

Sample Level I Questions

1. Supply-side economics stresses that:
 - A. an increase in government expenditures will directly stimulate aggregate supply.
 - B. a budget deficit will increase the real interest rate and thereby increase private spending.
 - C. a budget surplus will ward off inflation.
 - D. changes in marginal tax rates will affect aggregate supply.

2. At least in the initial stages of production, all of the following are major reasons why a firm may experience economies of scale except:
 - A. specialization.
 - B. mass production.
 - C. government licensing.
 - D. improvements in production as a result of experience.

3. A profit-maximizing monopolist will expand output to the point where:
 - A. marginal revenue equals marginal cost.
 - B. price equals average total cost.
 - C. price equals marginal cost.
 - D. total revenue equals total cost.

4. High and variable rates of inflation:
 - A. encourage decision makers to engage in long-term contracts at the expense of short-term contracts.
 - B. exert a positive impact on real output and will generally improve the economic efficiency of an economy.
 - C. divert resources from activities designed to protect individuals from inflation towards economically productive activities.
 - D. will distort relative prices since it is uncertain whether a price change is due to general inflation or due to shifts in supply or demand in a given market.

5. The nominal risk-free rate of interest is:
 - A. the real risk-free rate plus the inflation premium.
 - B. the real risk-free rate plus the default risk premium.
 - C. the real risk-free rate plus the default risk premium and the liquidity risk premium.
 - D. the real risk-free rate plus the inflation premium and the maturity risk premium.

6. Which of the following statements is *most* accurate?
- A. Trade restrictions that limit imports save domestic jobs.
 - B. Free trade with low-wage foreign countries will reduce the wages of domestic workers.
 - C. The law of comparative advantage explains why a nation will benefit from trade when it exports more than it imports.
 - D. The law of comparative advantage indicates that a nation can gain from trade even when it is at an absolute disadvantage in producing all goods.
7. If the central bank wants to follow expansionary policy it can:
- A. decrease reserve requirements, sell additional domestic securities, and/or raise the discount rate.
 - B. decrease reserve requirements, purchase additional domestic securities, and/or lower the discount rate.
 - C. increase reserve requirements, sell additional domestic securities, and/or raise the discount rate.
 - D. increase reserve requirements, purchase additional domestic securities, and/or lower the discount rate.

8. An analyst notices the following exchange rates in the newspaper:

SFr/\$: 1.3053

SFr/\$ 6-months forward: 1.2832

Is the Swiss franc trading at a discount or premium relative to the dollar in the forward market and what is the annualized forward discount or premium relative to the dollar?

	<u>Trading Relative to Dollar</u>	<u>Annualized Forward Rate</u>
A.	Discount	1.69 percent
B.	Discount	3.39 percent
C.	Premium	1.69 percent
D.	Premium	3.39 percent

9. In the short run, what is the *likely* impact on the real interest rate and employment to an unanticipated shift to a more expansionary monetary policy?

	<u>Real interest rate</u>	<u>Employment</u>
A.	Decrease	Decrease
B.	Decrease	Increase
C.	Increase	Decrease
D.	Increase	Increase

10. With multiple inputs, firms will expand their usage of each input until:
- A. total product divided by price is equal across all inputs.
 - B. average product divided by price is equal across all inputs.
 - C. derived demand divided by price is equal across all inputs.
 - D. marginal product divided by price is equal across all inputs.
11. Conti Corporation sells new homes on installment. If collectibility of the sales proceeds cannot be reasonably estimated, income is *least likely* to be overstated using which of the following revenue recognition methods?
- A. Installment method.
 - B. Completed contract method.
 - C. Cost recovery method.
 - D. At the time the house is delivered.
12. Under IAS GAAP, which of the following cash transaction classifications is *least likely* to be permissible?
- A. Interest paid may be classified as either an operating or a financing activity.
 - B. Interest received may be classified as either an operating or investing activity.
 - C. Dividends paid may be classified as either an investing or financing activity.
 - D. Dividends received may be classified as either an operating or investing activity.
13. Which of the following statements relating to the statement of cash flows is *least likely* to be true?
- A. Changes in operating assets and liabilities arising from acquisitions or divestitures are not included in the calculation of operating cash flow.
 - B. A change in net foreign asset investments due solely to exchange rate fluctuations is reported as part of investing, and not operating, cash flow.
 - C. For purposes of preparing the cash flow statement, cash includes both cash and short-term, highly liquid investments with maturities of 90 days or less.
 - D. Investors and creditors use the statement of cash flows to assess a company's ability to generate and manage cash flows, pay its liabilities and dividends, and to anticipate its need for financing.

Use the following information to answer Questions 14-15.

