2010 Level II Mock Exam: Morning Session

The morning session of the 2009 Level II Chartered Financial Analyst® Mock Examination has 60 questions. To best simulate the exam day experience, candidates are advised to allocate an average of 18 minutes per item set (vignette and 6 multiple choice questions) for a total of 180 minutes (3 hours) for this session of the exam.

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Theresa Lecompte Case Scenario

Theresa Lecompte, CFA, is an equity analyst for Topaz Group, a large full-service financial firm that offers insurance, investment banking, brokerage and investment management services. Topaz has adopted the CFA Institute Research Objectivity Standards to demonstrate their commitment to managing and fully disclosing conflicts of interest to all investors that have access to the firm's research.

Lecompte's primary responsibility is to follow the information technology sector for the firm's research department. She is working on two follow-up reports for NanoMem (NM) and UniFlash (UF). Topaz makes markets in both companies' securities and Lecompte owns a small position in NM only.

Lecompte has an excellent relationship with company officials at NM. In the past, LeCompte has made favorable recommendations regarding NM. In appreciation, she was invited to attend a company-sponsored event last December that was held at an exclusive ski resort overseas. NM paid all expenses relating to the trip and provided some excellent entertainment activities for the attendees. Lecompte disclosed this benefit to her supervisor at Topaz. Shortly thereafter, Topaz issued a secondary offering for NM. Lecompte believes that her excellent relationship with the firm played a large part in securing this business.

However, Lecompte considers her relationship with UF to be contentious since company officials seem reluctant to share as much information with her as they have in the past. She believes the change in their behavior is a direct result of recent reports she has written on the company, which have been less than favorable. Prior to publication of her follow-up reports, Lecompte shares her report on NM in its entirety with top management at NM. She shares only the part of her report on UF that provides factual information with UF management.

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Lecompte's compensation at Topaz includes an annual salary plus a bonus based on both the accuracy of her recommendations over time and the overall profitability of the company. Topaz makes public disclosure of the extent to which research analyst compensation in general is dependent upon the firm's investment banking revenues.

Following the release of her reports in early March, Lecompte is invited to appear on a television program to discuss her recommendations. During her appearance, she makes the following statements:

1. "My firm makes markets in the securities of both NanoMem and UniFlash and I currently own a position in NanoMem ."
2. "Although, I just issued my report on UniFlash which reflected a neutral rating, I really believe a sell rating is more appropriate."

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When she returns to her office the following day, Lecompte is informed by her supervisor that a company official at UF called to express his disappointment and anger regarding the negative remarks she had made about UF during her television appearance. Lecompte states that she believes her deteriorating relationship with UF will make it difficult to effectively cover the company in the future and recommends that Topaz discontinue coverage of UF immediately.

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1. In sharing her research material with the subject companies, Lecompte *most likely* violated CFA Institute Research Objectivity Standards with respect to her report(s) on:

   A. UniFlash.
   B. NanoMem.
   C. Both NanoMem and UniFlash.

2. With respect to the company-sponsored event that Lecompte attended, did she violate any CFA Institute Standards?

   A. Yes.
   B. No, because she disclosed it to her employer.
   C. No, because the Standards permit entertainment as long as it is business related.

3. Regarding Lecompte's compensation structure is Topaz in violation of CFA Institute's Research Objectively Standards?

   A. No.
   B. Yes, with respect to overall profitability of the firm.
   C. Yes, with respect to accuracy of her recommendations.

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4. According to the CFA Institute Research Objectivity Standards, does the first statement Lecompte makes in her television appearance provide all the recommended disclosures relating to potential conflicts of interest?

   A. Yes.
   B. Only with respect to UniFlash.
   C. Only with respect to NanoMem.

5. Does Lecompte's second statement during her TV appearance comply with the CFA Institute Research Objectivity Standards recommended procedures?

   A. Yes.
   B. No, with regard to her rating system.
   C. No, with regard to personal investments

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6. With respect to Lecompte's coverage of UniFlash, according to the CFA Institute Standards, the *least* appropriate course of action for Topaz to take would be to:

   A. discontinue coverage.
   B. change assigned analyst.
   C. upgrade recommendation.

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Erica Huang Case Scenario

Erica Huang is a derivatives trading advisor for Eastern Funds Company with expertise in forward and futures markets and contracts. She helps Eastern's portfolio managers to evaluate forward and futures contracts and to make appropriate decisions when the use of these derivatives is required.

When working with the portfolio managers, who have varying levels of derivatives knowledge, Huang is asked for input on issues of both an analytical and a conceptual nature. Three managers have approached her with the situations described below. Some of her responses to the portfolio managers rely on the financial market information given in Exhibit 1.

