



# Stalla

Review for the CFA<sup>®</sup> Exams

Level I  
2008 Edition

# **Solutions with Stalla Problem-Solving Workshop**

## Sample Examination and Solutions

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## NOTES

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## Welcome to Stalla's Free Problem-Solving Workshop, which has been designed to let you sample Stalla's Mock Exam and Review.

With Stalla's Mock Exam and Review Seminar, you get a final review – right before the exam. We help you discover your strengths and weaknesses, and pinpoint the best way to focus your remaining study time before exam day.

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## ABOUT THE LEVEL 1 EXAM

The 2008 CFA examinations will be offered on Saturday, June 7 and Saturday December 6. The Level I Exam consists of 240 multiple-choice questions. It is administered in a morning session and an afternoon session, each lasting three hours. The afternoon session covers the same topics as the morning session in exactly the same order. With a total of 240 questions, that means you'll have, on average, 90 seconds to answer each question. The major topical areas and *approximate* weights for each on the Level I Exam are as follows:

Approximate %	Major Topic Areas
15%	Ethical and Professional Standards
12%	Quantitative Analysis
10%	Economics
20%	Financial Statement Analysis
8%	Corporate Finance
10%	Equity Investments
12%	Fixed Income Investments
5%	Derivatives
3%	Alternative Investments
5%	Portfolio Management

The Level 1 exam emphasizes knowledge and comprehension. The topical distribution of exam questions are concentrated in the areas called Tools and Inputs with Ethics, Quantitative Methods, Economics, Accounting, and Corporate Finance making up almost two-thirds of the exam questions. With a target score of 70%, mastering these areas will accumulate most of the needed points. Remember that the goal is not a perfect score, but a *passing score*. You can afford to miss quite a few questions and still pass, so don't get frustrated or anxious if you find yourself skipping what seems like a lot at first. After completing your first pass, you will feel more relaxed and find that you can answer more of the questions that you had previously skipped.

Based on our experience, candidates fail the CFA exam for four primary reasons: 1) Poor preparation; 2) Panic (fear, apprehension, and an inability to handle pressure); 3) Poor time management; or 4) Failure to give the answers found in the assigned reading and/or failure to follow instructions.

If you are a Stalla System student and followed our program as advised, we have every confidence you will succeed. And our dedication to your success doesn't end until you've become a CFA charterholder. Because we believe that the Stalla System will ultimately help you master the Candidates' Body of Knowledge and pass the exams, we offer all Stalla System candidates Tuition Free Continuing Help. If you follow our program as advised and do not pass your examination, Stalla will allow you to repeat our complete course tuition-free. Please visit us at [www.stalla.com](http://www.stalla.com) for details.

**Wishing you great success on Exam Day!**

## NOTES

**ANSWER SHEET**

1.	(A) (B) (C) (D)
2.	(A) (B) (C) (D)
3.	(A) (B) (C) (D)
4.	(A) (B) (C) (D)
5.	(A) (B) (C) (D)
6.	(A) (B) (C) (D)
7.	(A) (B) (C) (D)
8.	(A) (B) (C) (D)
9.	(A) (B) (C) (D)
10.	(A) (B) (C) (D)
11.	(A) (B) (C) (D)
12.	(A) (B) (C) (D)
13.	(A) (B) (C) (D)
14.	(A) (B) (C) (D)

15.	(A) (B) (C) (D)
16.	(A) (B) (C) (D)
17.	(A) (B) (C) (D)
18.	(A) (B) (C) (D)
19.	(A) (B) (C) (D)
20.	(A) (B) (C) (D)
21.	(A) (B) (C) (D)
22.	(A) (B) (C) (D)
23.	(A) (B) (C) (D)
24.	(A) (B) (C) (D)
25.	(A) (B) (C) (D)
26.	(A) (B) (C) (D)
27.	(A) (B) (C) (D)
28.	(A) (B) (C) (D)

## NOTES

## QUESTIONS SECTION

### 1. L1-03529

Martin Higgins, a portfolio manager, is evaluating the performance of one of his accounts. The account was opened at the beginning of 20X1. Martin wants to measure the account's performance for the three-year period running from the beginning of 20X1 through the end of 20X3. The history of the account is as follows:

Date:	Cash inflow from investor:	Cash outflow to investor:
January 1, 20X1	\$10 million initial investment	
December 31, 20X1		-\$4 million
January 1, 20X3	\$5 million	
December 31, 20X3		-\$5 million
January 1, 20X4	\$3 million	

  

Year	Annual Return
20X1	8%
20X2	18%
20X3	-6%

Based on this information, calculate the dollar-weighted return and the time-weighted return over the three-year period.

