

Question #1 of 60

B) IV(A) Loyalty.

Explanation

Topel recommended the stock to his superiors, but they chose not to buy it. While Topel should not buy the stock in advance of his recommendation, he is not prohibited from purchasing it for himself should the company choose not to act. Kennedy's research may have been thorough, and there is no evidence that she violated the reasonable-basis Standard. However, the loyalty Standard requires that Kennedy put Samson Securities' interest before her own and not deprive her employer of her skills and abilities. Since Kennedy spent five days of company time researching Koral Koatings, the company has a right to benefit from her research.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #2 of 60

C) Neither gift would result in a violation.

Explanation

The Koons's gift does not violate Standard I(B). According to the standard, gifts from clients are different from gifts from other parties because the potential for obtaining influence to the detriment of other clients is not as great. Therefore, according to the standard, Garvey may accept the Koons's gift as long as she discloses it to her employer, which she did.

The Jones's gift is a bonus from a job that does not compete with Garvey's work for Samson, and as such, does not violate the Standard. The fact that Jones is a Samson client is irrelevant in terms of this gift, as there is no information in the vignette about Garvey providing investment-related services for Jones.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #3 of 60

C) Neither purchase was a violation.

Explanation

Topel's purchases of Vallo do not violate Standard II(A) because it was not based on material nonpublic information, and he has no duty to keep the information to himself. Therefore, Garvey's purchase of Vallo for her own account is also consistent with Standard II(A).

The brokers discussing Metrona mentioned that their star analyst came out with a report with a "buy" recommendation that morning, which suggests that the information has already been made public. Therefore, Garvey's purchase of Metrona for her own account is consistent with Standard II(A).

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #4 of 60

B) Standard V(A) Diligence and Reasonable Basis.

Explanation

Garvey's idea for a growth estimate is interesting, but a number of factors affect the growth rate of a beverage company, many arguably more so than GDP growth. In addition, it is not sufficient to use two years worth of quarterly data (eight observations) to estimate a regression model and forecast growth over the following three years. The research was not thorough enough to satisfy Standard V(A).

Standard I(C) as it deals with plagiarism was not violated because the consensus GDP estimates were derived from a recognized reporting service.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #5 of 60

C) Both statements are violations.

Explanation

In the first statement, Garvey accurately calls herself a Level III CFA candidate, but she is not permitted to project when she will receive the charter, as she must still meet the work and eligibility restrictions and pass the Level III exam. Therefore, the first statement violates Standard VII(B).

In the second statement, the use of the CFA mark as a noun also violates the Standard VII(B).

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #6 of 60

B) Nagoree is permitted to buy the stock after disclosing his wife's ownership to his supervisor and to the trustees of all the pension funds he manages.

Explanation

Nagoree is obligated to disclose conflicts in any matter that may potentially affect the member's ability to make an unbiased recommendation. The Research Objectivity Policy of the Research Objectivity Standards (ROS) requires that a formal written policy be established on the independence and objectivity of research, and this policy should require disclosure of any conflicts of interest. Additionally, Standard VI(A) Disclosure of Conflicts requires this disclosure to employer, clients, and prospective clients.

For Further Reference:

Study Session 1, LOS 3.b

SchweserNotes: Book 1 p.81

CFA Program Curriculum: Vol.1 p.212

Question #7 of 60

- C) Harris may not accept the trip because the offer from Quadrangle could impede her ability to make objective investment decisions on behalf of the client.

Explanation

Standard I(B) Professionalism: Independence and Objectivity prohibits members and candidates from accepting any gift that reasonably could be expected to compromise their independence and objectivity. The purpose of the gift appears to be to ensure that Islandwide continues to do business with Quadrangle and can be seen, therefore, as a clear attempt to influence her choice of brokers in the future.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #8 of 60

- C) Both are in violation.

Explanation

Standard II(A) Integrity of Capital Markets: Material Nonpublic Information prohibits members and candidates who possess material nonpublic information to act on or cause others to act on that information. Information disclosed to a select group of analysts is not made "public" by that fact.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #9 of 60

- C) must disclose the offer from Adams to her employer if she accepts it but must receive her employer's permission to accept the offer from Baker.

Explanation

Standard I(B) Professionalism: Independence and Objectivity indicates that gifts from clients are seen to less likely affect a member's independence and objectivity, and only disclosure is required. The offer from Baker is based on future performance and is seen to carry greater risk of affecting objectivity because preferential treatment for one client could be detrimental to others. Thus, according to Standard IV(B) Duties to Employer: Additional Compensation Arrangements, Harris must disclose the offer to her employer (in writing) and receive the employer's permission before accepting the offer from Baker.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #10 of 60

- C) There is no violation.