Exhibit 1
Financial Market Information

U.S. Three-month (90 day) Annualized Risk-free Rate	6.00%
U.S. Continuously Compounded Six-month (180-day) Annualized Risk-free Rate	5.83%
Broad Equity Index Level	1,250.00
Broad Equity Index Continuously Compounded Annualized Dividend Yield	3.00%
Japanese Three-month (90 day) Annualized Risk-free Rate	1.00%
Japanese Yen Spot Price	¥112.00/$

Manager A, an equity manager, has two requests:

1) Six months ago, to hedge against an expected decline in the value of a common stock of which he held 100,000 shares, he entered into a forward contract to sell the underlying stock at a price of $80. The forward contract has three months to expiration and the stock is currently trading at $75. He wants to know the value of his current position on a per share basis.

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2) He expects equities to go up and would like to take a long position in a 180-day forward contract on the Broad Equity Index, which a dealer has priced at 1,285.88. He wants to know whether the forward contract is fairly priced.

Manager B manages Eastern's Global Fund whose shareholders have approved the use of derivatives for hedging purposes. Knowing that she will receive a yen dividend payment in 90 days, she wants to know at what forward price she can sell yen for dollars. She also wants to understand the risks, if any, of entering into a forward contract and asks the following question:

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"If I agree to sell yen for dollars through a forward contract, am I guaranteed to be able to sell the number of yen at the price stated in the forward contract at its expiration?"

Manager C is responsible for a commodity portfolio and asks Huang the following questions:

1) "Because of mark-to-market, does a futures contract always have zero value?
2) Do convenience yields impact futures prices?"

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7. Using a 360-day year, the current value of Manager A's short position in the stock forward contract is *closest* to:

   A. \$2.73.
   B. \$3.84.
   C. \$5.00.

8. Using a 365-day year, Huang's *most* appropriate response to Manager A with regard to the Broad Equity Index forward contract is that the contract is:

   A. fairly priced.
   B. not fairly priced because the no-arbitrage price should be 1,267.57.
   C. not fairly priced because the no-arbitrage price should be 1,268.36.

9. Using a 365-day year, the 90-day yen/dollar forward price should be *closest* to:

   A. ¥106.72/\$US.
   B. ¥110.67/\$US.
   C. ¥113.34/\$US.

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10. Huang's *most* appropriate response to Manager B's question is no, because if the yen decreases in value compared to the dollar, Manager B:

    A. will terminate the forward contract early.
    B. faces the risk the other party will default at expiration.
    C. will pay a mark-to-market adjustment resulting in a higher overall cost.

11. What is Huang's *most* appropriate response to Manager C's first question?

    A. Yes.
    B. No, a futures contract has a value based on the price change since its last mark-to-market.
    C. No, a futures contract has a value based on the price change expected prior to expiration.

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12. Huang's *most* appropriate response to Manager C's second question is they will:

A. increase the futures price.
B. decrease the futures price.
C. not impact the futures price.

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Yeongsan Securities Case Scenario

Hee-young Park, CFA is a senior portfolio manager at Yeongsan Securities, a Korean investment management firm. She manages the firm's U.S. fixed income investments.

Yeongsan owns $15 million in Alleghany Manufacturing Corp bonds. In preparation for analyzing the credit quality of the Alleghany bonds, Park has gathered financial data for the firm for 2007-2009, which is presented in Exhibit 1 below.

Exhibit 1
Alleghany Financial Data
(millions of US$)

	2009	**2008**	**2007**
Revenue	1,245	1,174	1,149
COGS	641	638	672
Selling & Administrative	256	231	195
Research & Development	41	17	0
Depreciation	82	97	122
EBIT	225	191	160
Interest Expense	97	86	83
EBT	128	105	77
Taxes	51	30	42
Net Income	77	75	35
Total Assets	2,310	2,243	2,185
Short-term Liabilities	189	147	112
Long-term Liabilities	1,287	1,368	1,426
Shareholder's Equity	834	728	647

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The bonds are currently rated BB by Standard & Poor's. Park knows that the major credit rating agencies consider many aspects of Alleghany's financial condition and operations when determining its credit rating. In particular, Park believes that the ratings agencies will:

Factor 1: focus on Alleghany's cash flows from investing, rather than its cash flows from financing activities, as the best measure of its ability to service debt.

Factor 2: look favorably on the fact that most of Alleghany's senior management compensation is performance based.

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Factor 3: expect to see periodic certification by Alleghany that it is in compliance with all of the bond's covenants.

Park is evaluating a number of other securities for possible purchase. The bonds being considered include callable and non-callable corporate bonds with the same credit rating. Park wants a measure of how cheap or rich each security is relative to the others.

In addition to managing credit risk, Park is responsible for managing the interest rate risk of her portfolios. She measures the interest rate risk of each portfolio for four maturities; 2, 5, 10, and 20 years. Each portfolio's interest rate sensitivity is measured for a variety of yield curve change scenarios. Exhibit 2 below shows one portfolio's dollar exposure to the four maturities, the key rate duration of maturity, the current yield at each maturity, and three yield curve scenarios.

