Chartered Financial Analyst®

CFA®

LEVEL I

MOCK TEST
FOR THE 2007 JUNE CFA® EXAM

FOR STUDENTS IN CFA TRAINING PROGRAM ONLY

TEST 1

The Test 1 for CFA Level I Practice Exam has 120 questions. For grading purposes, all questions carry a weight of 1.5, which equals the number of minutes allocated to each question.

Questions	Topic	Percent	Minutes
1-18	Ethical and Professional Standards	15.00	27
19-32	Quantitative Analysis	11.67	21
33-44	Economic Analysis	10.00	18
45-78	Financial Statement Analysis &Corporate Finance	28.33	51
79-114	Asset Valuation	30.00	54
115-120	Portfolio Management	5.00	9
	Totai	100	180

QUESTIONS 1 TROUGH 18 RELATE TO ETHICAL AND PROFESSIONAL STANDARDS AND ARE ALLOCATED 27 MINUTES.

1. Thomas Alston, CFA, director of marketing at Redd Financials, plans to build on his firm's reputation as a leading investment advisor by marketing an exclusive investment advice letter to wealthy individuals. Alston views the complexity of Redd Financials' investment screening system, a combination of technical trading rules and portfolio optimization techniques designed to minimize risk, as a major obstacle to his plan. To simplify the newsletter, Alston decides to include only each week's top ten buy and sell recommendations and leave out information associated with the methods used to select securities. According to the *Standards of Practice Handbook*, would Alston's actions with respect to the advice letter 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.
D. Yes, with respect to communication with clients and prospective clients.

2. The Board of Directors at Hollymead Industries recently made two changes to the firm's corporate governance policies. The first change provides the firm's audit committee with the authority to approve or reject proposed non-audit engagements with Hollymead's external audit firm. The second change creates a firewall that restricts the audit committee's access to Hollymead's internal auditor. Are the interests of Hollymead's shareowners likely to be best served as a result of the:

	first change?	second change?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

3. Which of the following is **NOT** an objective of the Global Investment Performance Standards (GIPS®)?

A. Promote industry self-regulation.
B. Provide CFA Institute members a competitive advantages in the investment-management industry.
C. Obtain worldwide acceptance of a standard for the calculation and presentation of investment performance.
D. Ensure accurate and consistent investment performance data for reporting, record-keeping, marketing, and presentation purposes.

4. Janet Haye, CFA, is a successful senior portfolio manager for a company that manages investments for both institutions and wealthy individuals. Prior to accepting gifts from clients or others, Haye always discloses such benefits to her employer. One of Haye's individual clients is so pleased with the performance of his personal investment portfolio that he recently offered Haye season tickets to the opera. In addition, in appreciation for her business, a broker recently offered Haye shares in an oversubscribed initial public offering (IPO) for her personal account. According to the *Standards of Practice Handbook*, would Haye violate the CFA Institute Standard of Professional conduct relating to independence and objectivity if she accepts the:

	client's gift?	broker's gift?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

5. Samuel Kronowitz, CFA, recently left his job as a research analyst for a major brokerage company. While looking for a new position, he is hired by an investor-relations firm to write a research report on one of that firm's clients, a relatively small financial services company. The investor-relations firm hopes to generate investor interest in the subject company and will pay Kronowitz a flat free plus a bonus based on the number of new investors that purchase stock in the company as a result of the report. After completing his analysis, Kronowitz prepares a report that includes disclosure of his payment arrangement. According to the *Standards of Practice Handbook*, has Kronowitz violated any CFA Institute Standards of Professional Conduct?

A. No.
B. Yes, with respect to selective disclosure.
C. Yes, with respect to independence and objectivity.
D. Yes, with respect to additional compensation arrangements.

6. According to the *Standards of Practice Handbook*, a member is *least likely* to breach their duty to a client by:

A. diversifying investments if diversification is contrary to account objectives.
B. diversifying investments if diversification is inconsistent with plan guidelines.
C. consistently voting with management on proxies that relate to nonroutine governance issues.
D. providing confidential client information to the CFA Institute Professional Conduct Program.

7. Which of the following statements about the Global Investment Performance Standards is **NOT**

accurate? The GIPS standards require that composites:

A. are selected according to pre-established criteria.
B. show GIPS-compliant history for a minimum of five years or since inception if in existence less than five years.
C. include all actual, fee-paying, discretionary portfolios managed with the same investment objective or strategy.
D. include a statement disclosing that the calculation methodology used is in compliance with the Global Investment Performance Standards.

8. Johann Svetlane, CFA, manages investment portfolios for individuals and has no beneficial interest in any of the accounts that he manages. One of Svetlane's free-paying clients is his wealthy uncle, Marvin Baxter. If Svetlane receives shares in an oversubscribed initial public offering (IPO), he first allocates the shares on a pro-rata basis to all his clients for whom the investment is suitable, with the exception of Baxter. Only if any shares remain after the initial allocation to his other clients will Svetlane allocate shares to Baxter's account, provided that the investment is appropriate for his uncle. According to the *Standards of Practice Handbook*, does Svetlane's IPO allocation procedure violate the CFA Institute Standard of Professional Conduct relating to:

	priority of transactions?	fair dealing?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

9. Joe Wu, CFA, discovers that Lee Smith, CFA, one of the assistant portfolio managers he supervises, may have violated the law. According to the *Standards of Practice Handbook*, Wu's initial course of action must be to:

A. place limits on the employee's activities.
B. report the conduct to governmental authorities.
C. increase the monitoring of the employee's activities.
D. begin an investigation to determine the extent of the wrongdoing.

10. The stock price of Fishersville Corporation has remained at relatively depressed levels for the past two years. The Board of Directors at Fishersville reviewed its executive compensation program and decided to increase the proportion of executive compensation that is linked to quarterly profits and to reprice downward the strike prices of stock options previously granted to top executives. With respect to the quality of corporate governance, are the long-term

interests of the company's shareowners likely to be served by the change that involves:

	linking executive compensation to quarterly profits?	repricing of stock options?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

11. Saied Begg, CFA, manages a small, two-person investment advisory firm. Begg's firm subscribes to a service from a large investment research firm that provides independent research reports. Begg has found research reports from that firm to be consistently sound and reliable. The firm recently sent him a favorable research report about Howardsville Corporation. Begg had held Howardsville common stock in his personal account for several years. Begg relies on the report and recommends that his clients, for whom the investment is suitable, purchase Howardsville shares. Begg informs each clients about his personal holdings in Howardsville's stock. According to the *Standards of Practice Handbook*, has Begg violated the CFA Institute Standards of Professional Conduct with respect to:

	Diligence and reasonable basis?	disclosure of conflicts?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

12. Byron Rochioli, is a analyst covering the financial services industry for a large investment advisory firm. Rochioli is well respected in the investment community for his ability to identify undervalued companies, and the stock prices of companies he recommends increase immediately following release of his reports. After completing a thorough analysis on Rockport Bankcorp (RPB), Rochioli issues a "strong buy" recommendation on the company's shares. Prior to the release of this report, Rochioli calls his brother and tells him to purchase shares of RPB as soon as possible. According to the *Standards of Practice Handbook,* Rochioli is *least likely* to have violated the CFA Institute Standards of Professional Conduct relating to:

A. duties to clients.
B. duties to employers.
C. priority of transactions.
D. diligence and reasonable basis.

13. Can compliance with the GIPS standards be claimed by a firm:

	that does not manage assets?	for only one of that firm's products?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

14. Esther Trujillo, CFA, is a junior portfolio manager at Benet Investments, a firm recognized as a specialist in identifying investment opportunities in small-capitalization stocks. The firm's assets have grown rapidly in recent years, and to enhance liquidity, senior management recently made the decision to lift the maximum permissible market-cap ceiling from $500 million to $1 billion. At the same time, management changed the group responsible for selecting stocks to be added to the firm's "approved" list from individual portfolio managers to a committee consisting of the firm's research director and three senior portfolio managers. According to the *Standards of Practice Handbook*, must Trujillo notify her clients about the changes in the:

	market-cap ceiling?	group responsible for selecting stocks?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

15. Javon Spencer, CFA, supervises a team of ten portfolio managers and analyst. In preparation for a long holiday trip, Spencer delegates his authority to Joy Neuhaus, CFA. According to the *Standards of Practice Handbook*, Spencer:

A. is required to advise his supervisor and his compliance department, in writing, of the delegation of his supervisory duties.
B. still has supervisory responsibility and must instruct Neuhaus about methods to prevent and detect violations of applicable laws, rules, regulations, and the CFA Institute Code of Ethics and Standards of Professional Conduct.
C. still has supervisory responsibility but need not instruct a charterholder about methods to prevent and detect violations of applicable laws, rules, regulations, and the CFA Institute Code of Ethics and Standards of Professional Conduct.
D. is required to advise his team, in writing, of the delegation supervisory duties to Neuhaus about methods to prevent and detect violations of applicable laws, rules, regulations, and the CFA Institute Code of Ethics and Standards of Professional Conduct.

16. According to the *Standards of Practice Handbook*, an accurate list of requirements with respect to a member's duties to clients would **NOT** include:

A. seeking best execution at all times.

B. complying with the Global Investment Performance Standards.

C. gathering client information related to investment objectives and constraints.

D. treating all clients fairly when disseminating investment recommendations or taking investment action.

17. Jean Saville, CFA, is an equity analyst who recently prepared a full report on Boycee Corporation. The report included financial projections developed by Saville and information gathered from a third-party research firm, which she referenced. In the report, Saville wrote, "We recommend this stock for the portfolios of clients with aggressive risk profiles. This recommendation is based on third-party research we believe to be reliable." At the end of the report, Saville noted, "The author's family owns Boycee Corporation securities." The report was posted on the company's website for client access and distributed via e-mail. According to the *Standards of Practice Handbook*, has Saville violated any CFA Institute Standards of Professional Conduct?

A. NO.

B. Yes, because the report relied on third-party research.

C. Yes, because the report was not properly disseminated.

D. Yes, because the report did not disclose the amount of ownership by Saville's family.

18. Janice White, CFA, has supervisory responsibility and has determined that her firm has established and adequate compliance program designed to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards. Given that a compliance program is in place, which of the following actions is **NOT** included in the list of recommended procedures that White should follow according to the *Standards of Practice Handbook*?

A. Periodically update procedures.

B. Disseminate the contents of the program to appropriate personnel.

C. Test personnel on their knowledge and understanding of the program.

D. Incorporate a professional conduct evaluation as part of an employee's performance review.

QUESTIONS 19 THROUGH 32 RELATE TO QUANTTATIVE ANALYSIS AND ARE ALLOCATED 21 MINUTES.

