Question #47 of 88

Question ID: 1626118

Is Sims's regressions of European and British bond yields on the U.S. Federal Funds rate likely to produce valid results?

A) Neither Regression is valid.

B) Only Regression 1 is valid.

C) Only Regression 2 is valid.

Question #48 of 88

Question ID: 1560252

Which of the following is the *most* appropriate test for cointegration?

A) Breusch-Pagan.

B) Durbin-Watson.

C) Engle-Granger.

Overview for Questions #49-52 of 88

Question ID: 1560253

TOPIC: ECONOMICS

THE TOTAL POINT VALUE FOR THIS QUESTION SET IS 12 POINTS

Frank Hoskins and Paul Lanning are economists for a large U.S. investment advisory firm, Platinum Advisors. Hoskins and Lanning use their independent research on U.S. stocks and international stocks to provide advice for the firm's network of advisors. As the senior economist at Platinum, Hoskins is a partner in the firm and is Lanning's supervisor. Lanning has worked for Platinum for four years. At a lunch meeting, the two economists discuss the usefulness of economic theory, economic data, and the resulting forecasts of the global economic and stock market activity.

Lanning is examining the historical record of economic growth in Petra. He has gathered the data in Exhibit 1 to determine potential economic growth.

Exhibit 1: Economic Data for Petra from 20X1 to 20X7

Real GDP growth rate	3.9%
Growth rate in capital	1.4%
Growth rate in labor force	1.9%
Labor cost/total factor cost	0.52

Lanning then turns his attention to the countries of Alicia and Felicia. He notes that the GDP growth rate in both countries is comparable. Alicia's capital to labor ratio is USD 5,000. Felicia's capital to labor ratio is USD 2,800. Alicia has a relatively younger labor force and the labor cost represents 35% of total factor cost. Both countries have extensive restrictions on foreign direct investments in their economy.

It has long been Platinum's policy for its economists to use long-term economic growth trends to forecast future economic growth, stock returns, and dividends in a country. Lanning also examines the economy of Tiberia. Tiberia has a population of 11 million and is located in northern Africa. Its economy is diversified, and its main exports are agricultural products and heavy machinery. The country's economy has been growing at an annual rate of 6.2% for the past 10 years, in part because of technological advances in the manufacturing of heavy equipment. These advances involve the use of computer-operated welding machines that have made the manufacturing process more efficient. Lanning is worried, however, that the current GDP growth rate may not be sustainable and is considering advising Platinum's portfolio managers to decrease their portfolio allocations to the country. Before doing so, he will consult with Hoskins.

Question #49 of 88

Question ID: 1560254

Which country will experience a higher growth rate in potential GDP due to capital deepening and due to removal of restrictions on inflow of foreign capital?

	Capital deepening	Removal of restrictions on inflow of capital
A)	Alicia	Felicia
B)	Felicia	Felicia
C)	Felicia	Alicia

Question #50 of 88

Question ID: 1560255

Petra's GDP growth rate attributable to growth in total factor productivity is *closest* to:

A) 0.6%.

B) 1.6%.

C) 2.2%.

Question #51 of 88

Question ID: 1560256

The classical growth theory predicts that Tiberia's long-run future GDP per capita is *most likely* to:

A) decline due to diminishing marginal productivity of capital.

B) settle at subsistence level due to adjustments in the population.

C) remain unchanged from the current levels unless the government increases the budget deficit.

Question #52 of 88

Question ID: 1560257

The endogenous growth theory predicts that the Tiberian GDP growth rate is *most likely* to:

A) settle at a long-run steady state because of diminishing marginal productivity of capital.

B) continue to increase because technological advances will be shared by many sectors of the economy.

C) decline because the current GDP growth rate is not sustainable.

Overview for Questions #53-56 of 88

Question ID: 1754893

TOPIC: FINANCIAL STATEMENT ANALYSIS

THE TOTAL POINT VALUE FOR THIS QUESTION SET IS 12 POINTS

John Baragutti, CFA, works in the transaction services arm of HLBB, a large accountancy firm with a substantial advisory business on the east coast of the United States. He is currently advising on a potential M&A transaction between two airlines. Tarpon Airlines, Inc. (Tarpon), which operates out of the east coast of the United States, is the larger of the two companies and its board has entered into discussions with the smaller Clear Air S.A. (Clear). Clear, based in France, would provide Tarpon access to a significant number of landing slots in major European airports.