Exhibit 2
Key Rate Exposure, Current Yield Curve and Yield Curve Scenarios

Maturity (years)	**2**	**5**	**10**	**20**
Key rate durations (years)	2	5	10	20
Portfolio key rate exposure ($millions)	60	30	15	40
Current yield curve	3.20%	3.85%	4.30%	4.75%
Yield curve scenario 1	+0.50%	+0.50%	+0.50%	+0.50%
Yield curve scenario 2	+0.25%	+0.50%	+0.75%	+1.00%
Yield curve scenario 3	+1.00%	+0.75%	+0.50%	+0.25%

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13. Alleghany's pretax return on capital indicates that its financial performance has *most likely*:

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A. improved.
B. worsened.
C. stayed the same.

14. Which of these ratios suggest Alleghany's credit worthiness improved from 2007 to 2009?

A. Operating income/sales
B. EBITDA interest coverage
C. Long-term debt/capitalization

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15. Of the factors Park believes will be important in the rating of Alleghany's bonds, which is *most likely* incorrect?

    A. Factor 1.
    B. Factor 2.
    C. Factor 3.

16. The measure of security richness or cheapness that *best* meets Park's requirements is the:

    A. nominal spread.
    B. zero-volatility spread.
    C. option-adjusted spread.

17. Which of the yield curve scenarios listed in Exhibit 2 will cause the largest loss in the portfolio that is described in the same table?

    A. Scenario 1
    B. Scenario 2
    C. Scenario 3

18. Yield curve scenario 3 in Exhibit 2 is *best* described as an example of:

    A. a flattening of the curve.
    B. a positive butterfly shift.
    C. an upward parallel shift.

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Joan Hammond Case Scenario

Joan Hammond is the manager of Sparta Corporation's pension fund. She recently presented her quarterly report to the fund's board of directors, and is recommending a change in the fund's asset allocation. Based on her market expectations, she recommends an allocation of 30 percent of assets to value stocks, 50 percent to growth stocks, and 20 percent to bonds. Hammond's market expectations are shown in Exhibit 1.

Exhibit 1
Hammond's Market Expectations

	Value Stock Portfolio	Growth Stock Portfolio	Bond Portfolio
Expected Annual Return (%)	12	14	8
Expected Standard Deviation of Annual Returns (%)	16	22	8
Return Correlations			
Value Stock Portfolio	1.0	0.9	0.3
Growth Stock Portfolio	---	1.0	0.2
Bond Portfolio	---	---	1.0

Board member Benjamin Donner is skeptical about the recommended change in asset allocation for the pension fund, and he has several questions for Hammond. He asks Hammond to describe the risk and return characteristics of her recommended portfolio. Hammond responds:

> "I believe that the recommended asset allocation will produce a portfolio that is the global minimum-variance portfolio. The global minimum-variance portfolio has the lowest level of risk compared to all other portfolios on the efficient frontier and therefore it also dominates all other portfolios on the efficient frontier."

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Donner argues that Hammond should consider broadening the diversification of the fund's portfolio into a "fully diversified portfolio" by adding real estate and international stocks. He states that these additions will improve the efficiency of the fund. Donner estimates that the "fully diversified portfolio" would have an expected return of 13 percent and a standard deviation of 15 percent. He would then further expand the investment opportunity set by combining the proposed "fully diversified portfolio" with either risk-free borrowing or lending. He notes that the appropriate risk-free rate of return is 4 percent.

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Finally, Donner recommends that Hammond include a fundamental factor model analysis in future reports. Donner states that fundamental factor models relate asset returns both to surprises in macroeconomic variables and to company attributes such as market capitalization. He believes such an analysis will be beneficial in making future asset allocation decisions.

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19. Using Hammond's recommended asset allocation and return expectations, the expected standard deviation of annual returns for the pension fund's portfolio is *closest* to:

   A. 12.1%.
   B. 15.9%.
   C. 17.4%.

20. If Hammond wants to achieve an expected annual return of 12.5% while maintaining the pension fund's current 20% allocation to bonds, the proportion of the fund's assets that should be allocated to value stocks is *closest* to:

   A. 15%.
   B. 65%.
   C. 75%.

21. Hammond's statement about the risk level and dominance of the global minimum-variance is?

   A. correct about risk level and correct about dominance.
   B. correct about risk level but incorrect about dominance.
   C. incorrect about risk level but correct about dominance.

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22. If Donner wants to construct an optimal portfolio that has an expected standard deviation of annual returns of 12percent, he should combine his proposed "fully-diversified portfolio" with which of the following actions?