19. An analyst gathered the following information about a common stock for 2005:

Price per share on 1 January 2005	€48
Dividends paid per share	€4
Holding period return for year ended 31 December 2005	25%

The stock's price per share on 31 December 2005 was *closest* to:

A. €56
B. €60.
C. €64.
D. €65.

20. An investor's portfolio has a mean return of 14.5 percent and a Sharpe ratio of 0.4. If the risk-free rate of return is 5 percent, the portfolio has a coefficient of variation that is *closest* to:

A. 1.6
B. 1.8
C. 2.5
D. 3.8

21. The mean return on equity for all companies in a stock index is 13 percent, and the standard deviation of return on equity for all the companies in that index is 28 percent. Taking a random sample of 36 companies from the index would result in a standard error of the sample mean that is *closest* to:

A. 0.36%
B. 0.78%
C. 2.17%
D. 4.67%

22. With respect to measurement of downside risk associated with the returns from an investment, that investment's mean return is *least likely* to be used to calculate the:

A. semivariance.
B. semideviation.
C. standard deviation.
D. target semivariance.

23. The following information relates to the distribution of monthly returns from a diversified investment portfolio:

Mean	1.05%
Median	1.02%
Mode	0.98%

The distribution of monthly returns is *best* described as:

A. positively skewed with a long tail on the left side.
B. negatively skewed with a long tail on the left side.
C. positively skewed with a long tail on the right side.
D. negatively skewed with a long tail on the right side.

24. All else being equal, as compounding frequency changes from semiannual compounding to daily compounding, the difference between the stated annual interest rate and the effective annual rate for an investment will:

A. increase.
B. decrease.
C. remain the same because the future value factor increases at a decreasing rate.
D. remain the same because there is a limiting value associated with the future value factor.

25. To evaluate the performance of different investment managers over many periods, the *most* appropriate return measure would be the:

A. internal rate of return.
B. time-weighted rate of return.
C. dollar-weighted rate of return.
D. money-weighted rate of return.

26. If a normal distribution has a mean of 12 and a standard deviation of 20, a standardized value of 0.3 corresponds to an observation value that is *closest* to:

A. 6.0
B. 18.0
C. 40.0
D. 78.7

27. If an analyst wants to assess the relative degree of variability of data sets that have either different means or different units of measurement, the most appropriate measure would be the:

A. variance.
B. standard deviation.
C. coefficient of variation.
D. mean absolute deviation.

28. An investor currently holds the following portfolio of common stocks:

Stock	Amount Invested	Expected Annual Return	Standard Deviation of Returns
1	€20,000	13%	22%
2	€30,000	15%	26%

The expected correlation of returns between Stock 1 and Stock2 is +0.8.

The investor sells Stock 1 and uses the €20,000 proceeds to purchase another stock that has the same expected annual return and standard deviation of returns as Stock 1, but has an expected correlation of returns with Stock 2 of +0.6. The investor's actions would *most likely*:

A. increase the portfolio's expected return.
B. decrease the portfolio's expected return.
C. increase the portfolio's expected standard deviation of returns.
D. decrease the portfolio's expected standard deviation of returns.

29. An analyst calculated the following performance statistics for a mutual fund over a 15-year period:

Geometric mean return	12.5%
Arithmetic mean return	9.6%
Standard deviation	19.5%
Mean absolute deviation	21.9%

The analyst *most likely* made one or more errors in calculating the measures that are related to:

A. both return and dispersion.
B. neither return nor dispersion.
C. return but not in calculating the measures related to dispersion.
D. dispersion but not in calculating the measures related to return.

30. An analyst regressed the return on a stock against the returns on the market portfolio and generated the following statistics:

Coefficient of determination	0.42
Intercept (a)	1.19
Slope of the regression line (b)	1.00

The results of the regression suggest that:

A. the correlation coefficient is 0.18.
B. the stock has a higher level of systematic risk than the market.
C. if the return on the market is 0.0%, the stock's return is 1.00%.
D. less than half of the variation in the stock's return is explained by the market return.

31. All else being equal, risk-averse investors would *most likely* prefer portfolios that have relatively:

A. low coefficients of variation and low Sharpe ratios.
B. low coefficients of variation and high Sharpe ratios.
C. high coefficients of variation and low Sharpe ratios.
D. high coefficients of variation and high Sharpe ratios.

32. The correlation between the returns for two stocks must be negative if:

A. a consistent inverse relationship exists between the returns for the two stocks.
B. returns on both stocks are consistently above expected returns at the same time.
C. returns on both stocks are consistently below expected returns at the same time.
D. any diversification benefits are derived by combining the two stocks to from a portfolio.

QUESTIONS 33 THROUGH 44 RELATE TO ECONOMIC ANALYSIS AND ARE ALLOCATED 18 MINUTES.

33. A foreign currency trader reviewed the following information on spot exchange rates:

In New York	Number of U.S. dollars ($) per Euro (€)	$1.2102
In Tokyo	Number of Japanese yen (￥) per U.S. dollar ($)	￥117.275
In London	Number of U.S. dollars ($) per U.K. pound (£)	$1.7678

Based on the cross-exchange rates, the quoted spot rate for the yen per pound in London will be closest to:

A. ￥66.340
B. ￥171.310
C. ￥207.319
D. ￥250.897

34. Do the advantages associated with fiscal programs that act as automatic stabilizers include minimizing the:

	Effects of countercyclical fiscal policy programs?	Need for legislative action?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

35. If accurately calculated, will the amount of economic profit for a firm generally:

	exceed that firm's accounting profit for the same time period?	consider both that firm's explicit and implicit costs?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

36. Do the three major, at least partially valid, arguments for a countr to adopt trade restrictions include the:

	national-defense argument?	anti-dumping argument?
A.	No	No
B.	No	Yes
C,	Yes	No
D.	Yes	Yes

37. In the short run, would a shift to a more expansionary macroeconomic policy likely lead to an increase in both output and employment according to the:

	rational expectations hypothesis?	adaptive expectations hypothesis?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

38. Consumer indifference curves for two goods for any one individual are *least likely* to:

A. slope downward to the right.
B. indicate the desirability of those two goods.
C. indicate the attainability of those two goods.
D. indicate the marginal rate of substitution for those two goods.

39. According to the crowding-out theory, is a country that finances a budget deficit by borrowing likely to experience a:

	reduction in domestic private investment?	depreciation in the domestic currency?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

40. Country 1 has an absolute advantage over Country 2 in the production of both steel and clothing. If the relative costs of producing steel and clothing differ between the two countries, gains from trade can be achieved by:

A. Country 1 only.
B. Country 2 only.
C. Both Country 1 and Country 2.

D. Neither Country 1 nor Country 2.

41. The factor that will most likely have an effect on spreads in the forward currency market but will have no effect on spreads in the spot currency market is:

A. Trading volume.
B. Bank/dealer positions.
C. Bank/dealer risk aversion.
D. The maturity of the contract.

42. Supply-side economics is best described as a:

A. Long-run fiscal strategy that advocates lower marginal tax rates.
B. Long-run fiscal strategy that advocates higher marginal tax rates.
C. Short-run fiscal strategy that advocates lower marginal tax rates.
D. Short-run fiscal strategy that advocates higher marginal tax rates.

43. Will a shift to a more expansionary monetary policy most likely result in an increase in real output in the short run if decision makers:

	Anticipate the shift in policy?	Do not anticipate the shift in policy?
A	No	No
B.	No	yes
C.	Yes	No
D.	Yes	Yes

44. If a government's budget deficit increases and leads to the crowding-out effect, will that country's:

	Currency most likely depreciate?	Net exports most likely decrease?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

QUESTIONS 45 THROUGH 78 RELATE TO FINANCIAL STATEMENT ANALYSIS AND CORPORATE FINANCE AND ARE ALLOCATED 51 MINUTES.

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

45. All other factors being equal, a company's cash conversion cycle will *most likely* be shortened if that company experiences a decrease in the turnover ratio associated with:

A. equity.
B. payables.
C. inventory.
D. receivables.

46. An analyst developed the appropriate common-size financial statements to analyze trends over time for a company. Selected information from those common-size statements follows:

	2002	2003	2004	2005
Stated as a percentage of assets for each year:				
• Inventory	6%	6%	5%	5%
Stated as a percentage of sales for each year:				
• Cost of goods sold	45%	43%	40%	37%
• Earnings before interest and taxes	15%	18%	19%	23%
• Interest expense	5%	6%	6%	7%

Which of the following conclusions based on the information above would be correct regardless of changes in the company's total asset turnover ratio during the same period?
From 2002 to 2005, the company *most likely* experienced a(n):

A. increase in the interest coverage ratio.
B. decrease in the interest coverage ratio.
C. increase in the inventory turnover ratio.
D. decrease in the inventory turnover ratio.

47. All else equal, compared to using high salvage values for new depreciable assets, using low salvage values for those same assets will *most likely* increase a company's:

A. net profit margin.
B. stockholder's equity.
C. total asset turnover ratio.

D. cash flow from operations.

48. An analyst gathered the following information about an asset sold by a company at the end of the year:

Original cost	$80,000
Accumulated depreciation at date of sale	$45,000
Cash proceeds form the sale	$35,000

Which of the following *best* describes the effect of the sale on the company's financial statements for that year? The sale will increase:

A. cash flow from investing activities but not net income.
B. cash flow from operating activities but not net income.
C. both net income and cash flow from investing activities.
D. both cash flow from operating activities and cash flow from investing activities.

49. During a period of rising prices and stable inventory quantities, compared to using the LIFO method, a company using the FIFO method would *most likely* experience a higher:

A. quick ratio.
B. cost of goods sold.
C. inventory turnover ratio.
D. amount of tax income expense.

50. A lessee company entered into a new capital lease agreement. The lease payments are $150,000 annually and are due at the end of each year for five years. The appropriate discount rate is 12 percent. Depreciation is on a straight-line basis with zero salvage value. The total expense that should be reported on the company's income statement for the first full year of the new capital lease is *closest* to:

A. $48,000.
B. $126,000.
C. $173,000.
D. $240,000.

51. In 2005, the average market price of a company's common stock was $50 per share and basic earnings per share was $1.60. With respect to the computation of 2005 diluted earnings per share for that company, use of the treasury stock method would *most likely* result in incremental shares outstanding related to the company's:

A. 6% convertible bonds.
B. 6% convertible preferred stock.
C. options with an exercise of $60 per share.
D. warrants with an exercise of $40 per share.

52. An analyst gathered the following information about a company:

	2003	2004	2005
Return on the equity	20.2%	21.3%	22.8%
Return on the total assets	7.4%	7.2%	7.0%
Total asset turnover	1.8	1.9	2.1

If sales did not change from 2003 to 2005,the company *most likely* experienced a(n):

A. decrease the financial leverage.
B. decrease in the net profit margin.
C. increase in the interest coverage ratio.
D. Increase in the proportion of common equity in the capital structure.

53. During 2005,a company reported the sale of accounts receivable but retained the effective credit risk for the uncollected receivables. That company's 2005 financial statements will *most likely* overstate:

A. current assets.
B. current liabilities.
C. cash flow from operating activities.
D. cash flow from financing activities.