Explanation

Michaels has not violated Standard II(B) Integrity of Capital Markets: Market Manipulation by either of these actions. In neither case is there the intent to mislead market participants. A large buy program may well increase the price of a stock. The trading desk has informed market participants that they will create additional liquidity for a period of 90 days after the offering and created no expectation that the liquidity of the stock will permanently remain at that level.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #11 of 60

A) secure written permission from her employer before performing services for the symphony.

Explanation

According to Standard IV Duties to Employers, Swamy must secure written permission before undertaking the investment advisory work for the symphony because this work competes with her employer and could create a conflict of interest, as she is receiving compensation in the form of season tickets. Her service on her brother-in-law's board may be subject to employer rules about outside employment but is not covered by the Standard because there is no likely competition or potential conflict with her employer. The question says *most likely*, so it is important to focus on the key difference between the two outside activities. Both are compensated; the fact that one is cash and the other tickets is irrelevant. The key difference is that for the symphony, Swamy is acting as an investment advisor for a large endowment, which clearly competes with her employer's business.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #12 of 60

C) Both actions are violations.

Explanation

Standard III(B) Fair Dealing requires that shares of an oversubscribed IPO be prorated fairly to all subscribers. Arbitrarily increasing the allocation to the "problem client" is a violation, as is the resulting underallocation to the remainder of the firm's clients.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #13 of 60

A) 150.67.

Explanation

We must start by calculating the JPY/EUR spot rate. This is a simple algebra problem. We know that the JPY/USD spot rate is 120 and the EUR/USD spot rate is 0.7224. Dividing JPY/USD by EUR/USD leaves us with JPY/EUR. Plugging in the numbers, we get a JPY/EUR spot rate of 166.113 ($= 120 / 0.7224$). Next, we estimate the JPY/EUR spot rate two years from now using the relative PPP formula (for two years):

$$E(S_1) = S_0 [(1 + i_{JPY})^2 / (1 + i_{EUR})^2] = 166.113 [(1)^2 / (1.05)^2] = 150.67$$

For Further Reference:

Study Session 4, LOS 13.g

SchweserNotes: Book 1, p.249

CFA Program Curriculum: Vol.1 p.522

Question #14 of 60

B) Neither forecast is consistent.

Explanation

Using the international Fisher relation, we can solve for the inflation forecasts in Japan and Europe, given interest rate differentials and the U.S. inflation forecast:

$$R_{\text{nominal}_A} - R_{\text{nominal}_B} = E(\text{inflation}_A) - E(\text{inflation}_B)$$

For Japan: $7.00\% - 3.88\% \neq 3\% - 0\%$

For Eurozone: $9.08 - 7.00 \neq 5\% - 3\%$

Both implied inflation rates are inconsistent with the forecasts from the econometrics department.

For Further Reference:

Study Session 4, LOS 13.e

SchweserNotes: Book 1, p.242

CFA Program Curriculum: Vol.1 p.518

Question #15 of 60

A) 116.50.

Explanation

Uncovered interest rate parity forecast:

$$120(1.0388) / (1.07) = 116.50$$

For further reference:

Study Session 4, LOS 13.g

SchweserNotes: Book 1 p.249

CFA Program Curriculum: Vol.1 p.522

Question #16 of 60

C) its USD reserves.

Explanation

Under Mundell-Fleming model, an expansionary monetary policy would lead to depreciation of the JPY. Under a fixed exchange rate regime, to counteract the depreciation of the JPY, the Japanese government has to support its currency by purchasing it in the market. This action is limited by its foreign currency reserves.

For further reference:

Study Session 4, LOS 13.k

SchweserNotes: Book 1 p.257

CFA Program Curriculum: Vol.1 p.555

Question #17 of 60

C) One currency should be left unhedged and the other should not.

Explanation

This question requires you to look at deviations from international parity conditions and then determine whether those deviations will tend to work to the advantage of the customer. In this problem, you are given the necessary information to examine parity conditions using relative purchasing power parity (RPPP). For the JPY, RPPP tells us that, since the spot rate one year ago was 116, the spot rate today should be (JPY is considered the foreign currency):

$$S_{\text{today (assuming RPPP held)}} = S_{\text{last year}} \left[\frac{1 + i_{\text{JPY}}}{1 + i_{\text{USD}}} \right] = 116 \left[\frac{1.00}{1.03} \right] = 112.62$$

Since the expected spot rate today, based on RPPP (i.e., 112.62), is not equal to the actual spot rate today (i.e., 120), RPPP did not hold over the past year. Since the actual rate is higher than the rate forecast by RPPP, the long-term trend based on deviations from international parity conditions will be for the rate to fall and the JPY to appreciate. Hence, using deviations from parity conditions as indicators of future currency movements, the bank should recommend that the JPY exposure be left unhedged.