   A. Lend 20% of total assets.
   B. Lend 80% of total assets.
   C. Borrow 20% of total assets.

23. If Donner uses his proposed "fully-diversified portfolio" to construct an optimal portfolio that has an expected standard deviation of annual returns of 12 percent, the expected annual return for the resulting portfolio is *closest* to:

   A. 7.2%.
   B. 11.2%.
   C. 14.4%.

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24. Is Donner's description of the factor model he recommends to Hammond correct?

A. Yes.
B. No, he is incorrect about surprises in macroeconomic variables and correct about company attributes.
C. No, he is correct about surprises in macroeconomic variables and incorrect about company attributes.

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Diotrephes Foundation Case Scenario

Aydin Yusuf, CFA, is director of investments for the Diotrephes Foundation, a non-profit that supports Turkish artistic and cultural events in the U.S. Yusuf has lowered his return expectations for the portfolio's equity and fixed income holdings for the next two years. In order to improve the portfolio's return, he is considering allocations to additional asset classes, including alternative investments. His current focus is commodities and hedge funds.

After a careful assessment of investing in commodities, Yusuf decides that he will seek investments in those commodities that are most likely to produce positive "roll yield." Yusuf is also considering investments that will track a broad commodity index. He is confused, however, by reports that illustrate that while the long-run geometric return of the average commodity was close to zero, the geometric return of the commodity index for the same period was strongly positive. He wants to do further analysis into the cause of this apparent disparity.

Yusuf focuses on establishing goals for hedge fund investments before making any investment decisions about specific hedge funds or hedge fund strategies. He decides that Diotrephes will benchmark hedge fund investments against the 30-day Treasury bill rate plus a spread of 250 bps. Yusuf considered other benchmarks, including hedge fund indexes. He found that there are numerous statistical problems associated with these indexes, including:

Problem 1: backfill bias may overestimate returns.
Problem 2: the funds in each index are subject to turnover.
Problem 3: autocorrelation in returns may overestimate volatility.

Yusuf understands that hedge fund investments will be substantially riskier than the portfolio's investments in fixed income and equities. Yusuf decides to use maximum drawdown as a risk measure to compare the risks of the hedge funds that he is considering for the portfolio. After his analysis is completed, Yusuf identifies a multi-strategy hedge fund that invests in fixed income, equities, and commodities.

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25. The commodities in which Yusuf invests are *most likely* to have:

    A. few limitations to storage.
    B. prices that are volatile and at historic lows.
    C. prices that are volatile and at historic highs.

26. Yusuf's confusion about commodity index returns is *best* explained by:

    A. misreporting of historical index values.
    B. changes in the index constituents over time.
    C. rebalancing of the index due to commodity price changes.

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27. Yusuf's intended benchmark for hedge fund investments would be *most* appropriate for:

    A. distressed securities funds.
    B. equity market neutral funds.
    C. fixed income arbitrage funds.

28. Of the problems with hedge fund indices that Yusuf has identified, which is *most likely* incorrect?

    A. Problem 1
    B. Problem 2
    C. Problem 3

29. The hedge fund risk measure that Yusuf selects:

    A. typically assumes that returns are normally distributed.
    B. measures the probability that a loss of a certain size will occur.
    C. focuses on the minimum value between successive maximum values.

30. The hedge fund Yusuf identifies is *least likely* to be at risk of:

    A. style drift.
    B. changes in credit spreads.
    C. rising correlations between equity and fixed income.

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Merick Manufacturing Case Scenario

Merick Manufacturing is a U.S. based textile manufacturer whose equity securities are listed on the New York Stock Exchange and the London Stock Exchange. Merick prepares financial statements under both U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). On 1 January 2009, Merick acquired 50 percent of the equity of Lisam, Inc., a small international textile manufacturer. The purchase price was $500 million in cash. The remaining 50 percent equity in Lisam is owned by a governmental entity outside of the U.S.

Kim King, CFA, has been assigned the task of determining the potential effect of the acquisition on Merick's reported financial results using both U.S. GAAP and IFRS. She is particularly interested in the potential effect on various financial ratios that might occur if the equity method is used. King is unsure at this point whether Merick will account for the acquisition using the equity method, proportionate consolidation method, or consolidation method. She has tentatively concluded, however, that under U.S. GAAP Merick is unlikely to have control over Lisam, but that under IFRS Merick is likely to be deemed to have joint control. Even if Merick uses the particular accounting methods prescribed by U.S. GAAP and IFRS, King may produce financial statements with alternative methods to improve financial information for users.