	<u>Dollar-Weighted Return</u>	<u>Time-Weighted Return</u>
a.	7.0%	6.7%
b.	4.4%	6.2%
c.	13.7%	6.2%
d.	9.0%	6.7%

**2. L1-00125**

A stock with a coefficient of variation of 0.5 has a(n):

- a. Variance equal to half the stock's expected return.
- b. Expected return equal to half the stock's variance.
- c. Expected return equal to half the stock's standard deviation.
- d. Standard deviation equal to half the stock's expected return.

**3. L1-02842**

Ellen de la Rosa, CFA, has completed an empirical analysis of monthly investment-grade corporate bond excess returns (return earned less risk-free rate). Based on the sample data, Ellen estimates that the distribution of excess returns is approximately normal with skewness and excess kurtosis near zero.

The frequency distribution of these excess returns are shown below.

<u># of Observations</u>	<u>Monthly Return</u>
8	0.25%
2	1.25%
1	0.50%
1	0.00%
2	-0.75%
1	1.50%
1	-1.00%

Based on the information provided, the arithmetic average of this sample is *closest* to:

- a. 0.18%
- b. 0.25%
- c. 0.00%
- d. 0.34%

**4. L1-00272**

The following sample of dividend payments is taken from a population of dividend paying stocks: \$0.50, \$0.32, \$0.15, \$0.35, and \$0.20. The standard error of the sample mean is *closest* to:

- a. 0.0754
- b. 0.0614
- c. 0.2746
- d. 0.3000

**5. L1-00346**

The records of a national mutual funds association indicate that the average mutual fund achieves annualized returns of 9.0%. Due to recent market fluctuations, the association believes the annualized returns are higher than 9.0%. In a study of 100 randomly selected funds, it was found that the average annualized return was 9.4% with a standard deviation of 2.2%. At the 5% significance level:

- a. The analyst can conclude that the annualized return has decreased.
- b. The analyst can conclude the annualized return is 9.0%.
- c. The analyst can conclude that the annualized return has increased.
- d. The analyst cannot conclude that the annualized return has increased.

**6. L1-01341**

WELLESLEY PRODUCTS COMPANY  
Balance Sheet and Other Financial Data  
(\$ Millions)  
As of December 31

ASSETS	<u>20X1</u>	<u>20X2</u>
Current Assets		
Cash	\$ 600	\$ 800
Accounts Receivable	800	900
Inventories	600	550
Prepaid Expenses	<u>100</u>	<u>100</u>
Total Current Assets	2,100	2,350
Long-Term Investments	100	200
Property, Plant and Equipment	4,000	4,700
Less: Accumulated Depreciation	<u>(1,500)</u>	<u>(1,700)</u>
Net Property, Plant and Equipment	2,500	3,000
Other Assets	<u>200</u>	<u>200</u>
Total Assets	<u>\$4,900</u>	<u>\$5,750</u>
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Short-Term Debt	\$ 100	\$ 150
Accounts Payable	400	450
Accrued Expenses	300	350
Income Taxes Payable	<u>100</u>	<u>200</u>
Total Current Liabilities	900	1,150
Long-Term Debt	1,000	1,100
Common Shareholders' Equity	<u>3,000</u>	<u>3,500</u>
Total Liabilities and Shareholders' Equity	<u>\$4,900</u>	<u>\$5,750</u>
 OTHER FINANCIAL DATA		
Net Income		\$400
Dividends Declared and Paid		100
Depreciation Expense		200
Capital Expenditures		700
 Retirement of Long-Term Debt		 100

How much new common stock did Wellesley issue in 20X2?

- a. \$200 million.
- b. \$400 million.
- c. \$500 million.
- d. \$800 million.