54. An analyst gathered the following information about a company ($ millions):

	2004	2005
Year-end inventory (LIFO inventory method)	45.3	61.2
LIFO reserve	27.3	33.4
Cost of goods sold (LIFO)	147.2	163.9

If the company used the FIFO inventory method instead of LIFO, the company's 2005 cost of goods sold ($ millions) would be *closest* to:

A. 131.
B. 148.
C. 158.

D. 170.

55. A analyst gathered the following information about a company:

Total assets	$38.5 million
Equity	$15.4 million
Return on total assets	8.6%
Retention rate of earnings	40.0%

The company's potential (sustainable) growth rate is closest to:

A. 3.4%
B. 8.6%
C. 12.9%
D. 21.5%

56. If an analyst makes the appropriate adjustments to the financial statements of a lessee company that recently entered into a substantial number of new operating leases, will those adjustments most likely result in a decrease in the company's:

	Asset turnover ratio?	Financial leverage multiplier?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

57. The following information relates to a profitable company that offered a warranty on a new product introduced in 2005:

Actual expenditures for repairs under the warranty in 2005	$200,000
Accrued warranty expenses for the warranty in 2005	$300,000

If the company's tax rate is 35 percent, which of the following most accurately describes the deferred tax that should have been recorded in 2005 with respect to that new product warranty?

A. Deferred tax asset of $35,000.
B. Deferred tax asset of $65,000.
C. Deferred tax liability of $35,000
D. Deferred tax liability of $65,000

58. Compared with capitalizing interest costs during the construction period for a particular company's self-constructed assets, expensing the interest costs during that period will *most likely* increase that company's:

A. net income.
B. interest coverage ratio.
C. total asset turnover ratio.
D. cash flow from operating activities.

59. An analyst gathered the following information about a company's two convertible bond issues that were both outstanding throughout 2005:

Size of Issue	Coupon Interest Rate	Number of Common Shares if Converted
$10,000,000	6%	200,000
$15,000,000	5%	275,000

If the company's tax rate is 30 percent, which of the following statements is *most likely* to be accurate? Both issues are dilutive if the company's basic earnings per share is:

A. less than $1.90.
B. more than $1.90.
C. less than $2.10.
D. more than $2.10.

60. A company issued bonds that will mature in exactly eight years. The annual amount of interest expense recorded for those bonds should decrease over time if the company issued the bonds:

A. at par.
B. at a discount.
C. at a premium.
D. as zero-coupon debt.

61. If inventory quantities are increasing and prices are rising, a lessee company will *most likely* report the highest amount of total assets if that company uses both the:

A. FIFO inventory method and capital leases.
B. LIFO inventory method and capital leases.
C. FIFO inventory method and operating leases.
D. LIFO inventory method and operating leases.

62. All else equal, compared to using long average lives and high salvage values for depreciable

assets, will using short average lives and low salvage values decrease a company's:

	Total asset turnover?	Cash flow from operations?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

63. An analyst gathered the following information for a company:

Ratios	2003	2004	2005
Inventory turnover	7	6	5
Total asset turnover	3	5	6
Accounts payable turnover	8	6	9
Accounts receivable turnover	16	12	11

All other factors being equal, which of the following is the best conclusion with respect to the information above? From 2003 to 2005, the company's:

A. Fixed asset turnover increased.
B. Credit policies become more strict.
C. Cash conversion cycle become shorter
D. Average inventory processing time decreased.

64. A U.S. company's financial records indicate that the company entered into the following transactions during 2005:

Received dividends of $5,000
Issued bonds with a face value of $200,000 in exchange for plant assets worth $200,000

Will either of the two transactions indicated above affect the amount reported in the company's 2005 cash flow from:

	Operating activities?	Investing activities?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

65. An analyst notes that the footnotes to the financial statements for a lessee company indicate

that the company leases a substantial portion of the facilities required for efficient operation. The present value of lease payments is $30 million for facilities leased under capital leases and $20 million for facilities leased under operating leases. Other companies in the same industry own their facilities.

Before the analyst compares the company's financial ratios with the industry's ratios, the *most* appropriate adjustments to that company's balance sheet would be to increase:

A. both liabilities and assets by $20 million.
B. both liabilities and assets by $50 million.
C. liabilities by $20 million and decrease equity by $20 million.
D. liabilities by $50 million and decrease equity by $50 million.

66. On 1 January 2005, a company had 1.6 million shares of common stock outstanding. Which of the following statements about the calculation of that company's 2005 earnings per share is *most* accurate? Assuming no other transactions involving common shares during 2005, the number of shares used to calculate 2005 earnings per share will be equal to:

A. 2.4 million if the company has a 2-for-1 stock split on 1 July 2005.
B. 2.4 million if the company if the company issues a100 percent stock dividend on 1 July 2005.
C. 3.2 million if the company has a 2-for-1 stock split at any time before issuance of the 2005 financial statements.
D. 3.2 million if the company issues 1.6 million shares for cash at any time before issuance of the 2005 financial statements.

67. An analyst gathered the following information from a company's 2005 financial statements ($ millions):

Year ended 31 December	2004	2005
Net sales	140.8	160.5
Accounts receivable	36.8	32.4
Inventories	45.9	52.3

Based only on the information above, the company's 2005 statement of cash flows prepared using the direct method should include should include an amount ($ millions) for cash collections that is *closest* to:

A. 128.1
B. 156.1
C. 158.5
D. 164.9

68. The following information is from a company's 2005 financial statements ($ millions):

Balances as of the year ended 31 December	2004	2005
Retained earnings	120	140
Accounts receivable	38	43
Inventory	45	48
Accounts payable	36	29

The company declared and paid cash dividends of $5 million in 2005 and recorded depreciation expense in the amount of $25 million for 2005. The company's 2005 cash flow from operations ($ millions) was closest to:

A. 10
B. 25
C. 30
D. 35

69. A company is considering a capital project that has higher risk than the company's overall risk. Will using a discount rate equal to the weighted-average cost of capital for the company most likely overstate the project's estimated:

	Internal rate of return?	Payback period?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

70. A profitable company is considering the replacement of old equipment used in the manufacturing process with new, more efficient equipment. An analyst gathered the following information about the old and new equipment:

Old equipment:	
Original cost	$50,000
Current book value	$10,000
Current market value	$15,000
New equipment:	
Cost	$90,000
Freight and installation	$3,000
Marginal tax rate for the company	40%
Increase in net working capital required	$6,000

The old equipment will be sold to another company at current market value if the new equipment is purchased. The initial (net) investment outlay for the replacement project is closest to:

A. $82,000
B. $84,000
C. $86,000
D. $96,000

71. A company that has a weighted average cost of capital of 16 percent is considering an independent capital project that has the same risk as the company, an estimated internal rate of return of 18 percent and cash inflows that are expected at equal intervals over the life of the project. If the project is accepted, cash flows associated with the project are received as expected, and the company's weighted average cost of capital remains unchanged over the life of the project, the actual rate of return earned by the project is most likely to be:

A. Less than 18 %
B. More than 18 %
C. Equal to 18%, because the project plots on the security market line.
D. Equal to 18 %, because the actual cash flows equal the expected cash flows.

72. A company is evaluating an independent investment project that has the same risk as the company. If the net present value of the project is calculated to be zero, the internal rate of return associated with the project is *most likely*:

A. equal to zero.
B. equal to the company's cost of capital.
C. overstated because of the reinvestment rate assumption.
D. understated because of the reinvestment rate assumption.

73. With respect to capital budgeting, the replacement chain approach and the equivalent annual annuity approach are *most likely* to be useful if a company is analyzing:

A. independent projects that have substantially different lives.
B. mutually exclusive projects that have substantially different lives,
C. independent projects that have the same life, but substantially different initial investment outlays.
D. mutually exclusive projects that have the same life, but substantially different initial investment outlays.

74. An analyst computed a degree of operating leverage of 2.5 and a degree of financial leverage of 1.4 for a company. If that company's sales decrease by 10 percent , the expected decrease in the company's earnings per share would be *closest* to:

A. 3.5 percent.
B. 3.9 percent.
C. 35.0 percent.
D. 39.0 percent.

75. The managers of companies that maintain a reserve borrowing capacity in normal time are *most likely* acting in according with arguments that support:

A. signaling theory.
B. tax preference theory.
C. trade-off theory of leverage.
D. Modigliani and Miller capital structure irrelevance proposition.

76. An analyst states that both the optimal capital structure and the optimal dividend policy for a company are best defined in terms of maximizing the company's dividend growth rate. Is the analyst correct with respect to the optimal:

	Capital structure?	Dividend policy?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

77. With respect to capital budgeting, which of the following items that is typically included in computing the initial investment outlay for a replacement project is least likely to be included in computing the initial investment outlay for an expansion project?

A. Change in investments.
B. Change in accounts receivable.
C. Increase in income tax liability.
D. Freight and installation charges.

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

Target (optimal) capital structure:	
Long-term debt	40%
Preferred stock	10%

Common equity	50%
Before-tax component cost of:	
Long-term debt	10%
Preferred stock	12%
Retained earnings	18%

The company's marginal tax rate is 30 percent. If no significant size or timing differences exist among the company's capital projects and projects all have the same risk as the company, a project with a net present value of zero would have an internal rate of return closest to:

A. 9.9%
B. 12.6%
C. 13.0%
D. 14.2%

QUESTIONS 79 THROUGH 114 RELATE TO ASSET VALUATION AND ARE ALLOCATED 54 MINUTES.

79. All else being equal, the estimated growth rate of earnings and dividends for a company will *most likely* decrease as a result of an increase in that company's:

A. retention rate.
B. financial leverage.
C. total asset turnover.
D. dividend payout ratio.

80. The *most* appropriate way for an analyst to assess both the amount and nature of competitive pressure in a particular industry is by using:

A. the Herfindahl index.
B. the Confidence index.
C. relative-strength ratios.
D. support and resistance levels.

81. An analyst gathered the following information about a company:

Return on assets	5.0%
Financial leverage (Total assets/equity)	2.5
Beta for the company's stock	1.4

The analyst expects the information above to accurately reflect the future. If the company wants to achieve a growth rate of 10% without changing its capital structure or issuing new equity, the maximum dividend payout ratio for the company would be *closest* to:

A. 2.5%
B. 12.5%
C. 20.0%
D. 43.0%

82. An analyst gathered the following financial statement information about a company:

Preferred stock	$50 million
Common stock and additional paid in capital	$100 million
Retained earnings	$297 million
Total number of common shares outstanding	10 million
Tax rate	30%

The analyst also determined that the company uses the LIFO inventory method, but most companies in the industry use the FIFO method. The footnotes to the financial statements indicate that if the company had used the FIFO method, the inventory balance would have been $40 million higher than the amount reported on the company's most recent financial statements. The most appropriate book value per share to use in computing the company's price to book value ratio is:

A. $42.5
B. $43.7
C. $47.5
D. $48.7

83.Compared with fundamental analysis, does technical analysis place more emphasis on:

	A company's financial accounting statements?	Determining the effects of specific events on the value of a company's stock?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

84. An analyst gathered the following information about a company:

Current dividend (D_0) per share on common stock	€3.00
Expected annual growth rate for years 1 and 2	20%
Expected annual growth rate for year 3 and thereafter	9%
Expected risk-free rate of return	6%
Expected return on the market portfolio	11%
Beta for common stock	1.2

The value of a share of the company's common stock is closest to:

A. €110
B. €120
C. €132
D. €144

85. An analyst gathered the following annual data for a company:

Net profit margin	2%
Total assets	$200 million
Total liabilities	$120 million

Net income	$10 million
Dividends paid on common stock	$2 million

The company's estimated dividend growth rate is closest to:

A. 2.5%
B. 10.0%
C. 12.5%
D. 15.6%

86. The following expectations relate to two companies and their respective common stocks:

	Company1	Company 2
Earnings per share	$1.45	$1.60
Dividend payout ratio	55%	55%
Dividend growth rate	6%	6%
Required rate of return	12%	13%

Based on the expectations, which of the following is the *most* accurate statement about the two companies? Company 1 is expected to have a:

A. lower return on equity than Company 2.
B. higher return on equity than Company 2.
C. lower intrinsic common stock value than Company 2.
D. higher intrinsic common stock value than Company 2.

