Question #1 of 21

Question ID: 1573793

An analyst trying to mitigate representativeness bias would *most likely*:

A) perform scenario analysis.

B) consider both inside and outside views to generate forecasts.

C) use flexible models with few independent variables.

Explanation

Representativeness bias occurs due to a tendency to classify data based on past information and known classifications. This can be mitigated by considering both inside (taking a situation-specific view) and outside (focusing on the base rate, the rate of incidence in a larger population) views. Performing scenario analysis can help mitigate overconfidence bias, and using flexible models with few independent variables can help mitigate conservatism bias.

(Module 40.1, LOS 40.b)

Question #2 of 21

Question ID: 1573796

The earnings forecast of a firm is *most likely* to be optimistic if the industry has:

A) a high threat of substitute products.

B) low bargaining power of suppliers.

C) low barriers to entry.

Explanation

Low bargaining power of suppliers means the firms have more control over contracts with suppliers, such as successfully requesting price reductions. A high threat of substitute products means the firms will have less pricing power and may struggle to maintain volumes against these substitutes. If there are low barriers to entry, the threat of new entrants is high, which can make it difficult to maintain ROIC.

(Module 40.1, LOS 40.c)

Question #3 of 21

Question ID: 1573800

What is the *most likely* impact on revenue if a firm increases the selling price of a product with elastic demand?

A) Revenue will increase.

B) Revenue will decrease.

C) Revenue will be unaffected.

Explanation

If the product has elastic demand, the percentage reduction in unit sales (demand) will be greater than the percentage increase in selling price, causing revenue to fall.

(Module 40.1, LOS 40.d)

Question #4 of 21

Question ID: 1577952

An analyst who wants to create a sales-based pro forma model for a company is *most likely* to begin by:

A) modeling the company's working capital items.

B) estimating the company's revenue growth trend.

C) forecasting the company's capital spending.

Explanation

The first step in creating a sales-based pro forma company model is to estimate revenue growth and future revenue.

(Module 40.1, LOS 40.a)

Question #5 of 21

Question ID: 1573794

By including only variables with known explanatory power in a forecast, an analyst may be trying to mitigate the:

A) illusion of control bias.

B) overconfidence bias.

C) confirmation bias.

Explanation

The illusion of control bias is a false sense of security in one's forecasts. One way to mitigate this is by focusing only on variables with known explanatory power, or by seeking outside opinions from those who have a unique or specific perspective. Confirmation bias can be mitigated by considering and including opinions from analysts or colleagues who have different views and no emotional investment. Overconfidence bias may be mitigated by analyzing the efficacy of past forecasts and performing scenario analysis.

(Module 40.1, LOS 40.b)

Question #6 of 21

Question ID: 1577954

A company is *most likely* to have pricing power if it operates in an industry that exhibits high:

A) bargaining power of customers. ✗

B) barriers to entry. ✓

C) intensity of industry rivalry. ✗

Explanation

High barriers to entry imply a low threat of new entrants, which tends to increase the pricing power of the existing companies in an industry. High intensity of industry rivalry and high bargaining power of customers tend to decrease companies' pricing power.

(Module 40.1, LOS 40.c)

Question #7 of 21

Question ID: 1573791

In preparing a set of sales-based pro forma financial statements, which of the following steps would *most likely* be completed first?

A) Construct the pro forma cash flow statement. ✗

B) Estimate future capital expenditures. ✗

C) Estimate the financing costs. ✓

Explanation

The pro forma cash flow statement is constructed from the income statement and balance sheet; therefore, this statement cannot be built until the others are completed. The pro forma income statement should be completed first, including the financing costs, as the balance sheet is modeled based on items that flow from the income statement.

(Module 40.1, LOS 40.a)

Question #8 of 21

Question ID: 1573805

An analyst is forecasting performance of a firm and trying to incorporate inflection points. Which of the following is *most likely* to signal an inflection point?

A) A new marketing campaign with celebrity endorsement.