## 7. L1-01346

WELLESLEY PRODUCTS COMPANY  
Balance Sheet and Other Financial Data  
(\$ Millions)  
As of December 31

ASSETS	20X1	20X2
Current Assets		
Cash	\$ 600	\$ 800
Accounts Receivable	800	900
Inventories	600	550
Prepaid Expenses	<u>100</u>	<u>100</u>
Total Current Assets	2,100	2,350
Long-Term Investments	100	200
Property, Plant and Equipment	4,000	4,700
Less: Accumulated Depreciation	<u>(1,500)</u>	<u>(1,700)</u>
Net Property, Plant and Equipment	2,500	3,000
Other Assets	<u>200</u>	<u>200</u>
Total Assets	<u>\$4,900</u>	<u>\$5,750</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
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OTHER FINANCIAL DATA		
Net Income		\$400
Dividends Declared and Paid		100
Depreciation Expense		200
Capital Expenditures		700
Retirement of Long-Term Debt		100

Total cash outflows (ignoring inflows) used for investing and financing activities in 20X2 was:

- a. \$0.5 billion.
- b. \$0.8 billion.
- c. \$0.9 billion.
- d. \$1.0 billion.

**8. L1-00979**

Applebaum Construction Company signed a contract late in 20X0 to construct a turnpike for the State of Indiana. Applebaum follows the percentage-of-completion method. The contract price is \$42,000,000. The costs during the three-year construction period are expected to be:

<u>Year</u>	<u>Construction Costs Incurred</u>
20X1	\$10,000,000
20X2	\$15,000,000
20X3	\$ 5,000,000

How much gross profit would Applebaum recognize in 20X2 on the turnpike contract?

- a. \$6,000,000
- b. \$10,000,000
- c. \$12,000,000
- d. \$15,000,000

**9. L1-01565**

The B-Corporation has a sustainable growth rate of 6%. If its return on equity is 15%, what should its payout and retention ratios be in order to provide enough capital to finance its growth rate with internally generated funds?

	<u>Payout Ratio</u>	<u>Retention Ratio</u>
a.	0%	9%
b.	15%	85%
c.	40%	60%
d.	60%	40%

**10. L1-03118**Spartacus Corporation  
Balance Sheet

<u>Assets</u>	<u>12/31/20X1</u>	<u>12/31/20X0</u>
Cash	\$ 120,000	\$ 36,000
Accounts Receivable	240,000	360,000
Inventory	720,000	480,000
Property, Plant & Equipment	<u>1,680,000</u>	<u>1,764,000</u>
Total Assets	<u>\$2,760,000</u>	<u>\$2,640,000</u>
 <u>Liabilities and Shareholders' Equity</u>		
Accounts Payable	\$ 453,600	\$ 600,000
Mortgage Payable	960,000	996,000
Common Stock (250 shares o/s)	720,000	720,000
Retained Earnings	<u>626,400</u>	<u>324,000</u>
Total Liabilities & Shareholders' Equity	<u>\$2,760,000</u>	<u>\$2,640,000</u>

Spartacus Corporation  
Income Statement  
For the Year Ended December 31, 20X1

Net Sales		\$2,160,000
Less Expenses:		
Cost of Goods Sold	\$1,200,000	
SG&A Expense	396,000	
Depreciation Expense	84,000	
Interest Expense	48,000	
Total Expenses		<u>1,728,000</u>
Pre-Tax Income		432,000
Income Tax Expense (30%)		<u>129,600</u>
Net Income		<u>\$ 302,400</u>

The company's average collection period for accounts receivable for 20X1 is:

- a. 25.3 days.
- b. 40.6 days.
- c. 50.7 days.
- d. 63.3 days.

**11. L1-01798**

Herbal Tea Imports, Inc. has total assets of \$1,000,000, a debt ratio of 30%, sales of \$2,500,000, total fixed-costs of \$1,000,000, and earnings before interest and taxes (EBIT) of \$50,000. The firm's cost of debt is 10% and its corporate tax rate is 40%. What is the firm's return on equity (ROE)?

- a. 0.8%
- b. 1.2%
- c. 1.5%
- d. 1.7%

**12. L1-01021**

Herman's Sporting Goods and Morsan's Sporting World are identical in all respects with the exception that Herman's uses FIFO and Morsan's uses LIFO for its inventory cost flows. Over the last several years, both companies have faced rising prices. Which of the following would be *least likely* when comparing the financial statements of the two companies?

- a. The tax liability for Herman's would be less than the tax liability for Morsan's.
- b. The ending inventory for Herman's would be higher than the ending inventory for Morsan's.
- c. The retained earnings of Herman's would be higher than the retained earnings of Morsan's.
- d. The net income during the current year for Herman's would be higher than the net income for Morsan's.