The following are partial financial statements for the McMullen Corporation:

McMullen Corporation
Condensed Income Statement
For the Year Ended December 31, 2005

Sales	\$240,000
Operating expenses	<u>219,200</u>
Operating income	20,800
Gain on sale of equipment	<u>200</u>
Net income	<u><u>\$ 21,000</u></u>

McMullen Corporation
Partial Statement of Cash Flows
For the Year Ended December 31, 2005

Net income	\$21,000
<i>Adjustments for noncash effects:</i>	
Gain on sale of equipment	(200)
Depreciation	6,500
<i>Changes in operating assets and liabilities:</i>	
Increase in accounts receivable	(12,000)
Decrease in inventory	6,000
Increase in prepaid expenses	(5,000)
Decrease in accounts payable	(19,500)
Increase in unearned revenue	<u>18,400</u>
Cash flow from operations	<u><u>\$ 15,200</u></u>

14. Cash collections from customers is *closest* to:
- A. \$228,000.
 - B. \$233,600.
 - C. \$246,400.
 - D. \$252,000.
15. Cash payments on operating expenses is *closest* to:
- A. \$207,200.
 - B. \$231,200.
 - C. \$237,700.
 - D. \$244,200.

16. Which of the following actions alone would be *least likely* to shorten the cash conversion cycle?
- A. Offering more lenient credit terms to boost sales.
 - B. Delaying payment to suppliers.
 - C. Adopting just-in-time inventory system.
 - D. Offering cash discounts to customers who pay their bills early.

17. Devlin Inc. has 200,000 shares outstanding at the beginning of the year. The following stock transactions took place during the year:

March 1:	Issued 30,000 shares
June 1:	Issued a 2-for-1 stock split
June 30:	Issued 25,000 shares
October 1:	Issued a 15% stock dividend
October 31:	Reacquired 30,000 shares

Weighted average shares outstanding for the year is *closest* to:

- A. 384,855.
 - B. 526,875.
 - C. 533,375.
 - D. 552,750.
18. Gasson Inc. had 500,000 shares of common stock issued and outstanding at December 31, 2005. There were no stock transactions during the year other than 40,000 shares of common stock that were issued on July 1, 2005. Gasson also had unexercised stock options to purchase 30,000 shares of common stock at \$5 per share outstanding throughout the year. The market price of Gasson's common stock in 2005 was \$10 on average and \$15 at year-end. The number of shares that should be used in computing diluted earnings per share for the year ended December 31, 2005 is *closest* to:
- A. 495,000.
 - B. 500,000.
 - C. 535,000.
 - D. 540,000.

19. Which of the following actions would be *least likely* to be viewed as conservative?
- A. Company increases its estimated provision for bad debts.
 - B. Company uses the FIFO inventory method when inventory prices are declining.
 - C. Company discloses contingency losses in the footnotes to the financial statements.
 - D. Company uses the completed contract method for recognizing revenue for long-term contracts.
20. Which of the following statements relating to document sources is *most likely* to be correct?
- A. The Form 8-K is the best source to identify instances when the auditor has issued a modified opinion raising doubts over an entity's ability to continue as a going concern.
 - B. Details about stock option plans and executive compensation arrangements are most completely found in the footnotes to the financial statements.
 - C. Identifying the existence of an audit committee and evaluating the independence of its members is best found in the auditor's report.
 - D. The Management Discussion and Analysis section of the annual report provides a discussion of the firm's recent performance, outlook based on known trends, and disclosures about significant contractual obligations and commitments.

Answers

1. **D**
LOS: Study Session 4-15-c
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, 10th ed., pp. 279-83.
2. **C**
LOS: Study Session 5-20-f
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, 10th ed., pp. 492-93.
3. **A**
LOS: Study Session 5-23-c
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, 10th ed., pp. 547-50.
4. **D**
LOS: Study Session 4-14-d
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, 10th ed., pp. 193-96.

5. **A**
LOS: Study Session 5-25-e
Reference: Brigham, Houston, *Fundamentals of Financial Management*, 10th ed., pp. 307-08.
6. **D**
LOS: Study Session 6-26-a,e
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, pp. 400-01, 413-415.
7. **B**
LOS: Study Session 4-16-b
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, pp. 304-08.
8. **D**
LOS: Study Session 6-27-f

Since a \$ is worth SFr1.3053 now but worth SFr1.2832 six months from now, the dollar is worth less six months forward than now. Thus, the Swiss franc is trading at a premium relative to the dollar in the forward market.

$$\text{Annualized rate: } \left(\frac{0.0221}{1.3053} \right) * \frac{12}{6} * 100\% = 3.39\%$$

Reference: Bruce Solnik and Dennis McLeavey, *International Investments*, pp.14-15.