B) A new chairman being hired.

C) A new export tariff being imposed on the company’s products.

Explanation

While all of these are likely to have an impact on future performance, inflection points are instances where the future will not be like the past, due to changes in the overall economic environment, business cycle stage, government regulations, or technology. The new export tariff is a change in government regulation—and, therefore, likely to signal an inflection point.

(Module 40.1, LOS 40.e)

Question #9 of 21

Question ID: 1573806

For a highly cyclical company, which of the following would be the *most appropriate* forecast time horizon?

A) Until the middle of the business cycle.

B) Until two full business cycles have been included.

C) One year only.

Explanation

Although it would be useful to have two full business cycles in a forecast, it is likely that the information will be difficult to forecast with enough accuracy. Forecasting for only one year may give a higher level of accuracy, but it will present earnings that are above or below trend depending on the firm's current position in the business cycle. Forecasting until the middle of the business cycle means the forecast will include this midcycle, average level of sales, and profits, which will ensure the current phase does not skew the forecast.

(Module 40.1, LOS 40.e)

Question #10 of 21

Question ID: 1573792

An analyst has forecast earnings for the next year for a particular investment. Since the forecast was completed, the firm has made some announcements regarding new products and structural changes. A few of these were expected by the analyst and incorporated into the original forecast, and some were excluded. The analyst is reluctant to make any changes to the forecast. This analyst is *most likely* exhibiting which of the following biases?

A) Confirmation bias.

B) Conservatism bias.

C) Representativeness bias.

Explanation

Conservatism bias, also called anchoring, is where the analyst makes only small adjustments to his prior forecasts when new information becomes available. Confirmation bias causes an analyst to seek out data that affirms his earlier convictions and to disregard or underestimate information that disputes those opinions. We do not have enough information in the scenario to know whether the new information disputes the analyst's previous opinions or may actually support them. Representativeness bias occurs due to a tendency to classify data based on past information and classifications.

(Module 40.1, LOS 40.b)

Question #11 of 21

Question ID: 1573799

A firm has experienced an increase in some of its input costs and has decided to cut its advertising expenses to help maintain operating margins. This strategy is *most appropriate* if the input cost increases are deemed to be:

A) either short term or long term.

B) short term only.

C) long term only.

Explanation

Cutting some costs to help preserve operating margins in the face of cost increases is a strategy that can be appropriate in the short term, but it is not appropriate in the long term, as the operations of the business (e.g., missing out on revenue generated from the advertising) will most likely suffer.

(Module 40.1, LOS 40.d)

Question #12 of 21

Question ID: 1577953

An analyst who makes only a small change to a previous forecast, even when new information suggests a large change is needed, is *most likely* exhibiting:

A) conservatism bias.

B) confirmation bias.

C) base-rate neglect.

Explanation

Conservatism bias, or anchoring, reflects reluctance to incorporate new information into an outlook and may cause an analyst to make only small changes to a prior forecast even when new information makes a large adjustment more appropriate. Confirmation bias refers to seeking out information that confirms one's views. Base-rate neglect, in the context of financial analysis, refers to focusing on company-specific information while not adequately considering factors that affect its industry or the wider economy.

(Module 40.1, LOS 40.b)

Question #13 of 21

Question ID: 1573789

An analyst is developing a forecast for a firm and expects the units sold to be reduced by 5% in the next reporting period. Which of the following balance sheet current assets is this *most likely* to affect?

A) Accounts receivable, inventory, and prepayments.

B) Accounts receivable and prepayments.

C) Accounts receivable and inventory.

Explanation

Selling fewer units will reduce accounts receivable, all else (e.g., credit terms) being equal. Also, a reduction in sales will likely impact inventory: if the firm continues to purchase or produce the same number, then a reduction in sales will lead to higher inventory levels. Alternatively, if the firm adjusts its inventory strategy to reflect lower demand, it may see a reduction in inventory levels. Prepayments represent the amount paid for future period expenses (not purchases) and are unlikely to be affected by a change in sales demand.