Using the same RPPP process for the EUR exposure, we can calculate an RPPP spot rate today of 0.7340 (given that the rate was 0.72 one year ago).

$$S_{\text{today (assuming RPPP held)}} = S_{\text{last year}} \left[\frac{1 + i_{\text{EUR}}}{1 + i_{\text{USD}}} \right] = 0.72 \left[\frac{1.05}{1.03} \right] = 0.7340$$

Again, RPPP did not hold (i.e., the actual rate today, 0.7224, is not equal to the RPPP rate that should exist today given the inflation rates). However, for the EUR case, the RPPP expected spot is higher than the actual spot, indicating that the EUR may be currently overvalued and, thus, more likely to depreciate in the future. EUR exposure should be hedged.

For Further Reference:

Study Session 4, LOS 13.g

SchweserNotes: Book 1, p.249

CFA Program Curriculum: Vol.1 p.522

Question #18 of 60

C) the USD is trading above value implied by trends following trading rules.

Explanation

Bank should advise their clients to close out their FX carry trades when the volatility implied by market prices of options on equities or currency is high. Since option prices are positively related to volatility, higher option prices are correct signals for closing out FX carry trades. Trend following trading rules can also be used for risk management in FX carry trades. We are given that the bank's clients are long BU and hence would be concerned when the BU was trading above its value implied by the trend following trading rule. If USD is trading above its trend following trading rule, the BU would be trading below and therefore it is not a correct indicator for closing out FX carry trades.

For Further Reference:

Study Session 4, LOS 13.i, p

SchweserNotes: Book 1, p.255, 261

CFA Program Curriculum: Vol.1 p.539, 576

Question #19 of 60

C) No No

Explanation

Subsidiaries whose operations are well integrated with the parent will use the parent's currency as the functional currency. When the functional currency is the same as the parent's presentation currency (reporting currency), as it is in this case, the temporal method is used. Therefore, Statement 1 is incorrect.

Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the local currency as the functional currency. When the functional currency is not the same as the parent's presentation currency (reporting currency), as in this case, the current rate method is used. Therefore, Statement 2 is incorrect.

For Further Reference:

Study Session 5, LOS 18.d

SchweserNotes: Book 2 p.63

CFA Program Curriculum: Vol.2 p.134

Question #20 of 60

A) lower because the U.S. dollar depreciated during fiscal 2008.

Explanation

Sales will be lower after translation because of the depreciating U.S. dollar.

For Further Reference:

Study Session 5, LOS 18.e

SchweserNotes: Book 2 p.69

CFA Program Curriculum: Vol.2 p.143

Question #21 of 60

B) Depreciation expense and cost of goods sold.

Explanation

Depreciation expense and COGS are remeasured at the historical rate under the temporal method. Under the current rate method, depreciation and COGS are translated at the average rate. Because the U.S. dollar is depreciating, depreciation expense and COGS are lower under the current rate method.

For Further Reference:

Study Session 5, LOS 18.e

SchweserNotes: Book 2 p.69

CFA Program Curriculum: Vol.2 p.143

Question #22 of 60

B) A loss of CAD 31,200 is recognized in the income statement.

Explanation

Since the subsidiary's operations are highly integrated with the parent, the temporal method is used. Accordingly, a loss of CAD 31,200 is recognized in the parent's income statement (see balance sheet and income statement worksheet below). However, no calculations are actually necessary to answer this question. The parent has a net monetary asset position in the subsidiary (monetary assets > monetary liabilities). Holding net monetary assets when the foreign currency is depreciating will result in a loss. Under the temporal method, the loss is reported in the income statement. Only choice B satisfies this logic.

The Canadian dollar is the functional currency because the subsidiary is highly integrated with the parent. Therefore, the temporal method applies.

Step 1: Remeasure the balance sheet using the temporal method.

	2008 (USD)	Rate	2008 (CAD)
Cash and account receivables	775,000	1.32	1,023,000
Inventory (given in Item 9)	600,000	Given	810,000
PP&E (net)	730,000	1.50	1,095,000
Total assets	<u>2,105,000</u>		<u>2,928,000</u>
Accounts payable	125,000	1.32	165,000
Long-term debt	400,000	1.32	528,000
Common stock	535,000	1.50	802,500
Retained earnings	1,045,000	(a)	1,432,500
Total liabilities and shareholders' equity	<u>2,105,000</u>		<u>2,928,000</u>

(a) Retained earnings is a plug figure that makes the accounting equation balance
 CAD 2,928,000 assets – CAD 165,000 accounts payable – CAD 528,000 long-term debt – CAD 802,500 common stock = CAD 1,432,500.

Step 2: Derive net income from the beginning and ending balances of retained earnings and dividends paid as follows:

	CAD	
Beginning retained earnings	1,550,000	Given Item 6
Net income	(83,250)	Calculate
Dividends paid in the year	(34,250)	(25,000 × 1.37 historical rate)
Ending retained earnings	<u>1,432,500</u>	From Step 1

Step 3: Remeasure the income statement using the temporal method.