King uses historical 31 December 2008 balance sheets (Exhibit 1) and projected income statements for the year ending 31 December 2009 (Exhibit 2) for Merick and Lisam to determine how the financial results and ratios may differ under each of the three acquisition accounting methods. The balance sheet was prepared immediately following the acquisition, but the projected income statements do not reflect the acquisition, and there are no inter-company transactions between Merick and Lisam. For ratio computation purposes, King uses beginning-of-year balance sheet values rather than average balance sheet values. She considers this appropriate because year-end projected balance sheets are expected to remain essentially unchanged for both firms other than the direct effects of the acquisition. The fair values of Lisam's assets and liabilities at 31 December 2008 are equal to their historical reported amounts.

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Exhibit 1
Balance Sheets on 31 December 2008
(Immediately Following Acquisition)

	Merick Manufacturing		Lisam, Inc.	
	US$ Millions	Common Size Percentage (%)	US$ Millions	Common Size Percentage (%)
Cash	$400	16.00	$100	6.67
Inventory	500	20.00	300	20.00
Other Current Assets	100	4.00	200	13.33
Total Current Assets	$1,000	40.00	$600	40.00
Plant and Equipment	1,400	56.00	800	53.33
Accumulated Depreciation	(500)	(20.00)	(200)	(13.33)
Long-term investment	500	20.00		
Other Non-current Assets	100	4.00	300	20.00
Total Assets	$2,500	100.00	$1,500	100.00
Short-term Debt	$200	8.00	$0	0.00
Other Current Liabilities	200	8.00	200	13.33
Total Current Liabilities	$400	16.00	$200	13.33
Long-term Debt	800	32.00	300	20.00
Total Liabilities	$1,200	48.00	$500	33.33
Common Stock	200	8.00	100	6.67
Retained Earnings	1,100	44.00	900	60.00
Shareholders' Equity	$1,300	52.00	$1,000	66.67
Total Liabilities and Shareholders' Equity	$2,500	100.00	$1,500	100.00

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Exhibit 2
Projected Income Statements for the Year Ending 31 December 2009
Prior to the determination of Investment Income

	Merick Manufacturing		Lisam, Inc.	
	US$ Millions	**Common Size Percentage (%)**	**US$ Millions**	**Common Size Percentage (%)**
Net Sales	$3,750	100.00	$2,500	100.00
Cost of Goods Sold	(2,250)	(60.00)	(1,600)	(64.00)
Gross Profit	1,500	40.00	900	36.00
Depreciation Expense	(140)	(3.73)	(60)	(2.40)
Other Expenses	(985)	(26.27)	(600)	(24.00)
Operating Income	375	10.00	240	9.60
Interest Expense	(75)	(2.00)	(30)	(1.20)
Pretax Income	300	8.00	210	8.40
Income Taxes	(120)	(3.20)	(84)	(3.36)
Net Income	$180	4.80	$126	5.04

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31. If King's tentative conclusions about Merick's control are correct, the equity method is *most likely* the preferred method for accounting for the acquisition under:

    A. IFRS only.
    B. U.S. GAAP only.
    C. both U.S. GAAP and IFRS.

32. Immediately after the acquisition, Merick's current ratio would *most likely* be lowest under which method?

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    A. Equity
    B. Consolidation
    C. Proportionate consolidation

33. If Merick uses the preferred method for accounting for the acquisition under IFRS, the long-term debt to total asset ratio (%) would be *closest* to:

    A. 29.
    B. 32.
    C. 35.

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34. After incorporating Lisam's projected results Merick's gross profit margin for the year ending 31 December 2009 will be *most likely* be highest under:

    A. Consolidation.
    B. The equity method.
    C. Proportionate consolidation.

35. After incorporating Lisam's projected results Merick's times interest earned for the year ending 31 December 2009 will *most likely* be highest under:

    A. equity.
    B. consolidation.
    C. proportionate consolidation.

36. If Merick prepared a consolidated balance sheet on the date of acquisition the total shareholders' equity ($) under U.S. GAAP will be *closest* to:

    A. 1,300.
    B. 1,800.
    C. 2,300.

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Galaxy Electronics Case Scenario

Galaxy Electronics Ltd. (Galaxy) is a manufacturer and distributor of personal computers and hand-held electronic personal organizers. The company had grown rapidly from its inception in 2004 to 2008 but in early 2009, sales growth has slowed significantly and Nadeen Bhatty, the VP Finance, thought that it was a good time for Galaxy to review its accounting methods and ensure they were appropriate for an established company.

As a public company they are required to prepare their financial statements in accordance with U.S. GAAP. To this end, the company made the following changes in its accounting methods and estimates in 2009:

- Galaxy produces the computers and organizers based on orders received. A 25% deposit is required on all orders and then Galaxy manufactures and usually ships the units in 2 to 6 weeks. Some orders are placed even further in advance, while some shipments may not occur for up to 3 months following an order. Galaxy had been recording a sale when the product was shipped but now that they were more established, Bhatty changed the revenue recognition point to when the deposits were received. "If the products are made to order, then the critical event is when we receive the order," she explained. As at August 31, 2009, they had received deposits of $3 million for orders yet to be shipped.