87. An investor purchased on margin 100 shares of a stock priced at $60 per share. The investor borrowed the maximum amount allowed by the initial margin requirement of 50 percent. The maintenance margin is 25 percent. The lowest price share at which the stock could sell before the investor would receive a margin call is *closest* to:

A. $15.00
B. $22.50.
C. $37.50.
D. $40.00.

88. Differences among companies with respect to quality of earnings are *best* addressed when companies are compared using:

A. price to cash flow ratios.
B. price to book value ratios.

C. leading price to earnings ratios.
D. trailing price to earnings ratios.

89. For constant growth companies that all have the same dividend payout ratio, the highest earnings multiplier (price/earnings ratio) is *most likely* associated with the stock of the company that has the:

A. lowest required rate of return.
B. highest expected constant growth rate of dividends.
C. largest positive spread between that company's required rate of return and expected constant growth rate of dividends.
D. smallest positive spread between that company's required rate of return and expected constant growth rate of dividends.

90. An analyst gathered the following annual data for a company:

Return on equity	10.0%
Net income for 2005	$20,000,000
Dividends paid on common stock during 2005 (D_0)	$4,000,000
Shares of common stock outstanding	2,000,000
Required rate of return on company's common stock	14.5%

If the growth rate in dividends is constant, the value of a share of the company's common stock at the end of 2005 is closest to:

A. $30.77
B. $33.23
C. $44.44
D. $48.89

91. With respect to option strategies, the shape of the graph that illustrates both the value at expiration and profit for selling a put is *most* similar in shape to the graph for:

A. selling a call.
B. buying a call.
C. a covered call position.
D. a protective put position.

92. A portfolio manager entered into a swap with a dealer. The swap's notional principal is $50 million, payments are to be made semiannually, and the swap allows netting of payments. The

dealer agrees to pay a fixed annual rate of 4 percent while the asset manager agrees to pay the return on a stock index. The stock index value at initiation of the swap is 300. Six months after initiation of the swap, the stock index value that would result in no payment by either party is *closest* to:

A. 288.
B. 294.
C. 306.
D. 312.

93. An investor writes a call option priced at $4 with an exercise price of $100 on a stock that be owns. The investor paid $88 for the stock. If at expiration of the call option the stock price has risen to $105, the profit for the investor's position would be *closest* to:

A. $8.
B. $12.
C. $16.
D. $21.

94. An analyst stated that, in the typical currency swap, principal amounts are exchanged at both the beginning and end of the swap and interest payments are not netted during the life of the swap. Is the analyst correct with respect to:

	principal amounts?	interest payment?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

95. The following information relates to futures market transactions for both an investor with a long position and an investor with a short position in the market:

Initial futures price per contract on Day 0	$100
Initial margin requirement per contract	$5
Maintenance margin requirement per contract	$3
Number of contracts held by each investor	10
Settlement price per contract on Day1	$103

At initiation of the contracts, each investor deposited enough funds to just meet the initial margin requirements. Which of the following statements about the two investors is *most* accurate? The amount of funds that must be deposited on Day 2 by the investor holding the:

A. long position is \$20.
B. long position is \$30.
C. short position is \$20.
D. short position is \$30.

96. An investor paid \$5 for a put option that was in-the-money \$3. If the price of the underlying was \$58 at the time the investor purchased the put option, the exercise price of that put option was *closest* to:

A. \$50.
B. \$55.
C. \$61.
D. \$66.

97. With respect to real estate valuation, a factor common to the sales comparison approach and the income approach is that both approaches require:

A. use of a perpetuity discount model.
B. identification of benchmark properties.
C. knowledge of the investor's marginal tax rate.
D. calculation of the property's net operating income.

98. Compared to actively managed mutual funds, exchange traded funds (ETFs) *most likely* have:

A. greater transparency.
B. higher expense ratios.
C. fewer opportunities for short selling.
D. higher exposure to taxes on capital gains distributions.

99. To calculate the value of a real estate property using the income approach, an analyst is *least likely* to require information about:

A. the market capitalization rate.
B. the property's repair and maintenance expenses.
C. interest expense related to financing the property.
D. estimated vacancy and collection losses for the property.

100. The returns from hedge funds that contain infrequently traded assets *most likely* exhibit a

downward bias with respect to correlations with:

A. both conventional equity returns and conventional fixed income returns.
B. neither conventional equity returns nor conventional fixed income returns.
C. conventional equity returns but not with conventional fixed income returns.
D. conventional fixed income returns but not with conventional equity returns.

101. A list of the similarities between venture capital investing and distressed securities investing is *least likely* to include that both types of investing:

A. are illiquid.
B. require a long investment horizon.
C. are efficiently priced by the market.
D. require intense investor participation.

102. An analyst is considering an investment in a venture capital project. The probability of failure in year 1 of the project's life is 0.45. For year 2, the probability of failure is 0.40, given that the project survived through year 1. The probability that the venture capital project survives to the end of the second year is *closest* to:

A. 15 percent.
B. 18 percent.
C. 27 percent.
D. 33 percent.

103. The duration of an option-free bond is 9.92, and the convexity measure for that bond is 63.8. If interest rates increase by 200 basis points, the bond's percentage price change will be *closest* to:

A. -22.39%
B. -19.84%
C. -18.56%
D. -17.29%

104. All else being equal, the floor on a floating-rate security is *most likely* to benefit the:

A. issuer if interest rates fall.
B. issuer if interest rates rise.
C. bondholder if interest rates fall.
D. bondholder if interest rates rise.

105. An option-free 6 percent coupon bond has an annual discount rate of 5 percent, pays interest semiannually, matures in five years, and is valued at $1,043.76. One year later, the annual discount rate for that bond is 4.5 percent and the bond is valued at $1,054.35. The change in value for this bond that is attributable only to the passage of time is *closest* to:

A. -$18.50
B. -$7.91
C. $7.91
D. $18.50

106. All else being equal, an increase in expected yield volatility would *most likely* cause the price of:

A. both a callable bond and a putable bond to increase.
B. both a callable bond and a putable bond to decrease.
C. a callable bond to increase and the price of a putable bond to decrease.
D. a callable bond to decrease and the price of a putable bond to increase.

107. All else being equal, the price of a floating-rate security is *most likely* to react in the same way to changes in market interest rates as a fixed-rate coupon bond if market rates:

A. increase between coupon reset dates.
B. decrease between coupon reset dates.
C. are substantially below the floating rate security's cap rate.
D. are substantially above the floating rate security's cap rate.

108. All else being equal, is a callable bond likely to exhibit negative convexity when the prevailing market yield for that bond is relatively:

	low compared to the bond's coupon rate?	high compared to the bond's coupon rate?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

109. An analyst gathered the following information about the call structure for a 7 percent coupon bond that pays interest semiannually and matures in ten years:

- not callable for the next 5 years
- first callable at beginning of year 6 (end of the fifth year) at $102
- first par call date at beginning of year 8 (end of the seventh year) at $100

If the bond is correctly priced at $102.75, the bond's yield to first par call is *closest* to:

A. 6.50%
B. 6.55%
C. 6.69%
D. 6.71%

110. A $1,000 par value, zero-coupon bond has an annual discount rate of 4.5 percent and matures in eight years. The value of the bond is *closest* to:

A. $494.47
B. $700.47
C. $820.75
D. $836.94

111. Compared to an otherwise identical option-free bond, will a prepayable amortizing security likely have more:

	interest rate risk?	reinvestment risk?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

112. An analyst used a valuation model to develop the following information about an option-free bond:

Yield	Bond Price
6.40%	$96.685
6.50%	$95.878
6.60%	$95.080

Based on the information above, the duration of the bond is *closest* to:

A. 4.13
B. 4.24

C.8.37
D.8.44

113. According to the liquidity preference theory, the shape of the yield curve today is determined by:

A. expectations about future interest rates but not by a yield premium for interest rate risk.
B. a yield premium for interest rate risk but not by expectation about future interest rates.
C. both expectation about future interest rates and by a yield premium for interest rate risk.
D. neither expectation about future interest rates nor by a yield premium for interest rate risk.

114. All else being equal, is the amount of interest rate risk associated with an option-free bond positively related to:

	that bond's coupon rate?	the level of market interest rates?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

QUESTIONS 115 THROUGH 120 RELATE TO PORTFOLIO MANAGEMENT AND ARE ALLOCATED 9 MINUTES.

115. The covariance of the returns on a stock with the returns on the market portfolio is equal to the variance of the returns on the market portfolio. The stock is *most likely* to be property valued if the stock's estimated return is:

A. equal to the expected return on the market.
B. less than the expected return on the market.
C. greater than the expected return on the market because systematic risk for the stock is greater than average.
D. greater than the expected return on the market because unsystematic risk for the stock is greater than average.

116. In the context of capital market theory and the capital asset pricing model, investors should *most likely* expect higher returns for accepting increasing amounts of:

A. total risk.
B. unique risk.
C. systematic risk.
D. diversifiable risk.

117. Two portfolios have the same expected rate of return. If these two portfolios are combined on an equally weighted basis, the benefits of diversification are *most likely* maximized if the portfolios have:

A. the same standard deviation, and a correlation coefficient of 0.0.
B. different standard deviation, and a correlation coefficient of 0.0.
C. the same standard deviation, and a correlation coefficient of -1.0.
D. the same standard deviation, and a correlation coefficient of +1.0.

118. An investor has a portfolio that lies on the capital market line (CML), and the portfolio's expected return is less than expected return on the market portfolio. That investor's portfolio is *best* described as:

A. a lending portfolio.
B. a borrowing portfolio.
C. having less unsystematic risk than the market portfolio.
D. having more unsystematic risk than the market portfolio.

119. Given no major change in asset risk characteristics, an increase in the willingness of investors to accept risk will *most likely* result in a(n):

A. increase in the slope of the security market line.
B. decrease in the slope of the security market line.
C. parallel upward shift of the security market line.
D. parallel downward shift of the security market line.

120. With respect to the portfolio management process, a well-constructed investment policy statement is *least likely* to include:

A. investor objectives.
B. investor constraints.
C. the specific securities that should be purchased.
D. the normal weights assigned to each asset class.