	2008 (USD)	Rate	2008 (CAD)
Sales	1,352,000	1.35	1,825,200
Cost of goods sold (given Item 11)	(1,205,000)	Given	(1,667,250)
Depreciation expense	(140,000)	1.50	(210,000)
Remeasurement loss		(b)	(31,200)
Net income	<u>7,000</u>	From Step 2	<u>(83,250)</u>

(b) The remeasurement loss is a plug that is equal to the difference in net income of
 –CAD 83,250 and income before remeasurement of –CAD 52,050 (CAD
 1,825,200 sales – CAD 1,667,250 COGS – CAD 210,000 depreciation).

For Further Reference:

Study Session 5, LOS 18.e

SchweserNotes: Book 2 p.69

CFA Program Curriculum: Vol.2 p.143

Question #23 of 60

A) higher.

Explanation

The local currency (the USD) is depreciating, so the historical rate will be higher than the current rate. Fixed asset turnover (sales divided by net PP&E) will be higher under the current rate method. Net PP&E will be translated at the lower current rate, and because sales are the same under both methods, the ratio will be higher.

If you want to do the calculations, net PP&E under the current rate method is $\text{USD}730,000 \times 1.32\text{CAD/USD} = \text{CAD } 963,600$, and fixed asset turnover is $\text{CAD } 1,825,200/\text{CAD } 963,600 = 1.9$ times. Fixed asset turnover under the temporal method is $\text{CAD } 1,825,200/\text{CAD } 1,095,000 = 1.7$ times.

For Further Reference:

Study Session 5, LOS 18.e

SchweserNotes: Book 2 p.69

CFA Program Curriculum: Vol.2 p.143

Question #24 of 60

C) Different Same

Explanation

Return on assets prior to translation will be different than the ratio after translation because the numerator (net income) is translated at the average rate, and the denominator (assets) is translated at the current rate using the current rate method.

Net profit margin will be the same because both the numerator (net income) and the denominator (sales) are translated at the average rate using the current rate method.

For Further Reference:

Study Session 5, LOS 18.f

SchweserNotes: Book 2 p.77

CFA Program Curriculum: Vol.2 p.153

Question #25 of 60

B) \$20,000.

Explanation

The excess of purchase price over the pro-rata share of the book value of Optimax is allocated to PP&E. The remainder is goodwill.

Purchase price (in thousands)	\$300
Less: Pro-rata share of Optimax	<u>210</u> [$\$600 \text{ Optimax book value} \times 35\%$]
Excess of purchase price	90
Less: Excess allocated to PPE	<u>70</u> [$(\$1,200 \text{ fair value} - \$1,000 \text{ book value}) \times 35\%$]
Acquisition goodwill	\$20

For further reference:

Study Session 5, LOS 16.c

SchweserNotes: Book 2 p.24

CFA Program Curriculum: Vol.2 p.35

Question #26 of 60

B) \$345,500.

Explanation

Under the equity method, Wayland recognizes its pro-rata share of Optimax's net income less the additional depreciation that resulted from the increase in fair value of Optimax's PP&E.

Pro-rata share of Optimax's net income $\$87,500$ [$\$250,000 \times 35\%$]

Less: Additional depreciation from PPE	<u>7,000</u> [(\$200,000 / 10 years) × 35%]
Equity income	\$80,500

Wayland's investment account on the balance sheet increased by its equity income and decreased by the dividends received from the investment.

Beginning investment account	\$300,000
Equity income from Optimax	80,500
Less: Dividends received	<u>35,000</u> [\$100,000 dividends × 35%]
Ending investment account	\$345,500

For further reference:

Study Session 5, LOS 16.b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #27 of 60

A) \$2,625.

Explanation

Since all of the profit from the intercompany transaction is included in Optimax's net income, Wayland must reduce its equity income of Optimax by the pro-rata share of the unconfirmed profit. Since half of the goods remain, half of the profit is unconfirmed. Thus, Wayland must reduce its equity income \$2,625 [(\$15,000 total profit × 50% unconfirmed) × 35% ownership interest].

For further reference:

Study Session 5, LOS 16.b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #28 of 60

C) Debt securities that meet the business model test and the cash flow characteristic test must be measured at amortized cost.

Explanation

Under IFRS 9 (new standards), equity investments that are held for trading must be measured at fair value through profit or loss. Other equity investments can be measured at fair value through profit or loss or fair value through OCI and the choice is irrevocable. Debt securities that meet the business model and cash flow characteristic test must be measured at amortized cost *except when such measurement results in accounting mismatch in which case the debt securities can be classified as fair value through profit or loss.*

For further reference:

Study Session 5, LOS 16.a

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #29 of 60

A) U.S. GAAP only.

