

2011 Level 1 Sample Exam Volume 2

SS1-Ethics and Professional Standards

1. Which of the following least likely reflects the two primary principles of the CFA Institute Rules of Procedure for Professional Conduct?
 - A. Confidentiality of proceedings
 - B. Fair process to the member and candidate
 - C. Public disclosure of disciplinary sanctions

2. Fundamental Asset Managers (FAM) claims compliance with the CFA Institute Global Investment Performance Standards (GIPS®) and manages both discretionary and nondiscretionary accounts. Juma Dzuya, CFA, includes all discretionary, fee-paying value and growth accounts when constructing a composite for FAM. Does the composite Dzuya constructed most likely meet GIPS criteria?
 - A. Yes.
 - B. No, because value and growth accounts are included,
 - C. No, because nondiscretionary accounts are not included.

3. Adira Badawi, CFA, who owns a research and consulting company, is an independent board member of a leading cement manufacturer in a small local market. Based on Badawi's expertise in the cement industry, a foreign cement manufacturer looking to enter the local market has hired him to undertake a feasibility study. Under what circumstances can Badawi most likely undertake the assignment without violating the CFA Code of Ethics and Standards of Professional Conduct?
 - A. If he makes full disclosure to both companies,
 - B. If he receives written permission from the local company.
 - C. If he signs confidentiality agreements with both companies,

4. Noor Mawar, CFA, manages a trust fund for an orphaned 18-year-old student. The trust assets are expected to provide the beneficiary with a stable, low-risk source of income until she reaches 30. the student asks Mawar to invest in a new business venture expected to provide a handsome income return over the next 10 to 25 years as was discussed on an Internet blog. Mawar ignores the request, instead securing conservative investments to provide sufficient income. Did Mawar most likely violate the CFA Code of Ethics and Standards of Professional Conduct?
 - A. Yes
 - B. No, because the client's objectives were met.
 - C. No, because the student's age allows for a high-risk profile,

5. Vishal Chandarana, an unemployed research analyst, recently registered for the CFA Level I exam. After two months of intense interviewing, he accepts a job with a stock brokerage company in a different region of the country. While posting on his social networking webpage he brags about how being a CFA Candidate really helped him get a job. He adds he was so relieved his new employer didn't ask about his being fired from his former employer. Which CFA Code of Ethics or Standards of Professional Conduct did Chandarana least likely violate?
- A. Integrity
 - B. Duties to Employers
 - C. Reference to the CFA Program
6. Kam Bergeron, CFA, is an equity portfolio manager who often takes time off in the afternoon to play golf with important clients. Today, Bergeron is on the golf course when his game is interrupted by a phone call from his office. The call is from Bergeron's assistant, who notifies him of a steep and accelerating market decline. Bergeron, eager to get back to his clients tells his assistant to raise cash by selling 15 percent of all clients' holdings. Bergeron instructs his assistant to first sell the most liquid stocks in each client's portfolio and then do the same for his personal account. Bergeron is least likely to be in violation of which CFA Institute Standards of Professional Conduct?
- A. Suitability
 - B. Priority of transactions
 - C. Diligence and reasonable basis
7. Ileana Inkster, CFA, was recently offered a senior management position with the trust department of a regional bank. The department is now but the bank has plans to expand it significantly over the next few months; Inkster has been told she needs to aid that growth and has been asked to have her department conduct educational seminars and then pursue new business by follow-up contacts with the attendees. Inkster notices that advertisements for upcoming seminars, prepared by the marketing department, do not mention any investment products. The ads indicate attendees can "learn how to immediately and \$100,000 to their net worth." What is the first action Inkster most likely should take to avoid violating any CFA Institute Standard s of Professional Conduct?
- A. Decline to accept the new position,
 - B. Accept the position and revise the marketing material.
 - C. Accept the position but bring the lack of procedures to the attention of senior management.
8. Molly Burnett, CFA, is a portfolio manager that specializes in investing in environmentally friendly companies. A multinational utility company recently acquired

one of Burnett's best performing investments, a wind power company. The wind power company's shareholders received utility company shares as part of the merger agreement. The utility has one of the worst environmental records in the industry, but its shares have been one of the top performers over the past 12 months. Because the utility pays a high dividend every three months, Burnett holds the utility shares until the remaining two dividends are paid for the year, and then sells the shares. Burnett most likely violated the CFA Institute Standards of Professional Conduct concerning:

