

2007 December CFA Level 1 – Sample Exam 5 Answers

Q1. A Study Session 1-2-a

CFA Institute's Standards do not require members/candidates to report such activity.

Q4. C Study Session 1-2-a

CFA Institute's Standard on Investment Analysis, Recommendations, and Actions requires members/candidates to have a reasonable and adequate basis for their recommendations. Anali relied solely upon NCC for the information he used in putting together his research report. He did not have a reasonable and adequate basis for writing a research report about the company.

Standard V: Investment Analysis, Recommendations, and Actions.

Q7. A Study Session 1-2-a

The potential for clients to obtain influence to the detriment of other clients, although present, is not as great as in situations where no compensation arrangement exists. Therefore, members may accept gifts from clients but must disclose to their employers such benefits.

Q8. A Study Session 1-4-b,g

Firms claiming compliance with the GIPS Standards are encouraged, but not required to undertake the verification process, which is defined as the review of a firm's performance measurement processes and procedures by an independent third-party verifier.

Q9. A Study Session 1-2-a

Copying any material from other sources without acknowledgement, including plain-language descriptions of general concepts, is a violation of the Standard relating to misrepresentation.

Q10. D Study Session 2-7-h

The coefficient of variation is the ratio of the standard deviation of a set of observations to their mean value. This scale-free measure permits direct comparisons of dispersion across different data sets.

Q12. D Study Session 3-10-i

The Student's t-distribution has fatter tails than the normal distribution, or for a high number of degrees of freedom, has tails that resembles the normal distribution.

Q13. D Study Session 3-11-b

Failing to reject a false null hypothesis results in making a Type II error.

Q14. C Study Session 3-7-h

The Sharpe ratio is a relative measure that equals excess return of a portfolio (mean return less the risk free rate) divided by the standard deviation of the portfolio.

Q15. C Study Session 3-12-b

The relationship between variables A and B is perfect positive correlation (1.0) and the relationship between variables A and C is perfect negative correlation (-1.0).

Q23. A Study Session 7-34-c

The amount of cash recorded is identical for both methods and is equal to the total cash received less total costs incurred. At the end of Year 2, a total of \$3.9 million had been billed for and collected and \$3.9 million in costs had been incurred.

Q24. D Study Session 7-35-v, 7-36-b

An increase in net working capital investment because of the lower balance in accounts payable would reduce cash flow from operations relative to net income

Q25. C Study Session

Because the liability and interest expense recorded are both based on market rates of interest when the bond was issued, not the coupon rate on the bond. The market value of the bond at issuance was \$1,039.56 ($FV=1000$, $PMT=50$, $N=10$, $I/Y=4.5$). Interest expense is the market rate at date of issuance multiplied by the balance of the liability. $(\$1,039.56)(0.045)=\46.78

Q26. A Study Session: 9-41-c

Straight-line depreciation $(75,000-5,000)/8=\$8,750$, units-of-production $((75,000-5,000)/400,000) \times 42,000=\$7,350$

Q28. A Study Session 9-40-a

As long as inventory quantities are stable or increasing, the LIFO method provides the best matching of revenue and cost; the FIFO method better reflects current inventory costs for balance sheet purposes.

Q 29. A Study Session 10-45-d

An increases interest rates would reduce the market value of the debt and produce an economic gain for the issuing company; a change in market interest rates would not affect the amount of debt recorded on the issuing company's balance sheet.

Q30. C Study Session 10-46-c

The adjustment would increase both assets and debt. The increase in assets would reduce the return on assets and the increase in debt would increase the debt-to-equity ratio.

Q31. B Study Session 10-44-e

The company has a net deferred tax liability; a decrease in tax rates will reduce liabilities and increase equity.

Q32. C Study Session 9-40-c

A LIFO liquidation matches old inventory costs with current revenues, and can produce an increase in the gross profit margin.

Q33. C Study Session 10-46-b

Cash flow from operations will be reduced more under the operating lease (lease payment) than the capital lease (interest payment) and cash flow from financing will be reduced by more under the capital lease (principal payment) than the operating leases. The use of an operating lease will not affect cash flow from financing.

Q34. D Study Session 7-33-c

Comprehensive income includes unrealized gains and losses on available-for-sale securities and comprehensive income is included in the statement of stockholder's equity.

Q35 D Study Session 11-50-f

The correct sequence of the order of dates is declaration date, ex-dividend date, holder-of –record date, and payment date.