Explanation

Under the current standards, IFRS typically does not allow reclassification of investments into and out of fair value through profit or loss category and reclassification of investments out of held-for-trading category. U.S. GAAP does permit securities to be reclassified into or out of held-for-trading or designated at fair value.

For further reference:

Study Session 5, LOS 16.a, b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #30 of 60

B) \$45,000 profit.

Explanation

The change in market value for the period and dividends received from the investment are recognized in the income statement for trading securities. In 2008, there was a \$25,000 unrealized gain on the original 25,000 shares $[25,000 \text{ shares} \times (\$76 - \$75)]$ and a \$10,000 unrealized loss on the shares purchased in 2008 $[5,000 \text{ shares} \times (\$76 - \$78)]$. Wayland received \$30,000 in dividends from Vanry $(30,000 \text{ shares} \times \$1 \text{ per share})$. For 2008, the income statement impact is a \$45,000 profit $(\$25,000 \text{ unrealized gain on original shares} - \$10,000 \text{ unrealized loss on increase in shares} + \$30,000 \text{ dividends received})$.

For further reference:

Study Session 5, LOS 16.a, b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #31 of 60

B) Only Statement 1 is correct.

Explanation

Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.

Residual income models are applicable even when dividends are volatile.

For Further Reference:

Study Session 11, LOS 33.j

SchweserNotes: Book 3 p.215

CFA Program Curriculum: Vol.4 p.482

Question #32 of 60

C) High persistence factor.

Explanation

A high persistence factor will be associated with low dividend payments, which is exactly the case with Schubert.

A low persistence factor will be associated with significant levels of nonrecurring items. However, Schubert has very few nonrecurring items (which would suggest a high persistence factor).

For further reference:

Study Session 11, LOS 33.h

SchweserNotes: Book 3 p.209

CFA Program Curriculum: Vol.4 p.475

Question #33 of 60

A) \$36.43 \$0.38

Explanation

Beginning book value (B_{t-1}) \$32.16 (\$4,181,000 / 130,000)

Beginning book value = Total Equity

= Common shares + Retained earnings

= 2,100,000 + 2,081,000 = \$4,181,000

Earnings per share forecast (E_t) \$4.50 (given)

Dividend forecast ($D_t = E_t \times \text{payout ratio}$) \$0.23 (\$4.50 \times 5%)

Forecast book value per share ($B_{t-1} + E_t - D_t$) \$36.43

Equity charge per share ($r \times B_{t-1}$) \$4.12 (0.128 \times \$32.16)

Per share RI [$(E_t - (r \times B_{t-1}))$] \$0.38 (\$4.50 - \$4.12)

For further reference:

Study Session 11, LOS 33.c

SchweserNotes: Book 3 p.203

CFA Program Curriculum: Vol.4 p.467

Question #34 of 60

A) \$179,361 \$188,450

Explanation

Economic value added (EVA) is calculated as follows:

\$WACC = WACC \times total capital (beginning of 2008)

Note that total capital = net working capital + net fixed assets OR book value of long-term debt + book value of equity

= 0.119 \times (\$6,200,000 + \$3,281,000) = \$1,128,239

EVA = NOPAT - \$WACC

= EBIT(1 - t) - \$WACC

= \$1,868,000(1 - 0.30) - \$1,128,239

= \$179,361

market value of the company (year-end 2008) = market value of the equity + market value of the debt

= (\$36 \times 130,000) + (0.95 \times 6,211,000)

= \$10,580,450

market value added (MVA) = market value - total capital

= \$10,580,450 - (\$6,211,000 + \$2,100,000 + \$2,081,000) = \$188,450

For further reference:

Study Session 11, LOS 33.a

SchweserNotes: Book 3 p.200

CFA Program Curriculum: Vol.4 p.460

Question #35 of 60

B) 2.75%.

Explanation

$$g = r - \frac{[B_0 \times (ROE - r)]}{V_0 - B_0}$$

$$B_0 = [(2,100,000 + 2,081,000)] / 130,000 = \$32.16$$

r = cost of equity = 12.8%

$$g = 0.128 - \frac{[32.16 \times (0.14 - 0.128)]}{36 - 32.16}$$

$$= 0.0275 = 2.75\%$$

For further reference:

Study Session 11, LOS 33.g

SchweserNotes: Book 3 p.208

CFA Program Curriculum: Vol.4 p.475

Question #36 of 60

A)

foreign currency gains and losses under the current rate method.

Explanation

The clean surplus relationship (i.e., ending book value = beginning book value + net income - dividends) may not hold when items bypass the income statement and affect equity directly. Foreign currency gains and losses under the current rate method bypass income statement and are reported under shareholders equity as CTA. Changes in the market value of trading securities are included in net income and do not violate the clean surplus relationship. Changes in working capital do not bypass the income statement. [Usually, changes in working capital do not affect the income statement. When they do (e.g., inventory writeoffs, bad debts, etc.), the income statement will not be bypassed.]