- A. suitability
 - B. disclosure of conflicts.
 - C. Independence and objectivity.
9. Pia Nilsson is a sole proprietor investment advisor. The economic recession has reduced the number of clients that she advises and her revenues. As a result, Nilsson has not paid her CFA Institute membership dues for the past two years. When a national financial publication interviewed Nilsson recently, she indicated that she had been a CFA charterholder for many years. In addition, she stated that the completion of the CFA program contributed to her successful career, enhanced her portfolio management skill, and enabled her to achieve superior returns and performance results. Nilsson's actions concerning which of the following most likely violated the CFA Institute standards of Professional Conduct?
- A. Discussion of the CFA Program
 - B. Nonpayment of CFA Institute Membership dues
 - C. Statement about being a CFA charterholder

SS2/3-Quantitative Methods

10. An analyst has established the following prior probabilities regarding a company's next quarter's earnings per share (EPS) exceeding, equaling, or being below the consensus estimate.

	Prior probabilities
EPS exceed consensus	25%
EPS equal consensus	55%
EPS are less than consensus	20%

Several days before releasing its earnings statement, the company announces a cut in its dividend. Given this information, the analyst revises his opinion regarding the likelihood that the company will have EPS below the consensus estimate. He estimates the likelihoods the company will cut the dividend given that EPS exceed/meet/fall below consensus as reported below.

	Probabilities the company cuts dividends conditional on EPS exceeding/equaling/falling below consensus
P(Cut div EPS exceed)	5%
P(Cut div EPS equal)	10%
P(Cut div EPS below)	85%

Based on this analysis, the updated (posterior) probability that the company's EPS are below the consensus is closest to:

- A. 72%
- B. 85%
- C. 100%

11. If the distribution of the population from which the samples are drawn is positively skewed, the sampling distribution of the sample means for samples drawn from that population is most likely:

- A. approximately normally distributed,
- B. to have a variance equal to the entire population
- C. to have a mean smaller than the mean of the entire population

12. A project offers the following incremental after-tax cash flows:

Year	0	1	2	3	4
Cash flow (€)	-12,500	2,000	4,000	5,000	2,000

The appropriate discount rate to use in evaluating the project is 8 percent. The NPV (in €) of the project is closest to:

- A. -1,780
- B. -1,736
- C. 474

13. Over a four-year period, a portfolio has returns of 10 percent, -2 percent, 18 percent, and -12 percent. The geometric mean return across the period is closest to:

- A. 2.9%
- B. 3.5%
- C. 8.1%

14. Monte Carlo simulation is best described as:

- A. an approach to back testing data.
 - B. Providing exact analytic solutions to complex functions.
 - C. Providing a distribution of possible solutions to complex functions.
15. A subset of a population is best described as a:
- A. sample.
 - B. statistic
 - C. parameter.
16. Assume that the real risk-free rate of return is 3 percent and that the expected inflation premium is 5 percent. If the risk premium incorporates default risk, liquidity risk, and any maturity premium, and observed (nominal) interest rate of 12 percent implies that the risk premium is closest to:
- A. 2%
 - B. 4%
 - C. 8%

SS4/5/6-Economics

17. Which of the following government interventions in market forces is most likely to cause underproduction?
- A. Subsidies
 - B. Price floors
 - C. Production quotas
18. Demand for a good is most likely to be more elastic when:
- A. the good is a necessity.
 - B. a lesser proportion of income is spent on the good.
 - C. there has been a longer time since the price change
19. If the currency drain ratio is 1.05 and the desired reserve ratio is 0.20, the money multiplier is closest to:
- A. 1.26
 - B. 1.64
 - C. 5.25
20. An economy in which all firms and individuals, whether suppliers or consumers, accept the market price as their transaction price is best described as:

- A. an oligopoly.
 - B. perfectly competitive
 - C. monopolistic competition
21. Suppose that at a tax rate of 85 percent, a nation's growth rate in GDP is 2 percent and its tax revenue is the equivalent of \$100 billion. If the nation reduces its rate to 50 percent, growth rate of GDP becomes 6 percent, and tax revenue increase to \$120 billion. Such a possibility is best described as an example that is consistent with the:
- A. tax wedge.
 - B. Laffer curve
 - C. Phillips curve
22. In the United States, monetary policy is primarily a function of the:
- A. Congress.
 - B. President.
 - C. Federal Reserve System

