value at the 0.05 significance level | 1.96   |
| Critical value at the 0.01 significance level | 2.58   |

The analyst conducted a:

- A. one-tailed test and can reject his null hypothesis.
- B. two-tailed test and can reject his null hypothesis.
- C. two-tailed test and cannot reject his null hypothesis.

16. The mean and standard deviation of the net incomes for all companies composing a stock index is \$3.5 million and \$4.2 million, respectively. If a random sample of 49 companies is taken from the index, the standard error of the sample mean is closest to:

- A. \$85,714.
- B. \$500,000.
- C. \$600,000.

#### SS4/5/6-Economics

17. According to the short-run Phillips curve, when inflation is less than expected, the most likely initial effects is that:

- A. Real wage rates will fall.
- B. Real interest rates will fall.
- C. Unemployment will rise above its natural rate.

18. Which of the following is the least likely outcome when a monopoly adopts perfect price discrimination because of the customers' differing demand elasticities?

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

19. For markets with perfectly elastic supply, the introduction of a tax will most likely result in:

- A. A price increase and the seller pays the entire tax.
- B. A price increase and the buyer pays the entire tax.

- C. No change in price and the seller pays the entire tax.
20. The view that the money wage rates as well as the prices of goods and services are sticky is most likely held by which of the following schools of thought?
- A. Keynesian
  - B. New classical
  - C. New Keynesian
21. Cost included in the determination of company's economic profit that are also most likely to be included in that company's accounting costs are:
- A. Explicit costs
  - B. Economic depreciation and foregone interest
  - C. Opportunity costs associated with labor provided by the company's owners
22. In a regulated industry, the introduction of a marginal cost pricing rule that maximizes total surplus is most likely to be viewed as:
- A. Efficient but leaves the natural monopoly incurring an economic loss.
  - B. Efficient and allows the natural monopoly to realize an economic gain.
  - C. Inefficient and leaves the natural monopoly incurring an economic loss.

#### **SS7/8/9/10-Financial Statement Analysis**

23. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

What is the effect on the accounting equation when a company's Board of Directors declares a cash dividend?

- A. Assets decrease and owners' equity decreases.
  - B. Liabilities increase and owners' equity decreases.
  - C. There is no effect on the accounting equation until the dividend is paid.
24. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

An analyst gathers the following information about Waynesboro, Inc.'s common stock:

- 1 January 2008                      180,000 shares outstanding
- 1 June 2008                         60,000 shares issued

- 1 August 2008                      2-for-1 stock split
- 31 December 2008                480,000 shares outstanding

To calculate earnings per share for 2008, Waynesboro's weighted average number of shares outstanding is closest to:

- A. 215,000.
- B. 420,000.
- C. 430,000.

25. According to International Financial Reporting Standards, which of the following is one of the conditions 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.

26. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

A company entered into a three-year construction project with a total contract price of \$5.3 million and an expected cost of \$4.4 million. The following table provides cash flow information relating to the contract:

|                                      | <u>Year 1</u> | <u>Year 2</u> | <u>Year 3</u> |
|--------------------------------------|---------------|---------------|---------------|
| Costs incurred and paid              | \$600,000     | \$3,000,000   | \$800,000     |
| Amounts billed and payments received | \$1,200,000   | \$2,800,000   | \$1,300,000   |

If the company uses the percentage-of-completion method, the amount of revenue recognized in Year 2 will be closest to:

- A. \$2,800,000
- B. \$3,372,727
- C. \$3,613,636

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

- A. Profitability
- B. Cash flow generating ability
- C. Assets relative to its liabilities

28. Under International Financial Reporting Standards (IFRS), the preparation of a

complete set of financial statements is best described as a(n):

- A. objective of financial reporting.
- B. general requirement of financial statements.
- C. qualitative characteristics of the IFRS Framework.

29. Under International Financial Reporting Standards a bank, or other financial institution, would normally use which type of balance sheet format?

- A. Classified
- B. Liquidity-based
- C. Market-value based

30. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

A company issued shares to acquire a large tract of undeveloped land for future development. The correct recording of this transaction in the cash flow statement is as a(n):

- A. Disclosure in a note or supplementary schedule.
- B. Outflow in investing activities, and an inflow in financing activities.
- C. Outflow in operating activities, and an inflow in financing activities.

31. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

Is the reporting of an extraordinary item, net of tax, allowed under U.S.GAAP and International Financial Reporting Standards (IFRS)?