- The company provides a one-year warranty on their products and records it as a selling and administrative expense at the time of sale. Now, after five years experience with the products, they realized that the actual claims made have been less than the amounts they were accruing. In 2009, the related warranty accounts were adjusted to reflect the new estimated rates.

- On September 1, 2009, as a result of competitive pressures in the labor market and in recognition of their outstanding work in recent years, the company introduced a restricted stock grant program to all employees who had worked for the company for three years or more. The fair value of the stock on the grant date was $4.2 million; the employee had to remain with the company for 3 years for the shares to vest. While the average volatility of the company's stock had been in the 38%-42% range in the past three years, with the recent decline in growth that the firm was experiencing, the stock's volatility had declined to the 19%-24% range.

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Comparative income statements and balance sheets for Galaxy over the past few years are in Exhibit 1.

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Exhibit 1

Galaxy Electronics Ltd.
(U.S. $ thousands)

Income Statement
for the year ended August 31st

	2009	2008	2007
Sales	$100,000	$ 95,000	$ 65,000
Cost of goods sold	47,000	47,500	33,800
Gross profit	53,000	47,500	31,200
Operating expenses	34,000	38,000	28,000
Interest expense	2,400	2,700	3,000
Earnings before taxes	16,600	6,800	200
Income taxes 33%	5,478	2,244	67
Net Income	$ 11,122	$ 4,556	$ 134

Balance Sheet
as at August 31st

	2009	2008
Assets		
Cash & investments	$ 21,122	$ 25,000
Accounts receivable	25,000	13,500
Inventories	9,000	6,500
Prepaids and deferrals	4,000	2,000
Total current assets	$ 59,122	$ 47,000
Equipment, net	51,000	55,000
Intangibles	21,000	25,000
Total Assets	$131,122	$127,000
Liabilities		
Accounts payable	$ 15,000	$ 11,000
Unearned revenue		4,000
Warranty provision	2,000	4,000
Current portion of long term debt	5,000	5,000
Total current liabilities	$ 22,000	$ 24,000
Long term debt	35,000	40,000
Total liabilities	$ 57,000	$ 64,000
Shareholders' equity		
Common stock	58,000	58,000
Retained earnings	16,122	5,000
	$ 74,122	$ 63,000
Total liabilities & equity	$131,122	$127,000

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37. Which of the following is *most likely* to be a warning sign of deteriorating earnings quality? The new policy relating to:

    A. warranty expenses.
    B. revenue recognition.
    C. compensation using stock grants.

38. The change in estimate for Galaxy's warranty expense will *most likely* result in a(n):

    A. increase in revenue.
    B. reserve released into income.
    C. reduction in an off-balance sheet liability.

39. If an analyst were to adjust Galaxy's financial statements in an attempt to get a better indication of the company's revenues, gross profit ($-millions) would *most likel*y decrease by:

    A. 1.6.
    B. 4.8.
    C. 6.4.

40. The balance sheet aggregate accruals ($) in the past two years, prior to any adjustments, is *closest to*:

    A. 10,000.
    B. 10,122.
    C. 14,122.

41. The 2010 stock-based compensation expense ($ millions) will be *closest* to:

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    A. 0.0.
    B. 1.4.
    C. 4.2.

42. The recent change in the volatility of the company's stock *most likely* made the cost of the stock compensation program:

    A. lower.
    B. higher.
    C. the same.

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Scott Case Scenario

Cindy Scott is reviewing cash flow projections for a $300,000 capital investment for adaptable equipment to service her company's manufacturing efforts. After careful study, analysts have determined that when put to the best use over the next five years, the incremental contribution of the equipment produces a positive net present value assuming a 15% annual discount rate (see Exhibit 1).

Exhibit 1:
Forecasted Cash Flow (in $)

	Year 1:	Year 2:	Year 3:	Year 4:	Year 5:
Sales	370,000	425,500	510,600	663,780	531,024
Variable Cash Expenses	185,000	212,750	255,300	331,890	265,512
Fixed Cash Expenses	30,000	50,000	50,000	50,000	50,000
Depreciation*	60,000	60,000	60,000	60,000	60,000
Operating Income Before Tax	95,000	102,750	145,300	221,890	155,512
Tax (40%)	38,000	41,100	58,120	88,756	62,205
Operating Income After Tax	57,000	61,650	87,180	133,134	93,307
After Tax Operating Cash Flow	117,000	121,650	147,180	193,134	153,307
Salvage Value					20,000
Salvage Value After Tax					12,000
Total After Tax Cash Flow	117,000	121,650	147,180	193,134	165,307
*Straight-line over five years.					
NPV (15% annual discount rate): $183,109					

Scott receives a request from her manager, Pat Stevens, to change the cash flows from nominal to real. She decides to remove inflation effects from the sales, variable cost, and salvage value figures, but not to adjust either fixed costs or depreciation.