For further reference:

Study Session 11, LOS 33.k

SchweserNotes: Book 3 p.216

CFA Program Curriculum: Vol.4 p.483

Question #37 of 60

A) \$14.50.

Explanation

According to the H-model:

$$V_0 = \frac{D_0(1 + g_L)}{r - g_L} + \frac{D_0 H(g_S - g_L)}{r - g_L} = \frac{\$1 \times (1 + 0.04)}{0.12 - 0.04} + \frac{\$1 \times 3 \times (0.08 - 0.04)}{0.12 - 0.04} = \$14.50$$

For Further Reference:

Study Session 10, LOS 30.I

Question #38 of 60

A) Yes.

Explanation

The key assumption underlying the H-model is that the dividend growth rate declines linearly from a high rate in the first stage to a long-term level growth rate.

For Further Reference:

Study Session 10, LOS 30.i
SchweserNotes: Book 3, p.75
CFA Program Curriculum: Vol.4 p.224

Question #39 of 60

B) \$10.50.

Explanation

The relationship we need to evaluate is $V_0 = \frac{E_1}{r} + PVGO$.

This expression can be rewritten as $PVGO = V_0 - \frac{E_1}{r} = \$18 - \frac{\$0.90}{0.12} = \10.50 .

For Further Reference:

Study Session 10, LOS 30.e
SchweserNotes: Book 3, p.70
CFA Program Curriculum: Vol.4 p.218

Question #40 of 60

A) One statement is correct and the other statement is incorrect.

Explanation

The P/E ratio can become unreliable for ranking purposes when earnings are close to zero. When this happens, the P/E will be unrealistically large and its reciprocal, the earnings yield (E/P), will instead approach zero. Therefore, Statement 1 is correct. A high E/P suggests an underpriced security, and a low (or negative) E/P suggests an overpriced security. Therefore, Statement 2 is incorrect.

For Further Reference:

Study Session 11, LOS 32.d
SchweserNotes: Book 3, p.156
CFA Program Curriculum: Vol.4 p.353

Question #41 of 60

B) \$1.36.

Explanation

Earnings must be adjusted to reflect the nonrecurring extraordinary item restructuring costs and asset write downs.

Adjusted 2008 earnings before tax = \$30,400,000 + \$189,100,000 = \$219,500,000.
 Adjusted 2008 after-tax earnings = \$219,500,000 × (1 – 0.34) = \$144,870,000.
 2008 underlying EPS = \$144,870,000 / 106,530,610 = \$1.36

For Further Reference:

Study Session 11, LOS 32.c
 SchweserNotes: Book 3, p.156
 CFA Program Curriculum: Vol.4 p.352

Question #42 of 60

A) underpriced relative to the industry.

Explanation

$$\frac{\$18}{\left(\frac{\$6,435,900,000}{106,530,610} \right)} = \frac{\$18}{\$60.41} = 0.30.$$

FDS has a price-to-sales ratio in 2008 of:

Because its price-to-sales ratio is less than the industry average of 0.50, FDS is relatively underpriced.

For Further Reference:

Study Session 11, LOS 32.h, k
 SchweserNotes: Book 3, p.165, 174
 CFA Program Curriculum: Vol.4 p.363, 371

Question #43 of 60

C) 11.3%.

Explanation

Notice that in this case, $g_s = g_L$ and, accordingly, the H-model simplifies to the Gordon growth model. We can then solve for the unknown rate:

$$r = \frac{D_0 (1 + g_L)}{V_0} + g_L = \frac{\$1.25 \times (1 + 0.06)}{\$25} + 0.06 = 0.113 = 11.3\%$$

For Further Reference:

Study Session 10, LOS 30.m
 SchweserNotes: Book 3, p.85
 CFA Program Curriculum: Vol.4 p.237

Question #44 of 60

C) susceptible to manipulation with respect to revenue recognition.

Explanation

Among the choices given, the only drawback to the P/S ratio is that it is susceptible to manipulation if management should choose to act aggressively with respect to the recognition of revenue.

For Further Reference:

Study Session 11, LOS 32.c
 SchweserNotes: Book 3, p.156
 CFA Program Curriculum: Vol.4 p.352

Question #45 of 60

B) Overvalued Undervalued

Explanation

UHS trailing P/E = $\$25 / \$0.82 = 30.49$

UHS trailing PEG = $30.49 / 6\% = 5.08$

Trailing industry P/E = 22.50

Trailing industry PEG = $22.50 / 10\% = 2.25$

The PEG ratio for UHS exceeds that of the industry. This implies that UHS's growth rate is relatively more expensive than is the industry's growth rate. We can therefore conclude that on the basis of the PEG ratio, UHS stock is overvalued.