Q36. A. Study Session 11-49-a,b

The use of additional debt in a firm's capital structure will increase financial leverage, thereby increasing financial risk.

Q37 A Study Session 11-50-e

Buying shares back in the open market gives the company the greatest flexibility and in the shareholders' minds acts as a floor for the share price.

Q39. B Study Session 11-51-g

Cumulative voting allows shareholders to cast the cumulative number of votes allotted to their shares for one or a limited number of Board nominees, thus increasing the likelihood that their interests are represented on the Board

Q40. A Study Session 13-55-d

A security market in which all the bids and asks for a stock are gathered to arrive at a single price that satisfies most of the orders is a call market.

Q41. A Study Session 14-61-e

Both the ability to integrate backwards and the standardization of products decrease supplier power. Backward integration means buyers could cut out the supplier if they chose to do so and if raw materials are standardized, consumers can easily switch between suppliers.

Q42. A Study Session 13-57.a

The weak-form EMH assumes that current stock prices fully reflect all security market information.

Q44. B Study Session 14-61-a

The economy picks up from its slowdown or recession during the Recovery Stage and the country's cyclical stocks and commodities are considered to be attractive investment holdings during this stage.

Q45. C Study Session 14-64-b

Common	#	of	shares	Book	value	per	Price-to-book ratio
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shareholders' equity	outstanding	share	
$4+12+5-3=\$18\text{m}$	$2-0.2=1.8\text{m}$	$18/1.8=\$10$	$20/10=2.0\text{x}$

Q46. C Study Session 17-76-f

The maximum value of a call option is the underlying price; it makes no sense to pay more for the right to buy the underlying than the value of the underlying itself, and the maximum value of an American put is the exercise price because the best outcome would be if the stock fell to zero, the holder could capture the value of the exercise price.

Q47. D Study Session 17-77-b

A plain vanilla interest rate swap is a contract where one party pays fixed while the counterparty pays floating, both in the same currency.

Q48. B Study Session 17-75-f

Eurodollar futures contracts do not permit actual delivery of a Eurodollar time deposit; the contracts must be settled in cash.

Q49. D Study Session 18-79-e,f

Both statements are true. An ETF does not require investors who remain in the fund to pay capital gain taxes due to redemptions by others. The in-kind redemption feature of an ETF means that the fund itself does not have to sell stocks to make redemptions. Because market makers are instrumental in the ETF creation and redemption processes, arbitrage helps keep the price of an ETF more in line with its underlying value (NAV)

Q50. D Study Session 18-79.w

A collateralized Commodity futures position is a viable risk-diversification strategy because Commodities have a negative correlation with stock and bond returns and a positive correlation with inflation.

Q51. A Study Session 18-79.p

The fee charged by a fund of funds is in addition to that charged by each hedge fund, so the fees would most likely increase.

Q52. C Study Session 15-68.e

$$(7.59-5.63)/5.63=34.8\%$$

Q54. B Study Session 16-70.c

Future value = \$1,000; payment=\$ 25; n=6; i=2; resulting in a present value of \$ 1.028.01.

Q55. A Study Session 15-67.c

While the coupon rate itself is fixed, the coupon payment amounts are not as they change with the adjustment in the par value. The par value. The par values are not fixed as they adjust with change in the level of inflation.

Q56. B Study Session 16-71.c

In order to realize the 6% yield, the reinvestment income required is:

$$\$925.61(1.03)^{20} - \$1000 - \$500 = \$171.75.$$

Q57. D Study Session 16-70.d

Bond 1 is currently selling at a discount to par and Bond 2 is selling at a premium to par. If the discount rate does not change for either bond, Bond 1 will increase in price because of the passage of time, but Bond 2 will decrease in price.

Q58. A Study Session 12-53.f

Holding other factors constants, the lower the correlation of returns the higher the diversification benefit. The standard deviation (risk) of the portfolio will decrease as correlations decrease; the expected return remains the same.

Q59. B Study Session 12-53.f

The average covariance of a stock's returns with returns of all other stocks in a portfolio is the most important factor to consider when adding a new stock to a portfolio. Adding a stock whose returns are less than perfectly positively correlated with the returns of the other stocks in the portfolio will cause the total standard deviation of the portfolio to be lower than the weighted average of the components' standard deviations. This is the benefit of diversification.

Q60. D Study Session 12-53.h

The optimal portfolio will be different for investor with different levels of risk aversion, yet it will always lie on the efficient frontier, not inside or outside the curve.