SS7/8/9/10-Financial Statement Analysis

23. Which of the following is least likely to appear in a company's proxy statement?
- A. Compensation arrangements for management and directors
 - B. Significant events and contingencies that may affect future operations
 - C. Potential conflicts of interest between management, directors, and shareholders.
24. At the start of the year, a company's capital contributed by owners and retained earnings accounts had balances of \$10,000 and \$6,000, respectively. During the year, the following events took place:

Net income earned	\$4,000
Interest paid on debt	\$500
Repayment of long-term debt	\$1,000
Proceeds from shares issued	\$1,000
Dividends paid	\$600

The end-of-year owners' equity is closest to:

- A. \$19,400
 - B. \$19,900
 - C. \$20,400
25. A retailer provides credit cards only to its most valued customers who pass a rigorous

credit check. A credit card customer ordered an item from the retailer in May. The item was shipped and delivered in July. The item appeared on the customer's July credit card statement and was paid in full by the due date in August. The most appropriate month in which the retailer should recognize the revenue is :

- A. May
- B. July
- C. August

26. Which of the following will most likely result in an increase in a company's sustainable growth rate?

- A. Higher tax burden ratio
- B. Lower interest burden ratio
- C. Higher dividend payout ratio

27. During 2009, the following events occurred at a company. The company:

1.	purchased a customer list for \$100,000, which is expected to provide equal annual benefits for the next 4 years.
2.	recorded \$200,000 of goodwill in the acquisition of a competitor. It is estimated that the acquisition would provide substantial benefits for the company for at least the next 10 years.
3.	Repeatedly received favorable mention in the media for its response to a local natural disaster, in which it donated \$300,000 in products and services to the community. The CEO of the company was heard to say that the publicity enhanced the firm's reputation substantially and would likely be worth at least \$100,000 annually over the next 5 years.

Based on these events, the amortization expense that the company should report in 2010 is *closest* to:

- A. \$25,000
- B. \$45,000
- C. \$125,000

28. The following items are from a company's Cash Flow Statement.

Classification of cash flow	Item	Amount (£-000s)
Operating activities	Cash received from customers	55,000
Investing activities	Interest and dividends received	10,000
Financing activities	Net repayment of revolving credit loan	12,000

Which of the following standards and formats did the company most likely use in the preparation of its financial statements?

- A. IFRS, direct format
- B. IFRS, indirect format
- C. Either IFRS or U.S. GAAP, direct format

29. The following information is available about a manufacturing company:

	\$ million
Cost of ending inventory computed using FIFO	4.3
Net realizable value	4.1
Current replacement cost	3.8

Compared to U.S. GAAP, the company's gross profit (\$ millions) computed under International Financial Reporting Standards (IFRS) is most likely:

- A. the same
- B. 0.3 lower
- C. 0.3 higher

30. For which type of long-lived asset is it most appropriate to test for impairment at least annually/

- A. Property, plant, and equipment
- B. Intangible assets with a finite life
- C. Intangible assets with indefinite lives.

31. On 1 January 2010 the market rate of interest on a company's bonds is 5 percent and it issues a bond with the following characteristics:

Face value	€50 million
Coupon rate, paid annually	4%
Maturity date	December 31, 2019 (10 years)
Issue price	92.28

If the company uses IFRS, its interest expense (in millions) in 2010 is closest to:

- A. €1.846
- B. €2.307
- C. €2.500

32. An analyst is assessing a company's quality of earnings by looking at the cash flow earnings index (operating cash flow divided by net income). Potential problems would most likely be indicated if the ratio were consistently:
- A. equal to 1.0.
 - B. less than 1.0.
 - C. greater than 1.0.
33. As a result of a change in strategy to selling differentiated products at premium prices, a company's gross margin ratio increased by 5 percentage points (i.e., from 35 percent to 40 percent). The most likely effect on the company's operating margin ratio as a result of the changes in strategy would be an increase;
- A. equal to 5%
 - B. less than 5%
 - C. greater than 5%
34. A retail company that leases the majority of its space has total assets of \$4,500 million and total long-term debt of \$2,125 million bearing an average interest rate of 10 percent. Note 8 to the 2010 financial statements contains the following information about the company's leases:

Note 8: Operating leases	
Year	Millions
2011	\$140
2012	140
2013	140
2014	140
2015	140
2016 and thereafter	<u>1,260</u>
Total	\$1,960

After adjustment for the off-balance sheet financing, the debt-to-total-assets ratio for the company is closest to:

- A. 58%
 - B. 62%
 - C. 72%
35. Matrix pricing is a process in which a bond's yield-to-maturity is determined from bonds currently available in the market that have similar attributes as the bond being considered.