**13. L1-01221**

Musicmasters, Inc. uses the FIFO method of accounting for inventory. On December 31, 20X3, the company sold 200 special order music units at a price of \$30 each. The January 1 beginning inventory and 20X3 purchases consisted of the following units and costs:

<u>Beginning Inventory</u>			<u>20X3 Purchases:</u>		
<u>Date</u>	<u>Units</u>	<u>Unit Price</u>	<u>Date</u>	<u>Units</u>	<u>Unit Price</u>
6/30/X2	30	\$14	3/31/X3	60	\$16
9/30/X2	25	\$15	6/30/X3	75	\$18
12/30/X2	40	\$13	9/30/X3	70	\$19

The ending inventory balance and gross profit reported on the company's 20X3 financial statements was:

	<u>Ending Inventory</u>	<u>Gross Profit</u>
a.	\$1,870	\$2,697
b.	\$1,395	\$2,440
c.	\$1,395	\$2,697
d.	\$1,870	\$2,915

**14. L1-03200**

Zeta Corp. uses LIFO inventory accounting. The footnotes to the 20X9 financial statements contain the following inventory information:

	<u>20X8</u>	<u>20X9</u>
Raw materials	\$292,675	\$369,725
Finished product	<u>401,342</u>	<u>377,104</u>
	\$794,017	\$746,829
Less adjustments to LIFO basis	<u>(46,000)</u>	<u>(50,000)</u>
	<u>\$748,017</u>	<u>\$696,829</u>

Tax rate is 35%.

If FIFO had been used for both years, the 20X9 net income would have changed by:

- a. \$(2,600)
- b. \$1,400
- c. \$2,600
- d. \$4,000

**15. L1-01855**

Using the following information, calculate income tax expense, using the liability method:

Beginning of year deferred tax liability	\$200
End of year deferred tax liability	300
Taxes paid in cash	700
Beginning of year taxes payable	100
End of year taxes payable	100

- a. \$1,200
- b. \$1,400
- c. \$800
- d. \$1,000

**16. L1-02060**

Kehoe Construction reports tax expense of \$224,000 on its income statement. Included in pretax income was interest of \$40,000 from tax-free municipal bonds that the company owns. The company had a temporary difference of \$80,000 that will result in a future tax deduction. The company's tax rate this year is 40%, but its tax rate in future years will be 30%.

How should Kehoe Construction report the tax effect of the temporary difference on its balance sheet?

- a. A deferred tax asset of \$32,000 would be reported on its balance sheet.
- b. A deferred tax liability of \$24,000 would be reported on its balance sheet.
- c. A deferred tax liability of \$32,000 would be reported on its balance sheet.
- d. A deferred tax asset of \$24,000 would be reported on its balance sheet.

**17. L1-02156**

Two years ago a firm issued three bonds with 10-year maturities. All three had the same par and all traded at the same yield-to-maturity when they were issued. But, one was issued at a premium, one at par, and one at a discount. Which bond will have the largest interest expense for the second year post issuance?

- a. The bond issued at par.
- b. The bond issued at a premium.
- c. The bond issued at a discount.
- d. The recorded interest expense will be the same for all three.

**18. L1-01318**

An investor buys 100 shares of GHG Technology for \$50 per share. The investor pays \$4,000 of the purchase cost and uses margin borrowing for the remainder. The investor pays an 8% rate of interest on the margin balance. One year later, GHG announces poor earnings and the price falls to \$25 per share. What is the investor's one-year rate of return, with the use of margin borrowing, and what would have been the one-year rate of return if margin borrowing had not been used?

	<u>Margined Return</u>	<u>Unmargined Return</u>
a.	(64.5%)	(37.5%)
b.	(64.5%)	(50.0%)
c.	(62.5%)	(37.5%)
d.	(62.5%)	(50.0%)

**19. L1-02134**

Dr. Filly plans to invest \$100, with a portion in a risky asset and a portion in a risk-free asset. The risky asset has an expected return of 12% and a standard deviation of 15%, while the risk-free asset has an expected return of 5%.

What percentages of Dr. Filly's money must be invested in the risk-free asset and the risky asset, respectively, to form a portfolio with a standard deviation of 0.06?