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TEST 2

The Test 2 for CFA Level I Practice Exam has 120 questions. For grading purposes, all questions carry a weight of 1.5, which equals the number of minutes allocated to each question.

Questions	Topic	Percent	Minutes
121-138	Ethical and Professional Standards	15.00	27
139-152	Quantitative Analysis	11.67	21
153-164	Economic Analysis	10.00	18
165-198	Financial Statement Analysis &Corporate Finance	28.33	51
199-234	Asset Valuation	30.00	54
235-240	Portfolio Management	5.00	9
	Total	100	180

QUESTIONS 121 TROUGH 138 RELATE TO ETHICAL AND PROFESSIONAL STANDARDS AND ARE ALLOCATED 27 MINUTES.

121. Matthew Huett, CFA, is considered by many institutional investors to be one of the best airline industry analyst in the world. On several occasions in the past, substantial trading occurred in a company's stock immediately following the dissemination of a change in Huett's opinion about that company. Huett recently came to the conclusion that the stock of Global Airlines is overvalued and he plans to revise his opinion from hold to sell. The basis for Huett's change of opinion consisted of information gathered under the "mosaic theory" from Global's financial statements, oral presentations by Global executives, company press releases and various other contacts with suppliers, competitors, and travel agents. Huett prepares his report and distributes it to all his clients who immediately reduce their positions in the stock. Three days after the distribution of the report to his clients. Huett discusses his revised opinion on a globally televised financial news program. According to the Standards of Practice Handbook, did Huett violate any CFA Institute Standards of Professional Conduct?

A. No
B. Yes, with respect to fair dealing.
C. Yes, with respect to material nonpublic information
D. Yes, with respect t both fair dealing and material nonpublic information

122. The interests of shareowners are best served if only non-executive Board members are allowed to serve on committees related to:

A. Audits but not compensation.
B. Compensation but not audits.
C. Both audits and compensation
D. Neither audits nor compensation

123. With respect to the Global Investment Performance Standards (GIPS), which of the following is one of the eight major sections that reflect the elements involved in presenting performance information?

A. Real Estate.
B. Derivatives.
C. Legal and Ethical Considerations
D. Mandatory Third-party Verification.

124. Malcolm Meader, CFA, is an equity analyst employed by a sell-side firm. According to the Standards of Practice Handbook, are pressures that jeopardize Meader's ability to act

independently and objectively likely to increase as the profitability of Meader's firm becomes more dependent on:

Investment banking activities?	Large institutional buy-side clients?
A. No	No
B. No	yes
C. Yes	No
D. Yes	Yes

125. Sharon Xu, CFA, lost her job last month after her employer merged with another investment advisory firm. She had been an equity analyst following a few large technology stocks. An investor-relations firm that represents several small technology companies has just asked Xu to write a research report on one of the technology companies the firm represents. The investor-relations firm's only objective is to generate investor interest for the companies it represents. According to the Standards of Practice Handbook, if Xu accepts a flat fee for writing the report that is agreed on prior to submission of the report and includes in the report a disclosure related to the fee agreement, would she violate the CFA Institute Standard of Professional Conduct relating to:

	Independence and objectivity?	Misrepresentation?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

126. James Suzuki, CFA, is a mortgage loan officer at a bank that offers investment advisory services. The annual fee charged by the bank for investment advisory services is typically one percent of the client's assets under management. If a prospect referred by Suzuki becomes a client of the bank's investment advisory department. Suzuki receives five percent of that client's annual fee. According to the Standards of Practice Handbook, which of the following is the most accurate statement about Suzuki's responsibility with respect to disclosing the referral arrangement? Suzuki is:

A. required to disclose the referral arrangement to all his clients.
B. required to disclose the referral arrangement to only those clients whom he refers.
C. not required to disclose the referral arrangement because the value of the benefit is not a fixed amount and could be less than US$100 per client.
D. required to disclose to all clients whether or not they are referred.

127. Janie Walton, a verifier of the GIP's standards, made the following statements:

First statement: To ensure the integrity of input data, benchmarks and composites should be created/selected on an ex-post basis, not before the fact.
Second statement: The real estate proviation of the GIPS standards apply whether or not the real estate investment is producing revenue.

Is Walton correct with respect to the:

	First statement?	Second statement?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

128. Carla Scott, CFA, is a portfolio manager for a company that manages including her uncle's account. If shares in oversubscribed initial public offering (IPOs) become available. Scott first allocates shares to all her other clients for whom the investment is appropriate: only then does she place any remaining shares in her uncle's account, if the issue is appropriate for him. Scott provides each of her clients with full disclosure of her allocation procedures and has received cash client's verbal consent to her allocation procedures. According to the Standards of Practice Handbook, does Scott's method of allocating oversubscribed IPOs violate any CFA Institute Standards of Professional Conduct?

A. No
B. Yes, because she has breached her duty to her uncle.
C. Yes, because she has failed to obtain written consent with respect to her allocation procedures.
D. Yes, because there is still a possibility that she will distribute shares in an oversubscribed IPO to a family member.

129. With respect to the Standard relating to responsibilities of supervisors, which of the following statements is least appropriate? According to the Standards of Practice Handbook, members with supervisory responsibilities should encourage their employers to adopt codes of ethics that:

A. Are provided to the firm's clients.
B. Are applicable to all the firm's employees.
C. Incorporate the firm's compliance procedures.
D. Address fundamental ethical and fiduciary concepts.

130. With respect to the quality of corporate governance, are the long-term interests of a company's shareowners likely to be impaired if the company's executive compensation program includes:

a strategy that focuses on short-	downward repricing of strike prices

term increases in share value?		for previously granted stock options?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

131. Marcus Takeda, CFA, is an analyst at a small investment advisory firm. His firm routinely purchases third-party research that Takeda has found to be sound and reliable. Takeda recently prepared a written report recommending to clients for whom the investment is suitable, the purchase of Crozet Corporation common stock. Takeda's report contained financial projections from recent reports issued by his firm's third-party research providers, which Takeda referenced. Takeda wrote, "This recommendation is based on expectations for continued strong demand for Crozet's products." Finally, Takeda noted at the end of his report that he owns Crozet Corporation convertible bonds. According to the Standards of Practice Handbook, did Takeda violate the CFA Institute Standard of Professional Conduct relating to:

	reasonable basis?	independence and objectivity?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

132. Jarrod Brenner, CFA, is a portfolio manager at Northstone Capital who has a beneficial interest in the account that he manages for his parents. Brenner discloses to his employer his beneficial interest in his parents' account and follows the firm's pre-clearance and reporting requirements for all transactions related to that account. He is careful to undertake transactions in the account only after his clients and employer have had an adequate opportunity to act. With respect to managing his parents' account, according to the standards of Practice Handbook, has Brenner violated any CFA Institute Standards of Professional Conduct?

A. No
B. Yes, with respect to duties to clients
C. Yes, with respect to duties to employer.
D. Yes, with respect to priority of transactions.

133. Is compliance with the GIPS standards a process that is:

	Required for CFA Institute members?	Firm-wide?
A.	No	No
B.	No	Yes

C.	Yes	No
D.	Yes	Yes

134. Leon Hermander, CFA, is the portfolio manager for a firm recognized as a leader in the management of assets for wealthy clients seeking aggressive growth through investment in small-capitalization domestic stock. Because of the firm's growth in assets under management and concerns about liquidity, Hernandez has decided to:

- double the size of the maximum capitalization for domestic companies included in the firm's research universe
- further expand the firm's research universe by including selected international stocks with maximum capitalization at the firm's original threshold

Although Hemandez does not inform the firm's existing clients of the changes, he alters the firm's marketing literature to inform prospective clients of both the increase in domestic capitalization limits and the addition of international stocks to the research universe. According to the Standards of Practice Handbook, did Hemandez violate the CFA Institute Standards of Professional Conduct when he failed to inform existing clients about his decision to:

	double the size of maximum capitalization for domestic companies?	further expand the firm's research universe by including selected International stocks?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

135. If a current or former client has not authorized the disclosure of confidential information and disclosure of that confidential information does not conflict with applicable law, which of the following statements is most accurate? According to the Standards of Practice Handbook, a member will breach his duties by disclosing confidential client information that relates to:

A. an individual who has ended the client relationship with that member.
B. illegal activities on the part of an entity that is currently that member's client.
C. Illegal activities on the part of an individual who is currently that member's client.
D. Information requested by the CFA Institute Professional Conduct Program during the course of an investigation into that member's conduct.

136. Fairfax and Reilly Corporation's audit committee consists of independent Board members who hire and supervise the company's external auditors, have the authority to approve or reject proposed non-audit engagements between the company and the external audit firm, and control the

audit budget. Unrestricted access exists between the audit committee and the company's internal auditor. With respect to the quality of corporate governance, do these circumstances indicate that the Fairfax and Reilly audit committee is serving the interests of Fairfax and Reilly's shareowners?

A. Yes
B. No, because the audit committee should not control the audit budget.
C. No, because the audit committee should not have access to the internal auditor
D. No, because the audit committee should not have the authority to approve or reject non-audit engagements between the company of the external audit.

137. Chip McLeavey, a verifier of the GIPS standards, made the following statements:

- A firm claiming compliance with the GIPS standards must provide a compliant presentation and a description for any composite on the firm's list to any prospective client who makes such a request.
- A firm claiming compliance with GIPS standards is prohibited from stating that the calculation methodology used in composite presentations is also in accordance with the GIPS standards.

Is Mcleavey correct with respect to the:

First statement?	Second statement?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

138. Muriel LeMay, CFA, is a research analyst for a large investment management firm. She is invited to attend a luncheon with the top executives of a large pharmaceutieal company and three other buy-side analysts representing firms that also hold substantial positions in the company's stock. During the luncheon, material information is disclosed that has not yet been made available to the marketplace. According to the Standards of Practice Handbook, Lemay"s most appropriate initial course of action would be to:

A. refrain from discussing the information with anyone.
B. Encourage the company to make the information public
C. Disclose the information to her firm's compliance personnel.
D. Disclose the information to four equally important sell-side analysts so that the information is distributed in an equitable manner.

QUESTIONS 139 THROUGH 152 RELATE TO QUANTTATIVE ANALYSIS AND ARE ALLOCATED 21 MINUTES.

139. An analyst gathered the following information about a common stock for 2005:

Price per share on 1 January	€ 35
Price per share on 31 December	€ 37
Dividends paid per share	€ 4

The holding period return on the stock for the year ended 31 December 2005 was closest to:

A. 5.4%
B. 5.7%
C. 16.2%
D. 17.1%

140. When the risk-free rate of return is 4 percent, an investor's portfolio has a mean return of 13.5 percent and a Sharpe ratio of 0.3. The portfolio's coefficient of variation is closest to:

A. 2.27
B. 2.35
C. 3.33
D. 4.74

141. On 1 January, an investor's portfolio is valued at $1,000,000. The investor wants to make a donation to charity on 31 December of the same year, but does not want the year-end portfolio value to fall below $1,000,000. The expected annual return on the investor's existing portfolio is 10 percent with a variance of 144. If the investor wants a safety-first ratio of at least 0.5, the maximum amount the investor should plan to donate is closest to:

A. $40,000
B. $50,000
C. $60,000
D. $83.333

142. When considering the following four measures, which one measure compared to the other three would most likely provide different risk rankings for an asymmetric distribution?