9. **B**
LOS: Study Session 4-17-d
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, 10th ed., p. 325.
10. **D**
LOS: Study Session 5-24-d
Reference: Gwartney, Stroup, Sobel, and Macpherson, *Economics: Public and Private Choice*, 10th ed., p. 582.
11. **C**
LOS: Study Session 7-31-b
Income recognition is delayed the most under the cost recovery method because no profit is recognized until cash collections exceeds the cost of the asset sold.
Reference: White, Sondhi and Fried, *The Analysis and Use of Financial Statements*, pp. 39-45.
12. **C**
LOS: Study Session 7-33-f

Dividends paid under IASB rules may be classified as either an operating or financing activity.

Reference: White, Sondhi and Fried, *The Analysis and Use of Financial Statements*, p. 98.

13.

B

LOS: Study Session 7-32-a, 7-33-d

Translation gains and losses resulting from exchange rate changes are excluded from the calculus of cash flows from operating, investing and financing activities. Instead, they are reported in a separate category called “the effect of exchange rate changes on cash.” (A), (C) and (D) are all true.

Reference: Needles and Powers, *Financial Accounting*, pp. 559-562; White, Sondhi and Fried, *The Analysis and Use of Financial Statements*, pp. 75, 83-85.

14.

C

LOS: Study Session 7-33-c

Sales	240,000
Less: increase in accounts receivable	(12,000)
Add: increase in unearned revenue	<u>18,400</u>
Cash collections from customers	<u>246,400</u>

Reference: White, Sondhi and Fried, *The Analysis and Use of Financial Statements*, pp. 78-81.

15.

B

LOS: Study Session 7-33-c

Operating expenses	219,200
Less non-cash expense – Depreciation	(6,500)
Less: Decrease in inventory	(6,000)
Add: Increase in prepaid expenses	5,000
Add: Decrease in accounts payable	<u>19,500</u>
Cash payments of expenses	<u>231,200</u>

Reference: White, Sondhi and Fried, *The Analysis and Use of Financial Statements*, pp. 78-81.

16.

A

LOS: Study Session 8-35-b

(B) would result in higher accounts payable balances (a negative adjustment to the cash conversion cycle), (C) would reduce inventory balances and (D) would result in lower accounts receivables due to quicker collections. These actions would all reduce the cash conversion cycle. While increasing sales, (A) is likely to result in increased accounts receivables that are of poorer quality, and therefore will take longer to collect.

Reference: Reilly & Brown, *Analysis of Financial Statements*, pp. 324-327.

17. **B**
LOS: Study Session 8-36-b,c
- | | |
|---|----------------|
| Jan. 1 Beginning balance: 200,000 x 12/12 | 200,000 |
| March 1 issuance: 30,000 x 10/12 | 25,000 |
| June 1 stock split: (200,000 + 25,000) x 12/12 | 225,000 |
| June 30 issuance: 25,000 x 6/12 | 12,500 |
| October 1 15% stock dividend: [200+25+225+12.5] x 15% | 69,375 |
| October 31 reacquisition: -30,000 x 2/12 | <u>(5,000)</u> |
| Weighted average shares outstanding | <u>526,875</u> |
- Reference:** Kieso, Weygandt & Warfield, *Intermediate Accounting*, pp. 695-698.
18. **A**
LOS: Study Session 8-36-d
- | | |
|---|----------------|
| Jan. 1 Beginning balance (500,000 - 40,000) 460,000 x 12/12 | 460,000 |
| July 1 issuance: 40,000 x 6/12 | 20,000 |
| Add: stock options: 30,000 x [10-5]/10 | <u>15,000</u> |
| Weighted average shares outstanding | <u>495,000</u> |
- Note that only the ending balance on common stock outstanding is provided so we need to reverse the impact of stock transactions during the year to infer the beginning balance.
- Reference:** Kieso, Weygandt & Warfield, *Intermediate Accounting*, pp. 703-704
19. **C**
LOS: Study Session 8-37 and 38-b
- The more conservative approach for loss contingencies is to recognize the loss in the income statement and accrue the contingent liability on the balance sheet.
- Reference:** Schilit, *Financial Shenanigans*, pp. 53.
20. **D**
LOS: Study Session 8-37 and 38-d, 7-29-d
- The auditor's report is the best source for identifying any modified opinion issued by the auditor, so (A) is incorrect. (B) is also incorrect because the proxy statement provides the best source of information relating to executive compensation, including details of stock option plans. (C) is also incorrect because the presence of an audit committee and the composition of its members are disclosed in the proxy statement (also the registration statement and annual report), but not the auditor's report. (D) is correct.
- Reference:** Schilit, *Financial Shenanigans*, pp. 50-52; White, Sondhi and Fried, *The Analysis and Use of Financial Statements*, p. 20-21.