2006 Level 1 Sample Exam Volume 1 Answers

1. B.
Departing employees have a duty to act in the best interest of their employer until their resignations become effective. Spain was not acting in the best interest of his employer by telling clients of his impending departure.

2. B
A firm must initially show GIPS-compliant history for a minimum of five years, or since inception if the firm has been in existence for less than five years.

3. D
Moses violated the Standard that requires members to have a reasonable and adequate basis, supported by appropriate research and investigation, for investment recommendations or actions. Moses' buy recommendation was not supported by appropriate research and investigation.

4 D
When the applicable law states that the law of the locality where the business is conducted governs and that law is less strict than the Code and Standards, the member must adhere to the Code and Standards.

5 B
Clark may use the nonpublic information because none of the information is material

6 A
Warren informed her supervisor in writing of the gift as required by the Standards.

8 A
The fact that Moore has demonstrated an ability to pick takeover candidates does not imply that he has access to material nonpublic information regarding Megamove. Roberts has no reason to believe that the information was anything more than an opinion expressed by the broker.

9 D
The Standard prohibiting misrepresentation applies to all oral and written forms of communication, including electronic communications.

10 D
the null hypothesis in this case is that the parameter of interest (slope) is equal to zero. Acceptance of the null hypothesis means that the statistical analysis indicates that changes in the independent variable do not explain changes in the dependent variable.

11 B
There are seven annual periods between 1 January 1996 and 31 December 2002:

$\$100,000(1.05)^7=\$140,710$

12 C
The arithmetic average of the squared deviations around the mean is the variance. The standard deviations is the positive square root of the variance and is denominated in the same units as the original data.

13 C
Expected value=0.12
Variance=0.0008
Standard deviation=0.0283

14 D
The coefficient of variation is a measure of relative dispersion that indicates how much dispersion exists relative to the mean of the distribution. The coefficient of variation is the standard deviation divided by the mean.

15 B
The standard normal distribution (unit normal distribution) has a mean of zero and a standard deviation of one.

16 C
In a normal distribution, about 95 percent of the observations will fall within +/-2 standard deviations of the mean:
$100 -2(30)=$40 and $100+2(30)=$160

17 B
The crowding-out model suggests that budget deficits are associated with higher real interest rates, a decline in private investment, an inflow of capital from abroad, appreciation of the domestic currency, and a decline in net exports.

18 C
At less-than-full employment, an expected increase in the growth rate of the money supply will initially reduce the real rate of interest, increasing the demand for goods and services

21 B
Automatic stabilizers tend to create a budget deficit during an economic recession and a budget surplus during an economic boom; a balanced federal budget, by definition, creates neither deficit nor surplus.

22 B

Generally, when the price of a product increases, consumers reduce consumption by a larger amount in the long run than in the short run; this relationship between elasticity and time is referred to as the second law of demand.

23 C
All costs incurred to establish the economic feasibility of software should be expensed as incurred. Once economic feasibility is established, subsequent costs can be capitalized.

24 A
Payment of the note would reduce both current assets and current liabilities by the same amount. With the current ratio at 2.0, however, the reduction in current liabilities would be greater than the reduction in current assets on a relative basis. The current ratio would increase. Assets are reduced and sales remain the same; the asset turnover ratio would increase.

25 C
Growth is a function of the firm's earnings retention rate and the firm's return on equity. All else equal, the firm with the higher retention rate (lower dividend payout rate) will experience higher growth in earnings per share..

26 D
Present value of lease payments on 1 January 2003: $1,006,512.
Balance remaining on 1 January 2004:$937,033
2004 interest:$74,963
Interest coverage ratio for 2004;
$370,000/$74,963=4.94

27 C
The return on equity is equal to the equity turnover multiplied by the net profit margin;4.2χ5.5%=23.1%

28 C
The appropriate adjustment is to increase both accounts receivable and current liabilities by the amount of the receivables sold that have not yet been collected. Total debt-to-equity ratio; $140,000/$80,000=1.75

29 B
Cash flow from operations, prepared using the direct method, is $30,000; $150,000-$60,000-$40,000-$20,000=$30,000

30 D
In periods of rising prices and stable or increasing inventory quantities, using FIFO instead of LIFO will result in higher income before taxes, income taxes, net income, and assets. Cost of goods sold and cash flow will be lower with FIFO.