- A. Yes, under both.
- B. Yes under IFRS. But not under U.S.GAAP
- C. Yes under U.S.GAAP, but not under IFRS

32. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

An analyst calculates the following ratios for a firm:

| Sales/Total Assets | Net Profit Margin (%) | Return on Total Assets (%) | Total Assets/Equity |
|--------------------|-----------------------|----------------------------|---------------------|
| 2.8                | 4                     | 11.2                       | 1.6                 |

The return on equity for this firm is closest to:



- A. 6.40%
- B. 15.20%
- C. 17.92%

33. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

A capital lease requires rental payments of \$2,000 annually. Fair value of the leased equipment at inception of the lease is \$10,000 and the implicit interest rate is 12 percent. If the present value of the lease equals the fair value of the equipment at inception of the lease, the interest expense recorded by the lessee in the second year of the lease is closest to:

- A. \$1,056.
- B. \$1,104.
- C. \$1,200.

34. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

Two companies are identical except for their accounting treatment of research and development costs. One company expenses all such costs immediately, while the other company capitalizes a portion of the costs. Compared to the company that capitalizes costs, the company that expenses immediately will most likely report a lower:

- A. Financial leverage.
- B. Total asset turnover
- C. Cash flow from operations

35. When preparing pro forma income statements, which one of the following items is least likely to be sales driven?

- A. Current assets
- B. Interest expense
- C. Administrative expenses

#### **SS11-Corporate Finance**

36. A publicly listed company has a 12-person Board of Directors whose composition is as follows:

- The chairman, who is the past president of the company and was named

Chairman upon his retirement four years ago,

- Five members of senior management, including the current president, and
- Six outside directors.

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 experience. The Remuneration Committee is composed of the Chairman and two outside directors. Which of the following actions would provide the greatest improvement in the corporate governance of this company?

- A. The chairman of the Board should be an independent director.
- B. All members of the Board of Directors should stand for election every year.
- C. The company's Vice-president of Finance should be a member of Audit Committee.

37. Given two mutually exclusive projects with normal cash flow, the points at which the net present value profiles intersect the horizontal axis are most likely to be the:

- A. Cross rate for the projects.
- B. Internal rates of return of the projects
- C. Net present values of the projects at the weighted average cost of capital (WACC)

38. A company is considering building a distribution center on undeveloped land it acquired more than ten years ago at a cost of \$400,000. The company estimates the cost of putting in utilities, sewers, roads, and other such costs of preparing the land for the distribution center at \$200,000. Alternatively, the undeveloped land could be sold today to another company for \$600,000. If the company builds the distribution center, the cost of the land for capital budgeting purposes is closest to:

- A. \$400,000
- B. \$600,000
- C. \$800,000

39. A company is determining the cost of debt to use in its weighted average cost of capital. It has recently issued a 10-year, 6 percent semiannual coupon bond for \$864. The bond has a maturity value of \$1000. If the marginal tax rate is 35 percent, the cost of debt they should use in their calculation is closest to?

- A. 2.6%
- B. 3.9%
- C. 5.2%

40. Most of the differences among companies with respect to quality of earnings are addressed when companies are compared using:

- A. Price to earnings ratios.
- B. Price to cash flow ratios.
- C. Both price to cash flow and price to earnings ratios.

41. A continuous market most likely exists for a stock when:

- A. An overnight buildup of buy and sell orders for the stock occurs.
- B. New information about the company is continuously released to market participants.
- C. Numerous dealers are willing to make a market in the stock at any time that the market is open.

42. Capital market efficiency is desirable, but there are limitations in achieving full market efficiency. Which of the following is least likely to be a limitation in achieving full capital market efficiency?

- A. Survivorship bias
- B. Limits of arbitrage
- C. Cost of information.

43. For the common stock of a firm that reported a small loss for the year just ended, the price multiple that is least likely to be meaningful is:

- A. price to cash flow.
- B. trailing price to earnings.
- C. leading price to earnings.

44. An analyst gathers the following information about a company:

|   |       |
|---|-------|
| Return on equity  | 20%   |
| Earnings retention rate   | 50%   |
| Current dividend per share ( $D_0$ ) paid on the company's common stock | €2.00 |
| Required rate of return on the company's common stock                   | 15.0% |
| Current stock price   | €50   |
| Company's P/E ratio   | 30x   |
| Industry average P/E ratio  | 20x   |
| Stock's beta  | 0.7   |

Using the dividend discount model and the other data given, the company's stock is best

described as a :

- A. Growth stock
- B. Cyclical stock
- C. Speculative stock

45. An investor opens a margin account with an initial deposit of \$5,000. He then purchases 300 shares of a stock at \$30. His margin account has a maintenance margin requirement of 30 percent. Ignoring commissions and interest, the price at which the investor receives a margin call is closest to:

- A. \$19.05.
- B. \$23.08.
- C. \$23.81.

