

## 2006 Level 1 Sample Exam Volume 3

### Answers

1 c

Members are obligated to disclose to clients any consideration or benefit received by the member for the recommendation of any services to the client. The disclosure should include the nature and value of the benefit.

3 B

Factual information published by recognized financial and statistical reporting services can be used without acknowledgement.

5 C

Members have a responsibility to deal with all clients Fairly. The shares should be allocated to those accounts for which the shares were originally intended, regardless of the profitability of the trade.

9 B

Disclosure of the definition of firm used to determine the firm's total assets and firmwide compliance is required by the Global Investment Performance Standards; disclosure of the calculation method used by the firm is recommended.

11 B

Arithmetic mean:

$$\text{Reston} = (15.3 - 8.2 + 22.8) / 3 = 9.97\%; \text{Yau} = 9.83\%$$

Geometric mean:

$$\text{Reston} = (1.153 \times 0.918 \times 1.228)^{1/3} - 1 = 9.13\%; \text{Yau} = 9.83\%$$

12 B

All else equal, investors would prefer a greater probability of large gains (positive skewness) and would prefer higher excess return per unit of risk (higher Sharpe ratio)

13B

A nominal scale uses numbers only to categorize a particular attribute such as investment style or asset type; the only measure of central tendency that can be used is the mode.

16 B

Each screen is independent; the joint probability (2.4 percent) is the product of each of the individual probabilities.  $0.024 \times 500 \text{ stocks} = 12 \text{ stocks}$

20 D

Bond 2 has greater default risk than bond 1; Bond 2 has less maturity risk than Bond 3.

21 B

Because it takes time to gather reliable information about economic performance, a time period exists between an actual change in economic conditions and the recognition of the change by policymakers. This time period is called the recognition lag.

22 B

If an expansionary monetary policy is unanticipated, the short-run effects will be an increase in real output and employment and a decrease in the real interest rate.

23 A

An 8-K must be filed with the SEC when there is a change in auditors.

26 A

Both the coefficient of variation of operating earnings and the coefficient of variation of sales are used to measure the business risk of a company. Business risk refers to the uncertainty caused by the company's industry products, customers, or the way the company produces its products

27 C

The collection of accounts receivable would increase cash flow from operations \$20,000. The repayment of short term debt would have no effect on cash flow from operations; it would be included in cash flow from financing.

28 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 purpose.

31 B

If construction-in-progress exceeds billings, a company with a continuing flow of profitable long-term contracts using the percentage-of-completion method will have higher total assets, lower total liabilities, and higher equity compared to using the completed contract method.

32 A

An increase in 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.

33 A

$ROE = \text{Profit Margin} \times \text{Total Asset Turnover} \times \text{Financial Leverage}$

$30\% = \text{Profit Margin} \times 2.5 \times 2.2$

$\text{Profit Margin} = 5.45\%$

35 A

Given the company's dividend payout ratio, the amount of the expected addition to retained

earnings is \$66 million; the amount of new capital that could be raised without issuing new common stock is \$165 million. Because \$150 million is less than the break point for retained earnings, the component cost of equity is the cost of  $(0.5 \times 6\%) + (0.1 \times 10\%) + (0.4 \times 14\%)$

36 C

The component cost of equity will increase as financial risk increase.

37 C

The tax preference theory incorporates three tax-related issues that would all increase investors' preference for low dividend payouts; the bird-in-the-hand theory relates to the proposition that investors prefer high dividend payouts because high payouts reduce uncertainty.

43 A

In an informationally efficient securities market, price adjustments are assumed to be rapid but not perfect; the adjustment is unbiased, but the market may over or under adjust and investors cannot predict which will occur.

44 B

A short seller borrows stock from another investor and must pay any dividends due on that stock to the lender the corporation pays the dividend to the investor who purchased the stock from the short seller.

47 C

A call option is out of the money if the stock price is less than the exercise price

50 D

Arbitrage strategies result in option-like distributions that violate the assumption of normal distributions. Hedge funds using these strategies tend to bias traditional measures of risk such as standard deviation and traditional VaR; the risk or loss is understated

51 C

Counterparty credit risk results from an investment in derivatives;

52 A

the longer a bond's maturity and the lower a bond's coupon rate, the greater the bond's price sensitivity to changes in interest rate; (the greater the bond's interest rate risk)

54 D

The shape of the price/yield relationship for an option-free bond is convex and the capital gain that will be realized if yields decrease is greater than the capital loss that will be realized if yields increase by the same number of basis points.

57 C

$(8.59\% + 6.83\%) / 6.83\% = 25.8\%$