A. Semivariance.
B. The Sharpe ratio.

C. Standard deviation.
D. The coefficient of variation

143. An analyst gathered the following information about the monthly returns over the same time period from two diversified investment portfolios:

	Portfolio X	Portfolio Y
Mean	1.1%	1.1%
Median	1.0%	1.2%
Mode	0.9%	1.3%

The analyst stated that Portfolio X is negatively skewed and Portfolio Y is positively skewed. Is the analyst correct with respect to:

	Portfolio X?	Portfolio Y?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

144. Using Chelyshev's inequality , what is the proportion of observations from a population of 230 that must be within three standard deviations of the mean regardless of the shape of the distribution?

A. 67%
B. 75%
C. 88.9%
D. 99%

145. An analyst stated that for a given investment portfolio, both the money-weighted rate of return and the time-weighted rate of return are affected by cash additions to or withdrawals from the portfolio. Is the analyst correct with respect to the:

	Money-weighted rate of return?	Time-weighted rate of return?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

146. If a normal distribution has a mean of 15 and a variance of 200, the standardized value for an

observation that has a value of 12 is closest to:

A. −0.2121
B. −0.0150
C. 0.0150
D. 0.2121

147. An analyst gathered the following information about a portfolio's performance over the past ten years:

Mean annual return	11.8%
Standard deviation of annual returns	15.7%
Portfolio beta	1.2

If the mean return on the risk-free asset over the same period was 5.0%, the coefficient of variation and Sharpe ratio, respectively, for the portfolio are closest to:

	Coefficient of variation	Sharpe ratio
A.	0.75	0.36
B.	0.75	0.43
C.	1.33	0.36
D.	1.33	0.43

148. An investor currently holds the following portfolio of common stocks:

Stock	Market Value	Expected Annual Return	Expected Standard Deviation of Returns
A	£30,000	12%	20%
B	£70,000	14%	25%

The expected correlation of returns between Stock A and Stock B is +0.5.
The investor sells Stock A and uses the £30,000 proceeds to purchase another stock that has the same expected annual return and standard deviation of returns as Stock A., but has an expected correlation of returns with Stock B of +0.7. Will the investor's action increase the portfolio's expected:

	Annual return?	Standard deviation of return?
A	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

149. An analyst asked an associate to evaluate the performance of group of mutual funds over a selected period of time. The associated calculated the following performance statistics.

Mutual Fund	Geometric Mean Return	Arithmetic Mean Return	Standard Deviation	Mean Absolute Deviation
1	12.5%	15.2%	19.8%	24.6%
2	11.9%	13.3%	16.4%	18.2%

The analyst suspects that the associate has made some errors in calculating the performance statistics. Based only on the expected mathematical relationships between the two measures of return and between the two measures of dispersion calculated by the associate, did the associate most likely make errors in calculating the statistics associated with:

	Mutual Fund 1 ?	Mutual Fund 2 ?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

150. A regression using monthly returns on a sector fund as the dependent variable and monthly returns on a market index as the independent variable resulted in the following selected statistics:

R-squared	0.608
Standard error (%)	2.212
Observations	36
Intercept (%)	-0.106
Slope coefficient	1.188

If the market index is expected to return 0.3 percent, the predicted return on the sector fund is closest to:

A. 0.11%
B. 0.25%
C. 0.56%
D. 0.66%

151. An analyst gathered the following information:

Portfolio	Mean Return	Standard Deviation of Return
1	9.8%	19.9%
2	10.5%	20.3%

3	13.3%	33.9%
4	15.8%	49.3%

If the risk-free rate of return is 3.0 percent, the portfolio that had the best risk-adjusted performance based on the Sharpe ratio is:

A. Portfolio 1
B. Portfolio 2
C. Portfolio 3
D. Portfolio 4

152. The covariance of returns for two stocks:

A. has a value between –1.0 and +1.0.
B. will be equal to zero if the variances of the returns for the two stocks are the same.
C. Will be negative if an average inverse relationship exists between returns for the two stocks.
D. Has a value equal to the weighted average of the variances of the returns for two stocks.

QUESTIONS 153 THROUGH 164 RELATE TO ECONOMIC ANALYSIS AND ARE ALLOCATED 18 MINUTES.

153. If implementation of a restrictive monetary policy is anticipated by decision makers, that policy will most likely have the same effect in the short run compared to the long run on:

A. Real variables but not on nominal variables.
B. Nominal variables but not on real variables.
C. Both real variables and nominal variables.
D. Neither real variables nor nominal variables.

154. Will a shift to a more restrictive monetary policy most likely result in a decrease in real output in the short run if decision makers:

	anticipate the shift in policy ?	do not anticipate the shift in policy?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

155. An analyst stated that, for the typical company, accounting profit tends to be greater than economic profit because explicit costs are generally not included in calculating accounting profit. Is the analyst correct with respect to the:

	Relationship between accounting profit and economic profit?	Inclusion of explicit costs?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	yes

156. A compared with acting independently, a group of oligopolistic companies operating with perfect cooperation will most likely experience an increase in:

A. both output and prices.
B. Neither output nor prices.
C. Output and a decrease in prices.
D. Prices and decrease in output.

157. Will a shift to a more restrictive macroeconomic policy most likely result in decreased economic output in the short run, according to the:

	Adaptive expectations hypothesis?	Rational expectations hypothesis?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

158. Are consumer indifference curves for two goods for any one individual likely to:

	Slope downward to the right?	Cross one another at any point?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

159. All else being equal, which of the following is least likely to result in the appreciation of a country's currency?

A. A decrease in that country's inflation rate.
B. A decrease in that country's real interest rate.
C. Monetary policies that increasingly support price stability.
D. An unanticipated shift by that country to a more restrictive monetary policy.

160. An analyst gathered the following information about two countries:

Country	Daily Output of Food per Worker	Daily Output of Shoes per Worker
1	4	10
2	3	2

Given the information above, will Country 1:

	Have an absolute advantage over Country 2 In the production of both food and shoes?	Most likely benefit by engaging In trade with Country 2?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

161. A news article makes the following statements:

- "Full employment indicates no structural unemployment."
- "The natural rate of unemployment measures the portion of the unemployment rate that is related to recessionary business conditions."

Are the article's statements correct with respect to:

Full employment?	The natural rate of unemployment?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

162. According to the new classical model, a reduction in current taxes that is financed by government borrowing will most likely increase:

A. household saving but not real interest rates.
B. Real interest but not household saving.
C. Both household saving and real interest rates.
D. Neither household saving nor real interest rates.

163. Costs included in the determination of a company's economic profit that are most likely to be included in that company's accounting costs are:

A. Explicit costs.
B. Implicit costs.
C. Opportunity costs associated with labor provided by the company's owners.
D. Opportunity costs associated with equity capital provided by the company's owners/

164. Challenges to implementing a discretionary fiscal stimulus in a timely manner are least likely to include the:

A. Government payments for unemployment benefits.
B. Need to convince lawmakers that action must be taken.
C. Inability of policymakers to forecast a recession precisely.
D. Amount of time needed for a tax cut to have an effect on the economy.

QUESTIONS 165 THROUGH 198 RELATE TO FINANCIAL STATEMENT ANALYSIS AND CORPORATE FINANCE AND ARE ALLOCATED 51 MINUTES.

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

165. An analyst gathered the following information about a company:

Cost of goods sold	$18.4 million
Average inventory	$2.5 million
Receivables turnover	24 times
Payables payment period	25 days

The company's cash conversion cycle is closest to:

A. 40 days.
B. 59 days.
C. 65 days
D. 90 days

166. An analyst prepared common-size balance sheets for the two companies operating in the same industry. The analyst noted that both companies had the same 2.0 current ratio and 0.3 cash ratio as well as the same proportion of current liabilities, long-term liabilities, and shareholders' equity. The main difference between the two companies was that Company 1 had a quick ratio of 0.5 and Company 2 had a quick ratio of 0.8. The most reasonable conclusion is that, compared with Company 2, Company 1 had a:

A. higher percentage of assets associated with inventory.
B. High salvage value estimates and long average lives.
C. Low salvage value estimates and short average lives.
D. High salvage value estimates and short average lives.

167. All else equal, the net profit margin for a company will be highest if, for new depreciable assets, that company uses:

A. Low salvage value estimates and long average lives.
B. High salvage value estimates and long average lives.
C. Low salvage value estimates and short average lives.
D. High salvage estimates and short average lives.

168. An analyst gathered the following information about three equipment sales that a company made at the end of the year:

	Original Cost	Accumulated Depreciation at Date of Sale	Sales Proceeds
1	$200,000	$150,000	$70,000
2	$200,000	$200,000	$30,000
3	$300,000	$200,000	$40,000

All else equal for that year, the company's cash flow from operations will most likely be:

A. $40,000 less than net income.
B. $10,000 less than net income.
C. $10,000 more than net income.
D. $40,000 more than net income.

169. During period of rising prices and stable inventory quantities, compared to using the LIFO method, will a company using the FIFO method most likely experience a higher:

	Inventory turnover ratio?	Accounts receivable turnover ratio?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

170. At the beginning of the year, a lessee company entered into a new capital lease agreement. The lease payments are $100,000 annually and are due at the end of each year for five year. The appropriate discount rate is 12 percent. Depreciation is on a straight-line basis with zero salvage value. With respect to the effect of the lease on the company's financial statements in the first year of the lease, which of the following is most accurate? The reduction in the company's:

A. Pretax income is $72,096.
B. Cash flow from financing is $56,742.
C. Cash flow from operation is $72,096
D. Cash flow from operations is $115,353.

171. An analyst gathered the following information about a company:

Shares of common stock	1,000,000
Net income for the year	$1,500,000

Par value of convertible bonds with a 4 percent coupon rate	$10,000,000
Par value of cumulative preferred stock with a 7 percent dividend rate	$2,000,000
Tax rate	30 percent

The bonds were issued at par and can be converted into 300,000 common shares. All securities were outstanding for the entire year.
Diluted earnings per share for the company are closest to:

A. $1.26
B. $1.36
C. $1.46
D. $1.49

172. An analyst gathered the following information about a company:

	2003	2004	2005
Return on equity	19.2%	20.3%	21.8%
Return on total assets	8.4%	8.2%	8.0%
Total asset turnover	1.9	2.0	2.1

Based only on the information above, from 2003 to 2005,was there most likely a decrease in the company's:

Net profit margin?	Financial leverage?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

173. When a company reports a sale of accounts receivable but retains the effective credit risk for the uncollected receivables, the most likely result is that the company's:

A. Current assets are overstated.
B. Current liabilities are overstated.
C. Cash flow from operating activities is understated.
D. Cash flow from financing activities is understated.