31 C

The timing difference results in an increase in deferred tax liability; ($333,000-$100,000)× 0.40=$93.200

32 A

Basic earnings per share is equal to income available to common stockholders divided by the weighted average number of common shares outstanding;
($10,500,000-$2,000,000)/24,500,000 shares=$0.35

33 D

Each component of the deferred tax liability should be analyzed to evaluate the likelihood of reversal or continued growth;

34 C

A LIFO liquidation will match old inventory costs with current revenues, inflating gross margins and taxable income. Higher taxes will result in lower cash flow for the firm.

36 B

If a project with a net present value greater than hero has an internal rate of return of 12 percent, the weighted average cost of capital for the firm must be less than 12 percent . Reinvesting the project's cash flows at less than 12 percent would be expected to result in a realized return lower than 12 percent but higher than the firm's cost of capital.

37 D

Initial investment outlay; $80,000+$20,000+$10,000=$110,000
Final year total cash flow; ($25,000*0.70)+($20,000*0.30)+$5,000=$28,500

38 B

A dividend policy based on a strict residual model means the firm pays dividends only if it has earnings above the amount required to fund its optimal capital budget; all else equal, the greater the investment opportunities; the lower the dividend payout.

39 D

No tax adjustment is made because dividends paid on preferred stock are not tax deductible; $3.50/$47.00=0.0745 or 7.45%

40 C

In a market-value-weighted index, the total ending market value for the securities is divided by the beginning market value for the securities to determine the percentage of change, which in turn is applied to the beginning index value;
$1,100,000/$1,030,000=1.06796
1.06796X100=106.796

41 A

If the dividend is expected to remain constant, the value of the stock is determined by dividing the amount of the dividend by the required rate of return for the stock; $2.10/0.11=$19.09

42 C
All else equal, the higher the earnings retention ratio, the higher the company's growth rate. The higher the growth rate, the higher the company's earnings multiplier.

43 C
Expected earnings per share is expected net income divided by common shares outstanding; S459,000/120,000 shares=$3.83

44 C
Short sellers must post the same margin as investors who had acquired the stock.

45 D
The existence of a market anomaly indicates that stock prices do not always behave as predicted by the efficient market hypothesis

46 D
In the futures markets, the clearinghouse conducts a daily settlement. Holders of futures positions must maintain balances above a level called the maintenance margin requirement. The maintenance margin requirement is lower than the initial margin requirement.

47 C
The put cost is $2 and the value at expiration is $4; the net profit is $2.

48 A
The breakeven value of the asset is the difference between the current price of the asset and the amount received for writing the call; $75-$5=$70

49 D
The market price of a closed-end investment company's shares is determined in the secondary markets in which the shares trade.

50 A
The capitalization rate is equal to the annual net operating income divided by the estimated market value of the property; $250,000/$2,750,000=0.0909 or 9.09%

51 C
All other factors constant, the longer a bond's maturity and the lower the bond's coupon rate, the greater the bond's price sensitivity to changes in interest rates.

52 D
The value at expiration of a long position in a call option is either zero or the difference between the

stock price and the exercise price, whichever is higher. The value cannot be negative.

53 B

For securities with embedded options, a change in yield may substantially change the expected cash flows. Effective duration takes into account how the expected cash flows may change;

54 B

The one year forward rate at t+2=(1+three-year spot)^3/(1+two-year spot)^2-1
=(1.331/1.265625)-1=0.051654 or 5.17%

55 C

On 1 June 2003, the bond has seven years to maturity, an annual coupon payment of $80, and a discount rate of 7.1%. The value of the bond is $1,048.33 or 104.833% of par.

56 C

A bond issue that is nonrefundable prohibits the borrower from obtaining lower-cost funds to pay off the bonds. The holder of the bonds is protected from early redemption only if interest rates decline.

57 A

The floor on a floater benefits the bondholder when interest rates fall.

58 C

Movement along the security market line (SML) reflects a change in the risk associated with a specific investment. A shift in the SML affects all investments, as in the case, for example, of a change in the expected rate of inflation. A change in the slope of the SML affects all risky investments and results from a change in investors' Willingness to accept risk.

59 C

The nominal risk-free rate of return includes the real risk-free rate (time value of money) plus the expected rate of inflation. The risk premium (composite of all uncertainty) is added to the nominal risk-free rate to obtain the required rate of return.

60 A

The efficient frontier represents that set of portfolios having the maximum rate of return for every given level of risk, or the minimum risk for every given level of return.