- a. 30% and 70%, respectively.
- b. 70% and 30%, respectively.
- c. 60% and 40%, respectively.
- d. 40% and 60%, respectively.

**20. L1-01968**

XYZ Industries is a mature company that is growing at a 4% rate, which is equal to the nominal growth rate for the economy. Assuming XYZ's P/E ratio is 8, its payout ratio is 20%, the real risk-free rate of return is 1.0%, and the inflation rate is 1.5%, the estimated equity risk premium for the Company's shares is *closest* to:

- a. 2.5%
- b. 4.0%
- c. 6.5%
- d. 7.5%

**21. L1-01757**

A stock is not expected to pay dividends until three years from now. The dividend is then expected to be \$2.00 per share, the dividend payout ratio is expected to be 40 percent, and the return on equity is expected to be 15 percent. If the required rate of return is 12 percent, the value of the stock today is *closest* to:

- a. \$16.67
- b. \$21.26
- c. \$53.15
- d. \$66.67

**22. L1-02368**

If a 10-year, 8% coupon bond with a duration of 6.7 is priced at 101.28 immediately after a 90 basis point increase in yield, the bond's price prior to the change in yield is closest to:

- a. 107.78
- b. 94.78
- c. 106.95
- d. 96.67

**23. L1-02578**

<u>Maturity</u>	<u>YTM</u>	<u>Spot Rate</u>
1 yr.	3.0%	3.0%
2 yr.	4.0%	4.1%
3 yr.	5.0%	5.1%
4 yr.	4.5%	4.4%
5 yr.	4.5%	4.4%

Based upon the table above, calculate the forward rate for a 2-year bond, 3 years from now (assuming annual compounding).

- a. 1.74%
- b. 3.36%
- c. 4.51%
- d. 7.16%

**24. L1-02359**

You receive the following information on stock options with a six-month expiration:

Strike Price	\$12.00
Put Price	\$0.50
Interest Rates	6% annualized
Stock's Price	\$13.50

Compute the intrinsic value of a call option with the same strike price.

- a. \$0.00
- b. \$0.50
- c. \$0.86
- d. \$1.50

**25. L1-02223**

Suppose two parties agree to a \$100,000,000 1x4 FRA contract on LIBOR at a rate of 2.5%. In one month's time, the following LIBOR rates are observed:

	<u>LIBOR rate</u>	<u># days in period</u>
1 month	2.50%	30
2 months	2.60%	60
3 months	2.70%	90
4 months	2.80%	120
5 months	2.90%	150
6 months	3.00%	180

What is the payment amount due to the FRA buyer?

- a. \$74,478.65
- b. \$49,664.76
- c. \$50,000.00
- d. \$625,000

**26. L1-02730**

Jayesh Patel is estimating the appropriate discount rates to use to value the holdings in his client's private-equity portfolio. To do this, Jayesh is using the security market line (SML) and a measure of each stock's systematic risk (beta) to estimate the appropriate discount rate that he should apply to each stock's cash flows.

If all other factors stay the same, how would Jayesh's estimate of the SML change if there is a sudden increase in the expected inflation rate?

- a. The slope of the SML would increase.
- b. The slope of the SML would decrease.
- c. The SML would shift up.
- d. The betas of the various stocks would shift along the SML.

**27. L1-02122**

Dr. Filly plans to invest \$100, with a portion in a risky asset and a portion in a risk-free asset. The risky asset has an expected return of 12% and a standard deviation of 15%, while the risk-free asset has an expected return of 5%.

What percentages of Dr. Filly's money must be invested in the risky asset and the risk-free asset, respectively, to create a portfolio with an expected return of 9%?

- a. 75% and 25%, respectively.
- b. 65% and 35%, respectively.
- c. 67% and 33%, respectively.
- d. 57% and 43%, respectively.

**28. L1-02322**

The expected return on the stock market is 10% with a standard deviation of 20%. The risk-free rate is 5%. Bluemoon Corporation's common stock returns are 50% correlated with the overall market and its dividend next year will be \$1.00 per share. The dividend's growth rate is 10% and standard deviation of Bluemoon's shares is 70%. The stock is trading at \$18.25. Should the stock of Bluemoon be bought or sold?

- a. Bought (the stock is under-priced).
- b. Sold (the stock is over-priced).
- c. Neither bought nor sold (the stock is fairly priced).
- d. The stock should be bought only if the dividend payout rate increases.