

## 2006 Level 1 Sample Exam Volume 2

### SS1-Ethics and Professional Standards

1 According to the Standards of Practice Handbook, for a member who is an investment manager, which of the following statements about the member's use of client brokerage commission is least accurate? Client brokerage commission:

- A may be directed to pay for the member's operating expenses.
- B should be used by the member to ensure that fairness to the client is maintained.
- C should be commensurate with the value of the brokerage and research services received.
- D may be used by the member to pay for securities research used in managing the client's portfolio.

2 According to the standards of Practice Handbook, which of the following is least likely to threaten a member's independence and objectivity?

- A Beneficial ownership of a penny stock.
- B Receipt of a set of golf clubs from a client.
- C Receipt of a dozen tickets to the Olympics opening ceremonies from a broker-dealer.
- D Receipt of substantial financial support for a convention or seminar from a corporate donor.

3 When a CFA Institute member has limited number of shares of an initial public offering to distribute, the member would be least likely to violate CFA Institute Standards of Professional Conduct by:

- A allocating the shares pro rata to all subscribers for whom the issue is appropriate.
- B first filling the orders of individual clients, then filling the orders of institutional clients.
- C first filling the orders of clients who have generated the most commissions during the past year.
- D first filling the orders of those who have been clients of the member for the longest period of time.

4 Beth Knoll, CFA, is the portfolio manager for Techwood Industries pension fund, which has a substantial holding of Techwood common stock. Knoll also owns Techwood stock in her personal account. The chief financial officer at Techwood confides in Knoll that Techwood's earnings in the current quarter will be substantially below the consensus forecast of security analysts. According to the Standards of Practice Handbook, Knoll must:

- A sell the pension fund stock and hold her personal stock.
- B hold the pension fund stock and sell her personal stock.
- C sell both the pension fund stock and her personal stock.
- D hold both the pension fund stock and her personal stock.

5 The corporate finance department of an investment-banking firm decides to compete for the business of ETV Corporation. Knowing that the firm's brokerage department has a "sell"

recommendation on ETV common stock, the director of the corporate finance department writes a letter to the director of the brokerage department, who is a CFA Institute member, asking that the recommendation be changed to "buy." According to the Standards of Practice Handbook, the best action for the director of the brokerage department to take is to:

- A assign a new analyst to decide if the stock should receive a "buy" recommendation
- B have the director of the corporate finance department review the recommendation for the stock rating to ensure its accuracy.
- C change the recommendation to "buy" only after receiving written direction from the director of the corporate finance department.
- D remove ETV Corporation from the research universe and put it on a restricted list giving only factual information about the company.

6 DAVE Bauman, CFA, is a portfolio manager who wants to buy Arrow Company common stock for his clients' accounts and his personal account. According to the Standards of Practice Handbook, which of the following statements is most accurate? Bauman:

- A must buy the stock for his clients' accounts before buying for his personal account.
- B must wait 30 days after buying the stock for clients before buying for his personal account.
- C may buy for his personal account at any time as long as he discloses the trades to his employer and clients.
- D may buy for his personal account at any time as long as the execution price is not more favorable than the execution price realized by clients.

7 Louis Stark, CFA, is employed in the merger and acquisitions department of an investment firm. His friend, Elizabeth Mackie, CFA, is a portfolio manager in the investment management department of the same firm. Stark is helping a client acquire Gamma Corporation. According to the Standards of Practice Handbook, which of the following is the most appropriate action to take involving communication between the two departments?

- A Stark may tell Mackie about the pending merger if Mackie promises not to release the information to the public.
- B The investment firm should establish a Fire Wall between the merger and acquisitions department and the investment management department.
- C The investment firm must add Gamma corporation to its list of stocks that cannot be added to portfolios managed by employees of the investment firm.
- D Stark may tell Mackie about the pending merger if Mackie promises in advance not to use this information to help make an investment decision about Gamma corporation.

8 With respect to CFA Institute code of Ethics and Standards of Professional Conduct, CFA Institute members with supervisory responsibility are:

- A. not expected to prevent violations of laws, rules, and regulations by non-CFA Institute member employees.