UHS P/S = $\$25 / (\$7,400,100,000 / 95,366,000) = 0.32$

Industry P/S = 0.50

Relative to the industry, the P/S ratio for UHS stock is low, and it would therefore be considered as undervalued.

Conflicting results between different ratios is common in practice. When this occurs, an analyst must look deeper to arrive at a reliable conclusion. An important consideration in this case is whether or not there has been any manipulation of sales and/or earnings. The estimation of the dividend growth rate is also an important factor.

For Further Reference:

Study Session 11, LOS 32.h, i

SchweserNotes: Book 3, p.165, 169

CFA Program Curriculum: Vol.4 p.363, 365

Question #46 of 60

B) \$1.00.

Explanation

Average ROE = $\frac{0.032 + 0.040 + 0.045 + 0.039}{4} = 0.039$

BVPS₂₀₀₈ = \$25.58

Normalized EPS = $\overline{\text{ROE}} \times \text{BVPS}_{2008} = 0.039 \times \$25.58 = \$1.00$

For Further Reference:

Study Session 11, LOS 32.e

SchweserNotes: Book 3, p.162

CFA Program Curriculum: Vol.4 p.354

Question #47 of 60

A) 20.7.

Explanation

Beta = 0.8

4-year average ROE = 3.9% (Question 34)

8-year dividend growth forecast = 6%

Predicted P/E = $5 - (10 \times 0.8) + (3 \times 3.9\%) + (2 \times 6\%) = 20.7$

For Further Reference:

Study Session 11, LOS 32.i

SchweserNotes: Book 3, p.169

CFA Program Curriculum: Vol.4 p.365

Question #48 of 60

B) relative-strength indicators.

Explanation

The belief that there are patterns of persistence or reversals in returns provides the rationale for valuation using relative strength indicators. There has been a considerable amount of empirical research in this area. Research suggests that the investment horizon is also an important determining factor in the appearance of these patterns.

For Further Reference:

Study Session 11, LOS 32.p

SchweserNotes: Book 3, p.180

CFA Program Curriculum: Vol.4 p.419

Question #49 of 60

C) Both statements are correct.

Explanation

Statement 1 is correct. If the volatility of interest rates decreases, the call option is less valuable, which increases the value of the callable bond. Recall that $V_{\text{callable}} = V_{\text{noncallable}} - V_{\text{call}}$. Statement 3 is also correct. The value of the noncallable bond increases by more than the callable bond because as yield falls, the value of the call goes up. As the call value increases, the callable value (noncall value – call option value) goes up by less than the noncall value.

For Further Reference:

Study Session 13, LOS 37.d, e

SchweserNotes: Book 4, p.58, 59

CFA Program Curriculum: Vol.5 p.120, 122

Question #50 of 60

B) Only Statement 4 is correct.

Explanation

Statement 2 is incorrect because the noncallable bond value *will be affected* by a change in the *level* of interest rates.

Statement 4 is correct because higher interest rate volatility will increase the value of the embedded put option and increase the value of the puttable bond.

For Further Reference:

Study Session 13, LOS 37.d, e

SchweserNotes: Book 4, p.58, 59

CFA Program Curriculum: Vol.5 p.120, 122

Question #51 of 60

A) 1.56.

Explanation

The answer is 1.56 and is found by taking the difference between the value of the callable and the noncallable bonds: Call option value = $99.77 - 98.21 = 1.56$. *Note: This is an example of a basic question that you should get right! Don't give up these points or lose time by starting a complicated calculation. The question might be as easy as it seems.*

For Further Reference:

Study Session 13, LOS 37.b

SchweserNotes: Book 4, p.55

CFA Program Curriculum: Vol.5 p.115

Question #52 of 60

B) Equal to 100% Positive

Explanation

In this case, the bond is callable and puttable at the same price (100). Because Walters states that the embedded options (the issuer's call option and the holder's put option) will be exercised if the option has value (i.e., is in-the-money), the value of the bond must be 100 (plus the interest) at all times. Why? If rates fall and the computed value goes above 100, the company will call the issue at 100. Conversely, if rates increase and the computed value goes below 100, the bondholder will "put" the bond back to the issuer for 100.

The OAS is a constant spread added to every interest rate in the tree so that the model price of the bond is equal to the market price of the bond. In this case, using the interest rate lattice, the model price of the callable bond is greater than the market price. Hence, a positive spread must be added to every interest rate in the lattice. When a constant spread is added to all the rates such that the model price is equal to the market price, you have found the OAS. The OAS will be positive for the callable bond.

For Further Reference:

Study Session 13, LOS 37.f, g

SchweserNotes: Book 4, p.55, 59

CFA Program Curriculum: Vol.5 p.125, 134

Question #53 of 60

B) 93.26% of par.