Baragutti is currently reviewing the income statement of Clear in order to address some concerns raised by Tarpon's board. Merger discussions had initially progressed rapidly after an initial review of Clear's last five years' income statements, which revealed an operating profit margin that was in line with that of Tarpon. The board has historically been extremely cautious about acquiring any potential target with a profit margin lower than its own. However, further investigation has revealed concerns regarding the treatment of pension costs in the income statement.

Tarpon runs only a defined contribution pension scheme for its employees and an employee incentive stock option scheme. Clear, however, has a defined benefit scheme that is currently overfunded. Additionally, because of the rise in the value of Clear's stock price, in 20X5 there was a tax windfall from the employee incentive stock option scheme. Extracts from the pension note included in Clear's annual report are shown in Exhibit 1.

Exhibit 1: Pension Note (Extracts)

Present Value of Defined Benefit Obligations		Fair Value of Plan Assets	
	€ million		€ million
As at 1 January 20X5	8,110	As at 1 January 20X5	8,920
Current service cost	170	Return on plan assets	145

Past service cost	15	Employer contributions	306
Interest cost	365	Benefits paid	(202)
Benefits paid	(202)		
Remeasurement (gains)/loss	218		
As at 31 December 20X5	8,676	As at 31 December 20X5	9,169

Notes:

- Pension benefit obligation has been calculated using the average yield on high-quality corporate bonds with similar durations to the benefits in the scheme, currently 4.5%.
- Due to turbulent economic conditions in the eurozone, return on plan assets was only 1.63%.
- Remeasurement gains at the start of the year totaled €231 million.

Having never accounted for a defined benefit scheme, in its initial review, the board of Tarpon did not consider the impact of the defined benefit plan on the operating margin. As a result, Baragutti has been asked to address three issues.

First, Clear prepares its financial statements using IFRS whereas Tarpon reports under U.S. GAAP. The board wants to gain an understanding of Clear's pension expense for 20X5 as computed under U.S. GAAP. Secondly, the disclosure of certain elements of the pension cost has confused the board. Although the notes to the income statement identify that the pension cost has an interest element, this has been included within operating profit.

Finally, the board is concerned about future adjustments that may be required to deal with the amortization of the remeasurement gains that have accumulated in Clear's pension scheme. Baragutti intends to perform the following calculations to deal with each issue independently:

Issue 1

Recalculate pension expense included in the income statement under U.S. GAAP. Baragutti has observed that companies reporting pension expense under U.S. GAAP

have used an average of 3% for the expected return on plan assets and he intends to apply this rate where applicable. He does not intend to amortize any of this year's prior service cost.

Issue 2

Assuming IFRS, recalculate the local currency (€) operating margin excluding any pension scheme interest element. The current income statement before Baragutti's adjustments is shown in Exhibit 2.

Issue 3

Baragutti prepares the following note containing two statements to advise the board on the future amortization of actuarial gains and losses:

Statement 1

> "Under IFRS, when cumulative remeasurement gains/losses are large enough, they will be amortized through the income statement over the average service life of the employees, reducing net income if net losses are amortized, and increasing net income if net gains are amortized."

Statement 2

> "Under U.S. GAAP, the amortization of net actuarial losses will increase leverage (i.e., debt-to-equity ratio), whereas the amortization of net actuarial gains will decrease leverage."

Exhibit 2: Income Statement (Extracts)

	20X5 **€ million**
Revenue	
Passenger	9,321
Cargo	456
Total	**9,777**
Employee costs	3,654
Depreciation, amortization	894

Aircraft operating lease costs	156
Fuel and oil costs	1,853
Engineering and other aircraft costs	542
Landing fees	1,458
Exchange rate losses	221
Ground equipment costs	765
Total operating costs	**9,543**
Operating profit	**234**
Fuel derivative losses	32
Finance costs	193
Finance income	89
Profit before tax	**98**

Note: Employee costs include the defined benefit pension expense for the period.

Question #53 of 88

Question ID: 1754894

Due to its employee incentive stock option plan only, if Clear had presented its financial statements under U.S. GAAP, it would have reported:

A) the same net income but higher stockholders' equity.
B) higher net income but the same stockholders' equity.
C) lower net income and lower stockholders' equity.

Question #54 of 88

Question ID: 1754895

In dealing with Issue 1 as outlined, Baragutti is likely to calculate a pension expense *closest* to:

A) €149 million.

B) €267 million.