174. The year-end balances in a company's LIFO reserve were $56.8 million in the company's financial statements for both 2004 and 2005, the measure that will most likely be the same regardless of whether the company used the LIFO or FIFO inventory method is the:

A. Current ratio.
B. Inventory turnover.
C. Gross profit margin.
D. Amount of working capital.

175. A. U.S. company's financial records indicate that the company entered into the following transactions during 2005:
Sold plant assets that cost $220,000 with accumulated depreciation of $60,000 for $180,000.
Purchased new plant assets for $140,000 cash.
Received dividends of $5,000
Issued bonds with a face value of $100,000 in exchange for plant assets worth $100,000.

Considering only the transactions indicated above, the company's cash flow from investing activities during 2005 would be closest to:

A. -$60,000
B. -$55,000
C. $40,000
D. $45,000

176. For the fiscal year ended 31 December 2005, a company failed to accrue wages of $60,000 and also failed to record the collection of accounts receivable of $80,000. the company's tax rate is 30 percent. The combined affect of the two errors is most likely to result in the company's net income for 2005 being:

A. overstated by $18,000
B. overstated by $42,000
C. understated by $6,000
D. understated by $14,000

177. An analyst gathered the following annual information ($ millions) about a company that pays no dividends and has no debt:

Net income	45.8
Depreciation	18.2
Loss on sale of equipment	1.6
Decrease in accounts receivable	4.2
Increase in inventories	3.4
Increase in accounts payable	2.5
Capital expenditures	7.3
Proceeds from sale of stock	8.5

The company's annual free cash flow ($ millions) is closest to:

A. 53.1
B. 58.4
C. 61.6
D. 64.0

178. Compared to expensing interest costs during the construction period associated with a particular company's self-constructed assets, will capitalizing the interest costs during that period most likely decrease the company's:

	Interest coverage ratio?	Cash flow from operations?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

179. An analyst gathered the following information about a company's two convertible bond issues that were both outstanding throughout 2005:

Size of Issue	Coupon Interest Rate	Number of common Shares if Converted
$10,000,000	6%	200,000
$15,000,000	5%	275,000

The company's 2005 basic earnings per share was $2.00 and the company's tax rate was 40 percent. With respect to computing 2005 diluted earnings per share, which of the following statements is most accurate?

A. Both issues are dilutive.
B. Both issues are antidilutive.
C. The 6% issue is dilutive and the 5% issue is antidilutive.
D. The 6% issue is antidilutive and the 5% issue is dilutive.

180. At the beginning of the year, a company issued a $1,000 face value bond. Interest on that bond is paid semiannually, the annual coupon rate on the bond is 9 percent, and the bond matures in ten years. The market rate of interest at the time the bond was issued was 10 percent on an annual basis. The amount of the initial liability recorded for this bond was closest to:

A. $938
B. $961

C. $1,000
D. $1.065

181. An analyst stated that, when inventory quantities are increasing and prices are rising, a lessee company that uses the FIFO inventory method and capital leases will most likely have a lower asset turnover ratio than if the company used the LIFO inventory method and operating leases. Is the analyst correct with respect to the asset turnover ratio and:

Inventory method?	Leases?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

182. A company's financial records indicate that the company entered into the following transactions at the end of 2005:

Issued long-tern debt	$200,000
Repaid short-term debt	$30,000
Purchased inventory for cash	$50,000
Purchased property, plant, and equipment for cash	$150,000

What is the most likely combined effect of the four transactions indicated above on the company's 2005 cash flow from:

	Operating activities?	Financing activities?
A.	-$80,000	$170,000
B.	-$80,000	$200,000
C.	-$50,000	$170,000
D.	-$50,000	$200,000

183. Greene Corporation uses the LIFO inventory method, but most of the other companies in Greene's industry use FIFO. Which of the following best describes one of the adjustments that would be made to Greene's financial statements to compare that company with other companies in the industry? To adjust Greene's ending inventory to the FIFO method, the amount reported for Greene's ending inventory should be:

A. increase by the ending balance in Greene's LIFO reserve.
B. decrease by the ending balance in Greene's LIFO reserve.
C. increase by the change in Greene's LIFO reserve for that period.
D. decrease by the change in Greene's LIFO reserve for that period.

184. Intangible assets reported on a company's balance sheet are least likely to include:

A. Patents.
B. Copyrights.
C. Trademarks
D. Oil and gas reserves.

185. After reviewing the footnotes to a company's financial statements, an analyst determined the following information:

- The company is a lessee with respect to warehouse facilities required for efficient operation of the business. The present value of lease payments for warehouse space is $40 million under capital leases.
- The present value of the company's obligations for warehouse space under operating leases is estimated to be $80 million.
- Other companies in the industry utilize approximately the same amount of warehouse space as the company, but own their facilities.

To compare the company with the industry, the most appropriate adjustment to the company's financial statements would be to add:

A. $80 million to both liabilities and assets.
B. $80 million to liabilities but not to assets.
C. $120 million to both liabilities and assets.
D. $120 million to liabilities but not to assets.

186. An analyst gathered the following information about a company's common stock:

1 Jan 2005	180,000 shares outstanding
1 May 2005	60,000 shares issued
1 Sept 2005	2 for 1 stock split

The number of common shares that should be used to calculate the company's 2005 basis earnings per share is closest to:

A. 220000
B. 240000
C. 440000
D. 480000

187. In 2005, a company reported net income of $130 million and cash flow from operations of $120 million. All else equal, the most likely explanation for the difference between net income

and cash flow from operations in 2005 is that the company:

A. Tightened credit policies and increased collection efforts during the year.
B. Purchased new property, plant, and equipment at the beginning of the year.
C. Sold a long-term investment for an amount equal to book value at the end of the year
D. Increased raw materials inventory in anticipation of increased sales at the end of the year.

188. A company using the LIFO inventory method reported a $20,000 decrease in the LIFO reserve during the year that reduced the LIFO reserve to $85000 at year-end. If the company had used FIFO instead of LIFO in that year, the company's financial statements would have reported:

A. a lower cost of goods sold, but a higher inventory balance.
B. A higher cost of goods sold, but a lower inventory balance
C. Both a lower cost of goods sold and a lower inventory balance
D. Both a higher cost of goods sold an a higher inventory balance

189. If a company underestimates the rate of inflation used in estimating a project's cost of capital but appropriately estimates that project's cash flows, which of the following is most likely to occur? The project's calculated:

A. net present value will be overstated.
B. Net present value will be understated.
C. Internal rate of return will be overstated.
D. Internal rate of return will be understated.

190. A company is evaluating the following four capital projects that have the same risk as the company:

Project	Estimated Internal Rate of Return	Estimated Net Present Value
1	12%	$0
2	16%	$5400
3	22%	$8230
4	26%	$9800

If the company accepts each project, the actual cash flows associated with each project are received as expected, and the company's weighted average cost of capital remains unchanged over the life of each project, the project that is most likely to exactly earn its estimated internal rate of return is project:

A. 1
B. 2

C. 3
D. 4

191. A company's existing capital structure is 40 percent debt and 60 percent common equity, which is the same as the company's target capital structure. The company's marginal tax rate is 30 percent. The company has determined that an independent capital project has an expected net present value of $20,000. The amount of the expected net present value that accrues to the company's creditors is closest to:

A. $0
B. $2400
C. $5600
D. $8000

192. The optimal capital structure for a company is best described as the capital structure the maximizes that company's:

A. stock price.
B. Earnings per share.
C. Price/earnings ratio.
D. Dividends per share.

193. A company with a weighted average cost of capital equal to 10 percent is considering two mutually exclusive projects that have the same risk as the company. In either case the company will, on a continuing basis, replace the project at the end of its useful life with an identical project. The following information relates to the two projects.

	Project 1	Project 2
Useful life	4 year	8 year
Net present value (NPV)	$16000	$32000

The most appropriate decision for the company is to accept:

A. both project because both have a positive net present value.
B. Only project 1 because the equivalent annual annuity is $5048
C. Only project 2 because the equivalent annual annuity is $5998
D. Either project because both have an equivalent annual annuity of $54000

194. An analyst computed a degree of operating leverage of 3.0 and a degree of financial leverage of 2.0 for a company. The analyst states that if the company's sales increase by 10 percent, the

company's earnings before interest and taxes (EBIT) should increase by 30 percent and the company's earnings per share (EPS) should increase by 50 percent. Is the analyst correct with respect to the percentage increase in:

	EBIT?	EPS?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

195. Does the conclusion that a company's dividend policy will affect the required rate of return equity for that company follow from the:

Bird-in-the-hand theory?	Tax preference theory?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

196. With respect to operating leverage, the breakeven point is best defined as the volume of sales at which:

A. Total costs equal total revenues, causing net income to equal zero.
B. Fixed costs equal variable costs, causing net income to equal zero.
C. Total costs equal total revenues, causing earnings before interest and taxed to equal zero.
D. Fixed costs equal variable costs, causing earnings before interest and taxes to equal zero.

197. A company that has a corporate beta of 1.2 is considering a capital project that has a beta of 1.36. Regardless of the expected rate of return on that project, will acceptance of the project most likely result in an increase in the company's:

Corporate beta?	Required rate of return on common stock?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

198. The common stock of a company has a beta of 1.1. The expected return on the overall market is 10 percent and the risk-free rate of return is 4 percent. The company paid a dividend of $1.50 per share on its common stock during the past year, and the company is expected to maintain a

constant 6 percent annual growth rate on its dividend indefinitely. The company's current stock price is $30 per share and the estimated flotation cost is 10 percent. The company 's cost of newly issued common stock (external equity) is closest to:

A. 10.6%
B. 11.3%
C. 11.6%
D. 11.9%

QUESTIONS 199 THROUGH 234 RELATE TO ASSET VALUATION AND ARE ALLOCATED 54 MINUTES.

199. An analyst gathered the following annual data for a company:

Return on assets	8.6%
Total assets/equity	2.3
Net income	£25,000,000
Dividends paid on common stock	£5, 000, 000

If no external financing is used, the company's estimated dividend growth rate is closest to:

A. 1.8%
B. 12.6%
C. 15.8%
D. 19.8%

200. If an industry is characterized by unequal market shares, a decrease in the equivalent number of firms in that industry is most likely to be associated with an increase in:

A. both competitive pressures in the industry and the industry's Herfindahl index.
B. Neither competitive pressures in the industry nor the industry's Herfindahl index.
C. Competitive pressures in the industry
D. The industry's Herfindahl index but with a decrease in competitive pressures in the industry.