Explanation

The answer is 93.26. This value of the non-callable bond at node A is computed as follows:

$$\begin{aligned} \text{value} &= \frac{\left[0.5 \times \left(V_{\text{up}} + \frac{\text{coupon}}{2} \right) \right] + \left[0.5 \times \left(V_{\text{down}} + \frac{\text{coupon}}{2} \right) \right]}{\left(1 + \frac{\text{interest rate}}{2} \right)} \\ &= \frac{\left[0.5 \times \left(91.73 + \frac{6}{2} \right) \right] + \left[0.5 \times \left(96.17 + \frac{6}{2} \right) \right]}{\left(1 + \frac{0.0791}{2} \right)} = 93.26 \end{aligned}$$

For Further Reference:

Study Session 12, LOS 36.d

SchweserNotes: Book 4, p.37

CFA Program Curriculum: Vol.5 p.81

Question #54 of 60

A) 100.0% of par.

Explanation

The correct value is 100.00. The computed value of the callable bond at node A is obtained as follows:

$$\text{value} = \frac{\left[0.5 \times \left(100 + \frac{6}{2} \right) \right] + \left[0.5 \times \left(100 + \frac{6}{2} \right) \right]}{\left(1 + \frac{0.0315}{2} \right)} = 101.4$$

However, when working with a callable bond, you have to remember that the value of the bond at any node is the lesser of (1) the bonds computed value or (2) the call price. So, we have:

$$\text{value} = \min \left[100, \frac{\left[0.5 \times \left(100 + \frac{6}{2} \right) \right] + \left[0.5 \times \left(100 + \frac{6}{2} \right) \right]}{\left(1 + \frac{0.0315}{2} \right)} \right] = 100$$

In this case, since the computed value (101.4) is greater than the call price (100), the nodal value is \$100.

For Further Reference:

Study Session 13, LOS 37.f

SchweserNotes: Book 4 p.55

CFA Program Curriculum: Vol.5 p.125

Question #55 of 60

A) correct.

Explanation

Statement 1 is correct. Credit ratings tend to be stable over time and across business cycles, which has the effect of reducing price volatility in the debt market.

For Further Reference:

Study Session 13, LOS 38.c

SchweserNotes: Book 4 p.90

CFA Program Curriculum: Vol.5 p.192

Question #56 of 60

A) correct.

Explanation

Statement 2 is correct.

For further reference:

Study Session 13, LOS 38.a

SchweserNotes: Book 4 p.87

CFA Program Curriculum: Vol.5 p.185

Question #57 of 60

C) incorrect as structural models assume that default risk is constant over the life of the bond.

Explanation

One of the assumptions of structural models is that default risk is constant during the life of the bond and hence does not change over business cycles or in response to changing economic variables.

For further reference:

Study Session 13, LOS 38.f

SchweserNotes: Book 4 p.94

CFA Program Curriculum: Vol.5 p.210

Question #58 of 60

A) correct.

Explanation

Statement 4 is correct. Probability of default does not apply to asset-backed securities because ABS do not default when an underlying collateral defaults. For this reason, probability of loss is used in place of probability of default for ABS.

For further reference:

Study Session 13, LOS 38.i

SchweserNotes: Book 4 p.97

CFA Program Curriculum: Vol.5 p.218

Question #59 of 60

C) \$8.76.

Explanation

<i>Time to Cash Flow</i>	<i>Cash Flow</i>	<i>Risk-Free Rate</i>	<i>Spot Credit Spread (%)</i>	<i>Total Yield (%)</i>	<i>PV (Risk-Free Rate)</i>	<i>PV (Total Yield)</i>
0.5	25	0.23%	0.80%	1.03%	24.97	24.87
1	1,025	0.25%	0.85%	1.10%	<u>1,022.44</u>	<u>1,013.79</u>
				Total	\$1,047.47	\$1,038.66

$$PV(\text{risky } \$1,025) = 1,025 / e^{(1 \times 0.011)} = \$1,013.787$$

$$\begin{aligned} \text{Present value of expected loss} &= PV(\text{risk-free rate}) - PV(\text{total yield}) \\ &= 1,047.41 - 1038.66 = \$8.75 \end{aligned}$$

For Further Reference:

Study Session 13, LOS 38.h

SchweserNotes: Book 4, p.96

CFA Program Curriculum: Vol.5 p.214

Question #60 of 60

C) incorrect regarding specification of balance sheet composition being required.

Explanation

While Thompson's statement about reduced form models imposing assumptions on the output of structural models is correct, Thompson is incorrect about balance sheet composition being required; reduced form models do not require a specification of the company's balance sheet structure.

For Further Reference:

Study Session 13, LOS 38.f

SchweserNotes: Book 5, p.94

CFA Program Curriculum: Vol.5 p.210