#### **SS17-Derivative Investments**

46. When the underlying stock price is \$95, an investor pays \$2 for a call option with an exercise price of \$95. If the stock price moves to \$96, the intrinsic value of the call option would be:

- A. -\$1
- B. \$0
- C. \$1

47. Margin in the futures market is most accurately described as a:

- A. Loan to the futures trader.
- B. Requirement set by federal regulators.
- C. Down payment from the futures trader.

48. A derivative is most accurately defined as a financial instrument that provides:

- A. an adjustment to another asset's level of risk.
- B. a return based on the return of an underlying asset.
- C. an agreement between two parties to provide something for each other.

#### **SS18-Alternative Investments**

49. Which real estate valuation approach is most likely to use slope coefficients derived from a statistical analysis to estimate the value of a property?

- A. Cost approach.

- B. Sales comparison approach.
- C. Discounted after-tax cash now approach.

50. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.

An investor has gathered the following data, presented on an annual basis, for an apartment complex that is being considered for purchase:

|                                |           |
|--------------------------------|-----------|
| Gross potential rental income  | \$180,000 |
| Insurance and taxes            | \$15,000  |
| Utilities                      | \$10,000  |
| Repairs and maintenance        | \$18,000  |
| Depreciation                   | \$21,000  |
| Interest on proposed financing | \$16,000  |

The annual net operating income (NOI) for the apartment complex is closest to:

- A. \$116,000.
- B. \$121,000.
- C. \$137,000.

51. Which classification of hedge funds is least likely to use a short position in stock as a part of its strategy?

- A. Market-neutral funds.
- B. Emerging-market funds.
- C. Distressed securities funds.

#### **SS15/16-Fixed Income Investments**

52. A foundation's fixed income portfolio is composed of three bonds whose market values, coupon rates, and durations are given in the following table:

|              | <u>Bond 1</u> | <u>Bond 2</u> | <u>Bond 3</u> |
|--------------|---------------|---------------|---------------|
| Market value | \$500,000     | \$1,200,00    | \$300,000     |
| Coupon rate  | 11.0%         | 6.0%          | 9.0%          |
| Duration     | 6.2           | 8.1           | 2.9           |

The portfolio duration is closest to:

- A. 5.50
- B. 5.73

C. 6.85

53. Jasper Corporation sold its receivables to another corporation, JTL, created by Jasper for that purpose. If JTL sells securities backed by the receivables, the credit rating associated with those securities will most likely be based on the:

- A. Creditworthiness of JTL.
- B. Creditworthiness of Jasper.
- C. Collateral and credit enhancement mechanisms used.

54. A bond has a modified duration of 6.5 and convexity of -42.4. If interest rates decrease by 1.0 percent, the percentage change in the value of the bond will be closest to:

- A. -6.92%.
- B. -0.42%.
- C. +6.08%.

55. An investor is considering the purchase of two bonds. One of the bonds is tax-exempt and yields 4.5 percent while the other bond is taxable and yields 6.0 percent. If the two bonds are alike in all other characteristics, the marginal tax rate that would make the investor indifferent between the two bonds is closest to:

- A. 25.0%.
- B. 33.0%.
- C. 75.0%.

56. An investor is evaluating a diverse set of bonds from which he will select two issues. The investor's objective is to find bonds with cash flows that will precisely match a known stream of future cash outflows. The pair of bonds most likely to meet the investor's objective is a:

- A. puttable bond and a callable bond.
- B. zero-coupon bond and a Treasury strip.
- C. mortgage-backed security and an asset-backed security.

57. An analyst has gathered the following information:

| Year | 3-Year Treasury Rate | Treasury Spot Rate |
|------|----------------------|--------------------|
| 1    | 3.75%                | 3.00%              |
| 2    | 3.75%                | 3.50%              |
| 3    | 3.75%                | 4.00%              |

Based on the arbitrage-free valuation approach, a \$1,000 face value bond that pays a 5 percent annual coupon and matures in 3 years has a current market value closest to:

- A. \$1,027.75.
- B. \$1,028.67
- C. \$1,034.85

**SS12-Portfolio Management**

58. Which of the following statements about portfolio risk and diversification is least accurate?
- A. Unsystematic risk can be substantially reduced by diversification.
  - B. Systematic risk can be eliminated by holding securities in a well-diversified international stock portfolio.
  - C. Diversification results from combining securities that have less than perfect positive correlation between their returns to reduce portfolio risk.
59. Which of the following statements is most likely accurate? The asset allocation decision explains:
- A. more than 100% of the level of return for a fund.
  - B. about 90% of the variation in returns across funds.
  - C. an average of 40% of the variation in returns of a fund across time.
60. If the Capital Asset Pricing Model (CAPM) assumption that there are no transactions costs is relaxed and transactions costs are permitted, all else equal, the most likely result is that the security market line (SML) will:
- A. plot on a flatter line.
  - B. plot on a steeper line.
  - C. no longer plot on a single line.