201. An analyst gathered the following information about a company's common stock.

Price per share	€50
Expected dividend per share to be paid next year (D_1)	€3
Required rate of return	15%
Beta	1.1

If markets are in equilibrium, the expected constant dividend growth rate is closest to:

A. 6.0%
B. 9.0%
C. 13.6%
D. 16.5%

202. In an informationally sufficient securities market, does new information result in price adjustments that are:

	Biased?	Predictable?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

203. With respect to an investor's required rate of return, should a decrease in financial risk for a particular company he associated with a change in the:

	nominal risk-free rate used to value the company?	risk premium used to value the company?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

204. An analyst gathered the following information about a company:

Current annual earnings per share (E0) reported	£6.00
Current annual dividend per share (D0) paid on the company's common stock	£3. 00
Required rate of return on the company's common stock	16. 0%
Expected constant growth rate in earnings and dividends	8.0%

If markets are in equilibrium, which of the following statements best describes the company's price to earnings (P/E) ratios? The company's leading P/E ratio is:

A. Less than the company's trailing P/E ratio.
B. Greater than the company's trailing P/E ratio.
C. The same as the company's trailing P/E ratio because the company's dividend payout ratio remains constant.
D. The same as the company's trailing P/E ratio because the require rate of return on the company's stock remains constant.

205. Do the underlying assumptions of technical analysis include a belief that the market values of common stocks:

	instantly incorporate new information?	are determined by the interaction Of supply and demand?
A.	No	No
B.	No	Yes

C.	Yes	No
D.	Yes	Yes

206. An analyst developed the following expectations about two companies and their respective common stocks:

	Beltway, Inc.	Waldorf Company
Earnings per share	$1.35	$1.50
Dividend payout ratio	45%	45%
Dividend growth rate	6%	7%
Required rate of return	12%	14%

Based on the analyst's expectations, compared to Beltway, does Waldorf have a lower:

	Return on equity?	Intrinsic common stock value?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

207. An investor borrowed the maximum amount allowed by the initial margin requirement of 40 percent to purchase 100 shares of a stock selling at $60 per share. If the stock price increases to $70 per share, the investor's return before commissions and interest is closest to:

A. 16.7%
B. 27.8%
C. 41.7%
D. 60.0%

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

A. price to cash flow ratios but not price to earnings ratios.
B. Price to earnings ratios but not price to cash flow ratios.
C. Either price to cash flow ratios or price to earnings ratios.
D. Neither price to cash flow ratios nor price to earnings ratios.

209. An analyst gathered the following information about four common stock that all have the same dividend payout ratio:

Stock	Required Rate of Return	Dividend Growth Rate
1	15.6%	7.4%
2	16.1%	8.2%
3	16.5%	8.8%
4	18.5%	9.0%

The highest earnings multiplier (price earnings ratio) would most likely be associated with stock:

A. 1
B. 2
C. 3
D. 4

210. A company's $100 par perpetual preferred stock has a dividend rate of 7 percent and a required rate of return of 11 percent. The company has beta of 0.9. If the market price per share for the stock is $70, the perpetual preferred stock is most appropriately described as being:

A. Properly valued.
B. Overvalued by $6.36
C. Undervalued by $0.71
D. Undervalued by $31.00

211 The shape of the graphs that illustrate the value at expiration and profit for a covered call position is most similar to the shape of the graph for:

A. selling a put
B. buying a put
C. selling a call
D. buying a call.

212. A series of interest rate put options expiring on different dates but having the same exercise rate is best characterized as a(n)

A. zero-cost collar.
B. Interest rate cap
C. Interest rate floor.
D. Interest rate collar.

213. The party making the fixed-rate payment under a swap contract could also have to make the variable payment on that contract if the payments are related to a(n):

A. Equity swap.
B. Currency swap.
C. Interest rate swap
D. Plain vanilla swap.

214. An analyst stated that, compared with transactions in the futures markets, transactions in the forward markets involve greater credit risk and offer fewer opportunities for customization. Is the analyst correct with respect to transactions in the forward markets and:

	Credit risk?	Customization?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	yes

215. An analyst stated that both a protective put position and buying a call option offer no upper limit to the potential gain. Is the analyst's statement correct with respect to:

A protective put position?	Buying a call option?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

216. An investor establishes a short position in futures contract by depositing enough funds to just meet the initial margin requirement of $5 per contract. The Day 0 price per contract is $100 and the maintenance margin requirement per contract is $3. The Day 1 settlement price that would require the investor deposit additional funds on Day 2 equal to $4 per contract is closest to:

A. $96
B. $97
C. $103
D. $104

217. With respect to the income approach to real estate valuation, the most appropriate item to be included in calculating a property's annual net operating income is:

A. Utilities for the property.
B. Depreciation on the property.

C. Interest payments associated with the property's proposed financing.
D. Principal payments associated with the property's proposed financing.

218. An analyst stated that compared to investment in actively-managed mutual funds. Investment in exchange traded funds (ETFs) involves higher expense ratios and higher exposure to taxes on capital gains distributions. Is the analyst correct with respect to:

	Expense ratios?	Exposure to taxes?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

219. An investor gathered the following annual information about a proposed real estate investment:

Gross potential rental income	$95400
Proposed amount of financing	80%
Interest on investor's proposed financing	$31500
Estimated vacancy and collection losses	4%
Insurance and taxes	$9800
Electricity and water	$7500
Repair and maintenance	$13300
Depreciation	$15000

Using a market capitalization rate of 14 percent, the property's value according to the income approach is closest to:

A. $103000
B. $328000
C. $356000
D. $436000

220. Would hedge funds that contain infrequently traded assets most likely exhibit an upward bias with respect to:

	measured risk?	correlations with conventional equity returns?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

221. An analyst stated that successful investing in venture capital projects typically requires both a long time horizon and intense investor participation. Is the analyst correct with respect to:

Time horizon?	Investor participation?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

222. If some hedge funds fail to comply with performance presentation standards, data from hedge fund databases and indexes that includes those funds will most likely suffer from biases that overstate measures related to:

A. Return but not risk
B. Risk but not return.
C. Both return and risk
D. Neither return nor risk.

223. If market yield are expected to change by 100 basis points, which of the following is the most accurate statement about the price of an option-free bond that has a duration of 6.0. Compared with the estimated new price for that bond using duration alone, the actual price of that bond following the 100 basis point change in market yields will be:

A. Lower if yields increase, but higher if yields decrease.
B. The same if yields increase, but higher if yields decrease.
C. Higher, regardless of the direction of the change in market yields.
D. Higher if the bond was selling at a discount, but lower if the bond was selling at a premium.

224. Embedded options that are designed to benefit bondholders (investors) include:

A. the accelerate sinking fund provision but not the cap on a floater.
B. The cap on a floater but not the accelerated sinking fund provision.
C. Both the accelerated sinking fund provision and the cap on a floater.
D. Neither the accelerated sinking fund provision nor the cap on a floater.

225. An analyst determined that if interest rates increase 120 basis points the price of a bond would be 89.7 but if interest rates decrease 120 basis points the price of that bond would be 99.3. If the initial price of the bond is 95.4 the approximate percentage price change for a 100 basis

point change in yield is closest to:

A. 2.5
B. 4.2
C. 10.0
D. 10.6

226. All else equal, an increase in expected yield volatility to most likely to result in an increase in the price of a(n):

A. Putable bond.
B. Callable bond.
C. Option-free bond selling at a discount to par.
D. Option-free bond selling at a premium to par.

227. All else equal, is the interest rate risk associated with a floating-rate security negatively related to:

the amount of time to the next coupon reset date?	an increase in the investor-required basis point margin over the reference rate?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

228. With respect to bonds with call options, the zero-volatility spread will most likely be:

A. equal to the option-adjusted spread.
B. Less than the option-adjusted spread.
C. Greater than the option-adjusted spread.
D. Derived using only one point on the yield curve.

229. An analyst stated that computing both a bond's current yield and a bond's yield to refunding assumes that all interim cash flows from the bond are reinvested at that bond's yield to maturity. Is the analyst correct with respect to interim cash flows and computing a bond's:

Current yield?	Yield to refunding?
A. No	No
B. No	Yes
C. Yes	No

D. Yes	Yes

230. A zero-coupon bond issued three years ago with a par value of $1000 has seven years remaining to maturity. If the annual rate associated with the bond is 8 percent, the value of the bond is closest to:

A. $456
B. $463
C. $577
D. $583

231. With respect to analyzing yield spreads measures designed for use in time :eriods that re characterized by different levels of interest rates include:

A. The yield ratio but not the relative yield spread.
B. The relative yield spread but not the yield ratio.
C. Both the yield ratio and the relative yield spread.
D. Neither the yield ratio nor the relative yield spread.

232. A bond with a par value of $1000 has a duration of 6.2. If the yield on the bond is expected to change from 8.80 percent to 8.95 percent, the estimated new price for the bond following the expected change in yield is best described as being:

A. 0.93% lower than the bond's current price.
B. 0.93% higher than the bond's current price
C. 1.70% lower than the bond's current price.
D. 1.70% higher than the bond's current price.

233. According to the pure expectations theory, can an upward-sloping yield curve exist now if expectations are that interest rates in the future will:

Rise?	Be unchanged?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

234. A callable bond with a 6 percent annual coupon rate and 7 years to maturity currently has a yield to maturity of 7.5 percent. The bond is most likely to exhibit negative convexity if market

yields:

A. Increase by 30 basis points.
B. Decrease by 30 bass points.
C. Increase by 200 basis points.
D. Decrease by 200 basis points.

QUESTIONS 235 THROUGH 240 RELATE TO PORTFOLIO MANAGEMENT AND ARE ALLOCATED 9 MINUTES.

235. In the context of capital market theory and the capital asset pricing model (CAPM), the average investor is least likely to be compensated for assuming risk that can be:

A. reduced by diversification.
B. Related to interest rate volatility.
C. Related to changes in macroeconomic variables.
D. Measured by the standard deviation of returns of the market portfolio.

236. With respect to the capital asset pricing model, should investors expect higher returns for accepting increasing amounts of:

	Unsystematic risk?	Systematic risk?
A.	No	No
B.	No	Yes
C.	Yes	No
D.	Yes	Yes

237. An investor currently holds a portfolio that is expected to return 12 percent. The investor is planning to sell one of the securities included in the current portfolio that has an expected return of 14 percent and use the proceeds to purchase a security that has an expected return of 13 percent. Compared to the investor's current portfolio, the expected return for the investor's revised portfolio will be:

A. above 12 percent whether or not any change occurs in the standard deviation of the portfolio
B. below 12 percent whether or not any change occurs in the standard deviation of the portfolio
C. above 12 percent only if the covariance of the new security is lower than the covariance of the security that was sold.
D. Below 12 percent only if the standard deviation of the new security is higher than the standard deviation of the security that was sold.

238. An investor has a portfolio that lies on the capital market line (CML). According to capital market theory, if that investor has more than 100 percent of his wealth invested in the market portfolio, the investor has a portfolio:

A. with less unsystematic risk than the market portfolio.
B. With more unsystematic risk than the market portfolio.
C. Located on the CML to the left of the market portfolio.

D. Located on the CML to the right of the market portfolio.

239. Given no major change in asset risk characteristics, will an increase in the willingness of investors to accept risk typically result in a decrease in:

Yield spreads?	The slope of the security market line?
A. No	No
B. No	Yes
C. Yes	No
D. Yes	Yes

240. The major source of the variation in a portfolio's returns over time has been found to be:

A. Inflation.
B. The asset allocation decision.
C. The investment manager's skill with respect to market timing.
D. The investment manger's skill with respect to security selection.