- B. expected to establish and implement written compliance procedures about applicable statutes, regulations, and provisions of the Code and Standards.
- C. in compliance with the code and Standards after warning an offending employee to stop violating the applicable statutes, regulations, and provisions of the Code and Standards.
- D. expected, regardless of how many employees they supervise, to evaluate personally on a continuing basis the conduct of their employees concerning applicable statutes, regulations, and provisions of the code and Standard.

9 According to the Global Investment Performance Standards (GIPS), are disclosures related to total firm assets and treatment of withholding taxes, respectively, mandatory or recommended disclosures?

	Disclosures related to total firm assets	Disclosures related to treatment of withholding taxes
A	Mandatory	Mandatory
B	Mandatory	Recommended
C	Recommended	Mandatory
D	Recommended	Recommended

### SS2/3-Quantitative Methods

10 The probability that two or more events will happen concurrently is best characterized as:

- A joint probability
- B multiple probability
- C concurrent probability
- D conditional probability

11 An analyst has developed a ratio to identify companies expected to experience declining earnings per share (EPS). Research shows that 70 percent of firms experiencing a decline in EPS have a negative ratio, while only 20 percent of firms not experiencing a decline in EPS have a negative ratio. The analyst expects that 10 percent of all publicly traded companies will experience a decline in EPS next year. The analyst randomly selects a company and its ratio is negative. Based on Bayes' theorem, the posterior probability that the company will experience a decline in EPS next year is closest to:

- A 14%
- B 28%
- C 30%
- D 50%

12 A normal distribution would least likely be described as:

- A asymptotic

- B a discrete probability distribution
- C a symmetrical or bell-shaped distribution
- D a curve that theoretically extends from negative infinity to positive infinity

13 An investment strategy has an expected return of 12 percent and a standard deviation of expected returns of 10 percent. If investment returns are normally distributed, the probability of earning a return less than 2 percent is closest to:

- A 10%
- B 16%
- C 32%
- D 34%

14 Based on a normal distribution with a mean of 500 and a standard deviation of 150, the z-value for an observation of 200 is closest to:

- A -2.00
- B -1.75
- C 1.75
- D 2.00

15 If the standard deviation of a population is 100 and a sample size taken from that population is 64, the standard error of the sample mean is closest to:

- A 0.08
- B 1.56
- C 6.40
- D 12.50

#### **SS4/5/6-Economics**

18 A downward shift in a company's average total cost curve is least likely to result from;

- A. a decrease in taxes
- B. a decrease in historical costs
- C. a decrease in resource prices
- D. the use of improved technology

20 A profit-seeking company is most likely to continue production in the short run if the product price at least exceeds;

- A. total cost per unit of output
- B. fixed cost per unit of output

- C. average cost per unit of output
- D. variable cost per unit of output

22 The most likely objective of government regulation of a natural monopoly is to;

- A. expand output so consumer demand is fully met
- B. provide incentives for potential competitors to enter the market
- C. reduce the product price to the supplier's marginal cost per unit of output
- D. reduce the product price to the supplier's average total cost per unit of output

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

23 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted.. An analyst gathered the following financial information for a company

2004 earnings before interest and taxes	\$22 million
2004 interest coverage	5.0
Annual coupon rate on all debt outstanding in 2004	12%
Amount of debt maturing on 31 December 2004	\$20 million
Annual coupon rate on new debt issued at par 1 January 2005	9%

The company estimates that dollar sales and margins will remain constant in 2005. All debt outstanding during 2004 was issued at par and no debt retirement are scheduled in 2005. Debt covenants require minimum interest coverage of 4.0. The maximum amount of new debt the company could have issued on 1 January 2005 without decreasing the 2005 interest coverage below 4.0 is closest to:

- A \$12.2 million
- B \$32.0 million
- C \$35.0 million
- D \$39.0 million

24 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. On 1 January, a company entered into a capital lease resulting in an obligation of \$10,000 being recorded on the balance sheet. The lessor's implicit interest rate was 12 percent. At the end of the first year of the lease, the cash flow from financing activities section of the lessee's statement of cash flows showed a use of cash of \$1,300 applicable to the lease. The amount the company paid the lessor in the first year of the lease was closest to;