C) €390 million.

Question #55 of 88

Question ID: 1754896

Using IFRS and Baragutti's suggested adjustments for Issue 2, he is likely to calculate an adjusted operating margin *closest* to:

A) 2%.

B) 4%.

C) 6%.

Question #56 of 88

Question ID: 1754897

Which of Baragutti's statements on the amortization of actuarial gains and losses in response to Issue 3 are *most likely* correct?

A) Both statements are correct.

B) Only statement two is correct.

C) Neither statement is correct.

Overview for Questions #57-60 of 88

Question ID: 1761429

TOPIC: FINANCIAL STATEMENT ANALYSIS

THE TOTAL POINT VALUE FOR THIS QUESTION SET IS 12 POINTS

Jessica Goodfellow, CFA, is an asset manager in The United Kingdom. Goodfellow is investigating the financial standing of three banks. Exhibit 1 provides selected information.

Exhibit 1: Selected Data for Three Banks

	Banco Alpha	Beta Bank	Cappa Bank
Common equity Tier 1 capital ratio	9.80%	11.5%	11.2%
Tier 1 capital ratio	10.5%	12.6%	13.2%
Total capital ratio	13.7%	14.9%	15.2%
Provision for loan losses to loan charge offs	0.99	1.32	0.81
Liquidity coverage ratio	1.276	1.204	1.101
Net stable funding ratio	1.232	1.138	1.168
Trading Portfolio monthly VaR %	8%	9%	7%
Loan Portfolio monthly VaR %	5%	4%	6%

Note: VaR % = 5% monthly VaR / value of the underlying portfolio.

Jim Stephenson, CFA, is Goodfellow's colleague and makes the following statement: "Basel III requires maintenance of a net stable funding ratio."

Question #57 of 88

Question ID: 1761430

Based on Exhibit 1, when comparing the three banks, which of the following conclusions is *most appropriate?*

A) Banco Alpha has the riskiest trading operations.

B) Cappa Bank has the highest total capital.

C) Banco Alpha has the highest amount of highly liquid assets relative to its one-month expected cash outflows.

Question #58 of 88

Question ID: 1761431

Based on Exhibit 1, when comparing the three banks, which bank has the most conservative approach regarding accounting for loan losses?

A) Banco Alpha.

B) Beta Bank.

C) Cappa Bank.

Question #59 of 88

Question ID: 1761432

Based on Exhibit 1, which bank has the highest funding of its risk-weighted assets using the most important tier of capital?

A) Banco Alpha.

B) Beta Bank.

C) Cappa Bank.

Question #60 of 88

Question ID: 1761433

Stephenson's description of Basel III requirements relates to minimum:

A) capital requirements.

B) liquidity requirements.

C) value at risk.

Overview for Questions #61-64 of 88

Question ID: 1754933

TOPIC: FIXED INCOME

THE TOTAL POINT VALUE FOR THIS QUESTION SET IS 12 POINTS

Jon Stevenson, CFA, is an experienced equity fund manager who has recently taken a position with Lohsi Clearview, a UK-based hedge fund that has combined a wide range of strategies to deliver impressive returns over the last five years. One of the fund's strategies is to invest in high-credit-risk fixed income instruments. The fund has an

excellent track record of identifying bonds in this sector that subsequently outperform the market.

Stevenson wishes to familiarize himself with the fund's strategies and has started by looking at some of the techniques used in analyzing fixed income instruments. Exhibit 1 shows the firm's approach to analyzing credit risk.

Exhibit 1: Credit Analysis Tools

Credit Ratings
Before undertaking any level of detailed analysis, the credit rating from the three major agencies should be obtained. Typically an instrument that is investment grade according to all three agencies will not be worthy of further consideration.
Structural Models
An initial analysis using a simple structural model should be undertaken to calculate the present value of the expected loss.
Reduced Form Models
Detailed analysis should be undertaken using the reduced form models used by the fixed income team. This analysis should only be undertaken once the structural model analysis has been completed.

Stevenson has no experience with structural models and is interested in learning more. He finds an analysis that has been completed for a recent bond issue. The results are shown in Exhibit 2.

Exhibit 2: IMC Bond Issue (ID 062014555612) Structural Model Results

Asset value	A_t	1,200
Expected return on assets	μ	0.04
Risk free rate	r	0.02
Face value	K	850
Time to maturity	T−t	1.5
Return volatility	σ	0.28
d_1		1.26452