Matrix pricing is most similar to the:

- A. debt-rating approach only.
- B. yield-to-maturity approach only
- C. yield-to-maturity approach and the debt-rating approach.

SS11-Corporate Finance

36. A company has an equity beta of 1.4 and is 60 percent funded with debt. Assuming a tax rate of 35 percent, the company's asset beta is closest to:

- A. 0.71
- B. 0.98
- C. 1.01

37. A company's taxable income is 17.1 percent of sales. Assuming taxes of 42 percent and dividend payout of 50 percent, the net profit margin is closest to:

- A. 5.0%
- B. 7.2%
- C. 9.9%

38. A project has the following annual cash flows:

Year 0	Year 1	Year 2	Year 3	Year 4
-\$75,000	\$21,600	\$23,328	\$37,791	\$40,815

With a discount rate of 8 percent, the discounted payback period (in years) is closest to:

- A. 2.8.
- B. 3.2.
- C. 4.0.

39. Review the following income statement:

	\$ million
Revenues	10.2
Variable Operating Costs	4.6
Fixed Operating Costs	2.0
Operating Income	3.6
Interest	1.2
Taxable Income	2.4
Tax	1.0
Net Income	1.4

The firm's degree of financial leverage is closest to:

- A. 1.5.
- B. 1.7.
- C. 2.6.

SS13/14-Securities Markets and Equity Investments

40. The index weighting that results in portfolio weights shifting away from securities that have increased in relative value toward securities that have fallen in relative value whenever the portfolio is rebalanced is most accurately described as:
- A. equal weighting
 - B. fundamental weighting
 - C. float-adjusted market-capitalization weighting.
41. According to the industry life-cycle model, an industry in the shakeout stage is best characterized as experiencing:
- A. increasing demand but falling prices.
 - B. slowing growth and intense competition
 - C. little or no growth and industry consolidation.
42. An investor gathers the following data. To estimate the stock's justified forward P/E, the investor prefers to use:
- the earnings growth rate rather than the dividends growth rate and
 - the average of the payout ratios over the relevant period, in this case 2006-2009, rather than the most recent payout ratio.

Year	EPS	DPS	ROE
2009	\$3.20	\$1.92	12%
2008	\$3.60	\$1.80	17%
2007	\$2.44	\$1.71	13%
2006	\$2.50	\$1.60	15%

The yield on 10-year T-notes is 3 percent and the current equity risk premium is 6.5 percent. If the stock's justified forward P/E is closest to:

- A. 12.
 - B. 16.
 - C. 21.
43. An investor evaluating a company's common stock for investment has gathered the following data.

Current year's earnings per share	\$2.50
Dividend payout ratio	60%
Dividend growth rate expected during Year 1 and 2	25%
Dividend growth rate expected after Year 2	5%
Investors' required rate of return	12%

The value per share of this common stock is closest to:

- A. \$28.57
- B. \$31.57
- C. \$38.70

44. According to behavioral finance, observed overreaction in securities markets most likely occurs due to:

- A. loss aversion
- B. gambler's fallacy.
- C. disposition effect.

45. Companies pursuing cost leadership will most likely:

- A. invest in productivity-improving capital equipment.
- B. Engage in defensive pricing when the competitive environment is one of high rivalry.
- C. Establish strong market research teams to match customer needs with product development.

SS17-Derivative

46. Epsilon Inc., a U.S.-based company, is obligated to deliver 1,000,000,000 yen to its Japanese component supplier in 3 months. Epsilon approaches a dealer and enters into a USD/JPY currency forward contract with physical delivery to manage the foreign exchange risk associated with the cash flow. Which of these best describes the currency forward contract?

- A. the dealer will deliver yen on expiration.
- B. Epsilon has the right but not the obligation to deliver USD.
- C. The amount of USD exchanged for yen is determined on expiration.