- A \$1,200
- B \$1,300
- C \$2,500
- D \$10,000

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

If a company recognizes revenue earlier than is justified under accrual accounting, which of the following best describes the impact on:

	Accounts receivable?	Inventory?
A	Overstated	Overstated
B	Overstated	Understated
C	Understated	Overstated
D	Understated	Understated

26 An analyst gathered the following information about a company for a fiscal year;

Quarter	Purchases in Units	Cost per that	Purchases in Dollars
1	200	\$22	\$4,400
2	300	\$24	\$7,200
3	300	\$26	\$7,800
4	200	\$28	\$5,600
Total	1,000		\$25,000

- Sales for the fiscal year were 800 units.
- Inventory remaining at the end of the fourth quarter was 600 units.
- Inventory at the beginning of the first quarter was 400 units at \$20 per unit/

Reported inventory at the end of the fourth quarter using LIFO and FIFO, respectively, would be closest to:

	Reported inventory using LIFO	Reported inventory using FIFO
A	\$12,400	\$14,200
B	\$12,400	\$15,800
C	\$14,200	\$15,800
D	\$15,800	\$14,200

28 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. Which of the following expenditures to build a new plant is least likely to be capitalized as property, plant, and equipment?

- A Interest costs during construction
- B Freight expenses incurred shipping new machinery to the plant.
- C Increases in the fair value of the plant assets during construction
- D Personnel expenses incurred to install the new machinery before the plant begins operations.

29 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. A company uses LIFO inventory valuation and has a 40 percent marginal tax rate. The company reports an increase in the LIFO reserve of \$5,000 for the year. If the company had used FIFO instead of LIFO, the amount reported for;

- A net income would be \$3,000 higher
- B net income would be \$5,000 higher

- C cost of goods sold would be \$3,000 higher  
 D cost of goods sold would be \$5,000 higher

31 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. A company is planning to lease new equipment for use in its manufacturing facility. Which of the following combinations of effective tax rate and restrictive bond covenants would most likely cause the company to favor an operating lease structure?

	Effective tax rate	Restrictive bond covenants
A	20%	No
B	20%	Yes
C	40%	No
D	40%	Yes

32 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. On 31 December 2002, a company issued a \$20,000, 90-day note at 8 percent to pay for inventory purchased that day and issued \$130,000 of long-term debt at 11 percent annually to pay for new equipment purchased that day. Using the indirect method, which of the following most accurately reflects the combined effect of both transactions on the company's statement of cash flows for the year ended 31 December 2002's Cash flow from;

- A operations increases \$20,000  
 B financing increases \$130,000  
 C operations decreases \$20,000  
 D financing decreases \$130,000

33 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. Compared to firms that expense costs, firms that capitalize those same costs are most likely to have debt-to-assets ratios and cash flow from operations, respectively, that are;

	Debt-to assets ratios	Cash flow from operations
A	Lower	Lower
B	Lower	Higher
C	Higher	Lower
D	Higher	Higher

34 Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. An analyst is least likely to adjust a company's reported operating income for the effects of a decline in LIFO reserves if the decline in the LIFO reserve is the result of;

- A price declines  
 B strikes by union workers  
 C a decline in the number of units held in inventory  
 D industry-wide conditions leading to restructurings and/or write-downs for other companies

**SS11-Corporate Finance**

35 To measure the change in shareholder wealth associated with an investment project, the most appropriate evaluation method for an analyst to use is:

- A payback
- B net present value
- C internal rate of return
- D modified internal rate of return

36 An analyst gathered the following information about a manufacturing company

Expected cash dividends (per share) one year from today	\$6.00
Expected growth rate	7%
Common stock (current market price per share)	\$72.00
Company tax rate	34%

The company's post-tax cost of retained earnings is closest to:

- A 10.12%
- B 14.79%
- C 15.33%
- D 15.92%

37 When analyzing a proposed investment project, which of the following is least likely to be properly described as an incremental cash flow?