Stevens also requests Scott to calculate both economic and accounting income using the cash flow analysis in Exhibit 1. Scott learns that the equipment is to be financed entirely with a loan at 12%, with interest paid annually for five years and the full principal paid at the end of the fifth year.

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Scott asks another co-worker, Ted Ludlow, for additional suggestions about the analysis. Ludlow makes the following two suggestions:

- Consider the analysis in Exhibit 1 as a base case and then produce two additional analyses, an optimistic and a pessimistic case, assuming different possible economic environments.
- Produce these different analyses with a 5-year MACRS depreciation schedule (Exhibit 2).

Scott thanks Ludlow for these two suggestions. However, before leaving, Ludlow makes a third suggestion to also calculate operating income after tax less the dollar cost of capital (i.e. the weighted average cost of capital multiplied by the capital investment).

Exhibit 2

5-Year MACRS* Schedule					
Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
20.00%	32.00%	19.20%	11.52%	11.52%	5.76%
*MACRS: *Modified Accelerated Cost Recovery System for accelerated deprecation*					

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43. Scott's inflation adjustments to depreciation and fixed costs are *most likely*:

    A. correct.
    B. incorrect because both should be adjusted.
    C. incorrect because only fixed costs should be adjusted.

44. The economic income ($) for Year 3 is closest to:

    A. 48,365.
    B. 57,407.
    C. 109,877.

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45. The accounting income ($) for Year 2 is closest to:

    A. 25,650.
    B. 40,050.
    C. 61,650.

46. Ted Ludlow's first suggestion is best described as an example of:

    A. scenario analysis.
    B. sensitivity analysis.
    C. Monte Carlo simulation.

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47. If Ludow's suggestion of using the MACRS depreciation schedule is implemented, the first year's after-tax operating cash flow will most likely:

A. increase.
B. decrease.
C. remain unchanged.

48. Ludlow's third suggestion is best described as the calculation of:

A. residual income.
B. economic profit.
C. free cash flow to equity.

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Louise Tremblay Case Scenario

Louise Tremblay, CFA, is a portfolio manager for a global equity fund domiciled in the United States. She wants to add positions in foreign stocks of Canada and Brazil, two countries where there is currently no exposure. Tremblay places a call to Hal Baroque, the firm's economist, to arrange a meeting to discuss both his outlook for these economies and some issues related to foreign exchange relations and international asset pricing. During the meeting, Baroque presents the information he gathered in preparation for their discussion, as shown below in Exhibit 1.

Exhibit 1
Selected Currency Exchanges and Market Rates

Country	Currency	Spot Exchange Rate*	One Year Risk-free Rate	Expected Annual Inflation Rate
U.S.	USD$	NA	4.80%	2.30%
Canada	CAD$	1.2138-1.2259	4.10%	1.90%
Brazil	Real	2.3844-2.4082	8.80%	6.30 %

*Number of foreign currency units per one U.S. dollar

Baroque begins his discussion by reviewing some basic relations that are useful in understanding the interplay between exchange rates, interest rates, and inflation. He remarks, "Theoretically, the interest rate differential between two countries should be equal to the expected inflation rate differential over the term of the interest rate."

Tremblay provides two justifications for adding Canadian stocks to her portfolio:

1) The real returns are currently higher in Canada than in the United States.
2) By her own prediction, Canada will experience higher economic growth than the United States over the next three to five years. She is convinced that changes in Canada's financial account brought about by this higher growth will dominate any changes in Canada's current account that might occur because of this higher relative growth.

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Baroque's outlook for Brazil's economy is not favorable. He explains that in general, the economy of an emerging market tends to have a strongly positive correlation with the value of both its currency and its stock markets. Baroque thinks that Brazil's economic situation will continue to deteriorate along with the value of its currency, which he expects to depreciate by 5 percent against the U.S. dollar over the coming year.

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49. Given a bid-side quote on the three-month forward contract of CAN$1.1986 per U.S. dollar, the three-month forward U.S. dollar is quoted at an annualized:

    A. 5.00% discount.
    B. 1.25% discount.
    C. 5.00% premium.

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50. According to purchasing power parity and based on the spot rate bid quote, the one-year forward exchange rate for the Canadian dollar per U.S. dollar is closest to:

A. CAD$1.2057.
B. CAD$1.2091.
C. CAD$1.2186.

51. If a dealer's bid-side quote for the Canadian Dollar/Brazilian Real is CAD$0.5250, Tremblay's profit on a USD$1,000,000 initial investment in the triangular arbitrage opportunity is closest to:

A. USD$21,135.
B. USD$31,315.
C. USD$31,328.

52. The specific relation referred to in Baroque's remark most accurately describes the:

A. interest rate parity relation.
B. international Fisher relation.
C. purchasing power parity relation.

53. Which of Tremblay's justifications for adding Canadian stocks to the portfolio is most appropriate?

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

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54. Based on the data presented in Exhibit 1, Baroque's expectation for Brazil's currency is best described as:

A. interest rate parity.
B. purchasing power parity
C. uncovered interest rate parity.

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Chan Mei Yee Case Scenario

Chan Mei Yee is valuing McLaughlin Corporation common shares using a free cash flow approach. She assembled information about McLaughlin from several sources. She begins her analysis by determining free cash flow to the firm (FCFF) and free cash flow to equity (FCFE) for the 2009 fiscal year, using the financial statements in Exhibits 1 and 2 and other financial information contained in Exhibit 3. McLaughlin's fiscal year ends 31 December.

Chan plans to perform two different valuations of McLaughlin, which she calls the "base case" valuation and the "alternative" valuation. Critical assumptions for each are given below and in Exhibit 3.

Base case valuation

- 2010 FCFF will be $600 million.
- FCFF will grow forever at 4 percent annually.
- The market value and book value of McLaughlin's long-term debt are approximately equal.

Alternative valuation

- 2010 earnings per share (EPS) will be $1.80.
- EPS will grow forever at 6 percent annually.
- For 2010 and beyond:
  - Net capital expenditures (fixed capital expenditures minus depreciation) will be 30 percent of EPS.
  - Investments in working capital will be 10 percent of EPS.
  - 60 percent of future investments will be financed with equity and 40 percent will be financed with debt.

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Chan is also concerned about the effects on McLaughlin's 2010 FCFE of the following three possible financial actions by McLaughlin during the year 2010.

- Increasing common stock cash dividends by $110 million.
- Repurchasing $60 million of common shares.
- Reducing its outstanding long-term debt by $100 million.

Melissa Nicosia, Chan's supervisor, reviews McLaughlin's valuations. Specifically, Nicosia makes the following two statements:

1) The free cash flow valuation approach is superior to the discounted dividend valuation approach because the company's dividends have been substantially different from its FCFE, and
2) Because the company's capital structure seems unstable, the FCFE valuation approach is superior to the FCFF valuation approach.

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Exhibit 1
McLaughlin Corporation
Selected Financial Data
(in millions, except per share amounts)

For Year Ending 31 December	2009
Revenues	$ 6,456
Cost of goods sold	3,363
Selling, general, and administrative expense	1,744
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	1,349
Depreciation expense	243
Operating income	1,106
Interest expense	186
Pretax income	920
Income tax	294
Net income	$ 626
Number of outstanding shares (millions)	411
2009 Earnings per share	$ 1.52
2009 Dividends paid (millions)	$ 148
2009 Dividends per share	$ 0.36
2009 Fixed capital expenditures (millions)	$ 535

Exhibit 2
McLaughlin Corporation
Consolidated Balance Sheets
(in millions)

	at 31 December	
	2009	2008
Cash and cash equivalents	$ 32	$ 21
Accounts receivable	413	417
Inventories	709	638
Other current assets	136	123
Total current assets	1,290	1,199
Long-term assets, net	4,814	4,522
Total assets	$ 6,104	$ 5,721
Current liabilities	$ 2,783	$ 2,678
Long-term debt	2,249	2,449
Common stockholders' equity	1,072	594
Total liabilities and stockholders' equity	$ 6,104	$ 5,721

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Exhibit 3
Other Current Financial Information for McLaughlin Corp.

Effective tax rate	32.0%
Cost of equity	12.0%
Weighted average cost of capital	9.0%
Non-operating assets	$ 0

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55. McLaughlin's FCFF ($ millions) for 2009 is *closest* to:

    A. 418.
    B. 460.
    C. 485.

56. The estimate of 2009 FCFE ($ millions) is *closest* to:

    A. -327.
    B. 159.
    C. 509.

57. Using Chan's base case valuation assumptions and the FCFF valuation approach, the year-end 2009 value per share ($) of McLaughlin common stock is *closest* to:

    A. 18.25.
    B. 23.73.
    C. 29.20.

58. Using Chan's alternative valuation assumptions and the FCFE valuation approach, the year-end 2009 value of McLaughlin's common stock ($) is *closest* to:

    A. 18.00.
    B. 22.80.
    C. 24.17.

59. The *most likely* combined effect of the three possible financial actions will reduce McLaughlin's 2010 FCFE ($ millions) by:

    A. 100.
    B. 160.
    C. 270.

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60. The *most* accurate inference one can make in reference to Nicosia's two statements pertaining to McLaughlin's valuations is that she is:

A. correct with respect to both.
B. incorrect with respect to both.
C. correct with respect to statement (1) but not (2).

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