47. Which of the following options makes the following statement most accurate? The greater of either zero or the present value of the exercise price minus the underlying price is the lower bound on the price of a(n):

- A. European put
- B. American put
- C. American call

48. An investor executes a protective put strategy on ABC stock. At the time of execution, the price of ABC is \$71. A \$66 strike put option on ABC with a 2-month expiration is trading at \$1.45. the protective put strategy breaks even when the price of ABC is closest to:

- A. \$67.45
- B. \$69.55
- C. \$72.45

SS18-Alternative Investments

49. An analyst is evaluating an investment in an apartment complex based on the following annual data:

Gross rental income	\$2,100,000
Estimated vacancy and collection expenses	3%
Operating expenses	\$1,600,00
Depreciation	300,00
Current mortgage rate	5%
Financing percentage	80%
Capitalization rate	12%
Cost of equity	15%

Based on the income approach, the value of the investment is closest to:

- A. \$1,141,667
- B. \$3,641,667
- C. \$6,242,857

50. A project that requires an initial investment of €5 million is expected to pay €22 million at the end of 5 years if it is successful. The probabilities of failure for the project are provided below:

Year	1	2	3	4	5
Failure probability	0.2	0.2	0.1	0.1	0.1
	5	0	5	5	5

Assuming the cost of capital for the project is 16 percent, the project's expected net present value is closest to:

- A. -€3,157,000.
- B. -€1,140,000
- C. €2,017,000

51. Which of the following statements is most likely correct with respect to valuing a privately held company?

- A. The cost approach values company assets using historical book value.
- B. To estimate a control premium, the base is an estimate of that company's value of equity not reflecting control.
- C. Share prices should reflect a liquidity premium compensating investors for illiquidity in the market for the shares.

SS15/16-Fixed Income Investments

52. The table below provides a history of a fixed-income security's coupon rate and the risk-free rate over a five-year period.

Year	Risk-Free Rate	Coupon Rate
1	3.00%	6.00%
2	3.50%	5.00%
3	4.25%	3.50%
4	3.70%	4.60%
5	3.25%	5.50%

The security is most likely a (n):

- A. step-up note.
- B. inverse floater.
- C. deferred coupon bond.

53. For a 10-year floating-rate security, if market interest rates change by 1 percent, the change in the value of the security will most likely be:

- A. zero
- B. related to the security's coupon reset frequency.
- C. Similar to an otherwise identical fixed-rate security.

54. When a bank creates a collateralized loan obligation (CLO) by securitizing a portfolio of commercial loans that it holds, the process is best described as a(n):

- A. arbitrage transaction
- B. balance sheet transaction
- C. capital infusion transaction.

55. What is closest to the value of a 10-year, 6 percent coupon, \$100 par value bond with semiannual payments assuming an annual discount rate of 7 percent?
- A. \$92.89
B. \$99.07
C. \$107.44
56. Consider a \$100 par value bond with a 7 percent coupon paid annually and 5 years to maturity. At a discount rate of 6.0 percent, the value of the bond is \$104.21. One year later, the appropriate discount rate has risen to 6.5 percent and the bond's value is \$101.71. What part of this change in value is most likely attributable to the passage of time?
- A. \$0.37
B. \$0.74
C. \$1.76
57. A fixed-income security's current price is 101.45. You estimate that the price will rise to 103.28 if interest rates decrease 0.25 percent and will fall to 100.81 if interest rates increase 0.25 percent. The security's effective duration is closest to:
- A. 1.22
B. 4.87
C. 9.74

SS12-Portfolio Management

58. An investor's transactions in a mutual fund and the fund's returns over a four-year period are provided in the table below:

	Year			
	1	2	3	4
New investment at the beginning of the year	\$2,500.00	\$1,500.00	\$1,000.00	\$500.00
Investment return for the year	-20%	65%	-25%	10%
Withdrawal by investor at the end of the year	\$0.00	-\$500.00	-\$500.00	-\$500.00

Based on these data, the money-weighted return (or internal rate of return) for the investor is closest to:

- A. 2.15%
B. 3.96%
C. 7.50%

59. Risk that can be attributed to factor(s) that impact a company or industry is best described as:

- A. market risk
- B. systematic risk
- C. unsystematic risk

60. Which of the following factors is least likely to impact an individual's ability to take risk?

- A. Time horizon
- B. Personality type
- C. Expected income