- A Sunk costs
- B Externalities
- C Opportunity costs
- D Changes in net working capital

38 Financial leverage differs from operating leverage because financial leverage accounts for a company's;

- A use of debt
- B variability in sales
- C use of plant and equipment
- D variability in fixed operating costs

39 Graham Industries has two separate divisions; the Farm Equipment Division and the Household Products Division. Each division accounts for about 50 percent of the company's revenues and assets. Graham's management now wants to enter the toy industry. In assessing the attractiveness of investment projects in the toy industry, Graham's management should use a required rate of return based on;



- A a required return computed for the toy industry  
 B the required rate of return on the market portfolio  
 C Graham's current weighted-average cost of capital  
 D a weighted-average required return computed for the farm equipment, household products, and toy industries.

### SS13/14-Equity Investments

40 An analyst gathered the following information about a stock market index;

Required rate of return	16%
Expected dividend payout ratio	30%
Expected return on equity investment	20%

The expected price/earnings (P/E) ratio of the index is closed to:

- A 3.5  
 B 7.0  
 C 15.0  
 D 35.0

41 A price-weighted series is composed of the following three common stocks:

Common Stock	Number of Shares Outstanding	Price
A	1,000,000	\$10
B	5,000,000	\$20
C	6,000,000	\$30

If stock C completes a two-for-one stock split, the value of the index after the split will be closest to;

- A 15  
 B 20  
 C 67  
 D 97

42 An analyst gathered the following information about a perpetual preferred stock and a common stock issued by the same company

Par value of preferred stock (per share)	\$100
Dividend rate for preferred stock	7%
Required rate of return on preferred stock	12%
Last dividend paid on common stock (per share)	\$3.00
Constant growth rate for common stock dividend	5%
Required rate of return on common stock	15%

The values of a share of the company's preferred stock and common stock, respectively are closest to

	Value of preferred stock	Value of common stock
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A	\$58	\$30
B	\$58	\$32
C	\$100	\$30
D	\$100	\$32

43 Is the price to book value multiple most likely to be a meaningful indicator of value for companies that:

	Report negative earnings?	Are expected to discontinue operations?
A	No	No
B	No	Yes
C	Yes	No
D	Yes	Yes

44 An analyst gathered the following information about Fallow Corporation

Current dividend ( $D_0$ ) per share	\$1.00
Required rate return	15.0%
Expected annual growth rate for next two years	20.0%
Expected annual growth rate for year three and thereafter	5.0%

The value of a share of Fallow's common stock is closest to;

- A \$10.50
- B \$12.00
- C \$13.55
- D \$15.21

45 If one of the common stocks in a price-weighted series splits three-for-one, the;

- A value of the series will increase
- B value of the series will decrease
- C divisor for the series is adjusted upward to reflect the split
- D divisor for the series is adjusted downward to reflect the split

### SS17-Derivative Investments

46 The term (maturity) of a forward rate agreement is 90 days and the underlying rate is 180-day LIBOR. If 180-day LIBOR increases over the term (life) of the contract, which of the following best describes the descriptive notation for the contract and the party receiving payment at expiration, respectively?

	Descriptive notation	Party receiving payment at expiration
A	3 * 6	Long
B	3 * 6	Short
C	3 * 9	Long

D	3 * 9	Short
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47 A discount interest computation is used for quoting prices on;

- A. Treasury bill futures but not Eurodollar futures.
- B. Eurodollar futures but not Treasury bill futures.
- C. both Treasury bill futures and Eurodollar futures
- D. neither Treasury bill futures nor Eurodollar futures

48 Two parties enter into a three-year, plain-vanilla interest rate swap agreement now to exchange the LIBOR rate for a 10 percent fixed rate on \$10 million. LIBOR is 11 percent now, 12 percent at the end of the first year, and 9 percent at the end of the second year. If payments are in arrears, which of the following best characterizes the net cash flow to be received by the fixed-rate payer?

- A \$100,000 at the end of year 2
- B \$100,000 at the end of year 3
- C \$200,000 at the end of year 2
- D \$200,000 at the end of year 3

### SS18-Alternative Investments

49 Compared to other exchange traded funds (ETFs), which of the following types of risk is unique to ETFs that invest in index futures contracts and other derivatives?

- A Market risk
- B Trading risk
- C Tracking error risk
- D Counterparty credit risk

50 An analyst gathered the following information about a rental property.

Value of property using the income approach	\$300,000
Capitalization rate	14%
Annual depreciation	\$13,000
Annual payment on mortgage	\$39,000
Annual interest on mortgage	\$37,500

For an investor whose marginal tax rate is 30 percent, the investor's after-tax cash flow for the year is closest to:

- A -\$7,550
- B \$350
- C \$2,900
- D \$5,450

**SS15/16-Fixed Income Investments**

51 The interest rate risk of a non-callable bond is most likely to be positively related to the;

- A bond's coupon rate
- B risk-free rate of return
- C bond's time to maturity
- D bond's yield to maturity

52 An analyst determines the following information about semiannual coupon bond

Par value	\$1,000
Modified duration	10
Current price	\$800
Yield to maturity (YIM)	8%

If the YIM increases to 9 percent, the predicted decrease in price, using the duration concept, is closest to;

- A \$80.00
- B \$77.67
- C \$76.92
- D \$75.56

53 A three-year option-free bond with a 9 percent annual coupon rate has a yield to maturity of 9 percent. One-year and two-year spot rates are 6.5 percent and 7.0 percent, respectively. The three-year spot rate is closest to;

- A 6.4%
- B 8.1%
- C 9.0%
- D 9.2%

54 Which of the following most accurately describes the relationship between an option-free bond and a callable bond? All other factors equal, as interest rates;

- A increase, the price increase for the callable bond will be less than the price increase for the option-free bond
- B decrease, the price increase for the callable bond will be less than the price increase for the option-free bond
- C increase, the price change for the callable bond will be the same as the price change for the option-free bond
- D decrease, the price change for the callable bond will be the same as the price change for the option-free bond

55 On 1 January 2002, a 9.0 percent coupon rate bond with a par value of \$1,000 and 10 years to maturity had a discount rate of 8.0 percent. Because of an upgrade in the bond's rating on 1 January 2003, the discount rate decreased to 7.7 percent. If interest is paid annually, the change in the bond's price from 2002 to 2003 attributable only to the passage of time is closest to;

- A -\$15.13
- B -\$4.63
- C \$4.63
- D \$15.13

56 Which of the following statements about option-adjusted spread and nominal spread is most accurate?

- A Option-adjusted spread will equal nominal spread if the option favors the investor
- B Option-adjusted spread will be greater than nominal spread if the option favors the issuer.
- C The difference between option-adjusted spread and nominal spread can be significant for mortgage-backed securities
- D The longer the deferred call period, the greater the difference between the value of the option-adjusted spread and the value of the nominal spread.

57 Modified convexity and effective convexity differ in that effective can be;

- A negative when modified convexity is positive for option-free bonds
- B positive when modified convexity is negative for option-free bonds
- C negative when modified convexity is positive for bonds with embedded options
- D positive when modified convexity is negative for bonds with embedded options

## **SS12-Portfolio Management**

58 For the investment process, risk aversion is least likely to be implied by;

- A a security market line that is upward sloping
- B a promised yield on AAA-rated bonds that is higher than on A-rated bonds
- C investors' expectation of a positive relationship between expected return and expected risk.
- D investors' preference for portfolios that lie on the efficient frontier compared to other portfolios with equal rates of return

59 An investor is considering adding another investment to an existing portfolio. To achieve the maximum diversification benefits, the investor should add an investment that has a correlation coefficient with the existing portfolio closest to;

- A -1.0
- B -0.5

C 0.0

D +1.0

60 In the context of capital market theory, unsystematic risk;

A is described as unique risk

B refers to nondiversifiable risk

C remains in the market portfolio

D refers to the variability in all risky assets caused by macroeconomic and other aggregate market-related variables.