(Module 40.1, LOS 40.a)

Question #14 of 21

Question ID: 1573804

When forecasting the value of a stock using the discounted cash flow approach, a small change in which of the following estimates will *most likely* have the largest impact on the forecast value?

A) Annual depreciation.

B) Long-term growth rate.

C) Statutory tax rate.

Explanation

Depreciation is not a cash flow and should not be included in the discounted cash flow approach. Changes in the statutory tax rate will impact the forecast, but not by as much as the long-term growth rate. This is due to the terminal value taking the growth rate to perpetuity and applying the growth exponentially.

(Module 40.1, LOS 40.e)

Question #15 of 21

Question ID: 1573790

An analyst is developing a set of sales-based pro forma financial statements and states the following:

Statement 1:	COGS will grow at the same rate as sales.
Statement 2:	SG&A grows with sales.

Which of his statements are *most likely* correct?

A) Both Statement 1 and Statement 2.

B) Statement 1 only.

C) Statement 2 only.

Explanation

Statement 1 is incorrect. COGS may grow at the same rate as sales, but it may also include some fixed costs or have cost price changes which are different to sales. COGS should be estimated either based on a percentage of sales, or on a more detailed method based on business strategy or competitive environment. Although SG&A is commonly seen as fixed costs, it can also grow with sales (e.g., if labor costs are included which are dependent on units sold).

(Module 40.1, LOS 40.a)

Question #16 of 21

Question ID: 1573802

Fresh Farm Foods (FFF) achieved the following performance for the year ended December 31, 20X8, based on sales of 140,000 units.

Income Statement for Year Ended 20X8

Revenue	$800,000
COGS	($570,000)
Gross profit	$230,000
SG&A	($96,000)
Operating profit	$134,000

An analyst forecasts that FFF will be forced to increase its unit price by 8%, and this will result in a decrease in demand of 3,000 units. In percentage terms, which of the following will *most likely* see the biggest decrease?

A) Operating profit.

B) Revenue.

C) Gross profit.

Explanation

The 20X9 income statement will be forecast as follows:

Revenue	$736,000	($800,000 × 0.92)
COGS	($557,786)	($570,000 / 140,000 × 137,000)
Gross profit	$178,214	
SG&A	($96,000)	
Operating profit	$82,214	

Revenue will decrease by 8.00% [($800,000 $736,000) / $800,000]; gross profit by 22.52% [(230,000 $178,214) / 230,000)]; and operating profit by 38.65% [($134,000 $82,214) / $134,000].

(Module 40.1, LOS 40.d)

Question #17 of 21

Question ID: 1573801

An analyst is looking at the impact of sales and cost price changes for a multinational firm. Which of the following would *least likely* be helpful to be included in her analysis?

A) Hedging activities.

B) Capital structure.

C) Vertical structure.

Explanation

When considering the impact of price changes, an understanding of any hedging activities used to mitigate these changes is important. The analyst should understand the vertical structure of the business to consider whether industry or market-wide price changes impact the firm (e.g., if a large amount of a firm's sales are internal to a subsidiary, the pricing strategy may differ). While capital structure is crucial from an overall analysis perspective, this is not as relevant when analyzing sales and cost price changes.

(Module 40.1, LOS 40.d)

Question #18 of 21

Question ID: 1573798

Which of the following elements of Porter's five forces model is *most likely* to have the largest impact on elasticity of demand, assuming a competitive industry?

A) Availability of substitute products.

B) Bargaining power of customers.

C) Bargaining power of suppliers.

Explanation

The elasticity of demand is most affected by the availability of substitute products. In a competitive industry, the pricing decisions of other firms in the industry can affect the market shares of all firms in an industry. Therefore, the greater amount of available substitute products, the more sensitive consumers are likely to be to price changes.

(Module 40.1, LOS 40.c)

Question #19 of 21

Question ID: 1573797

Which of the following would *most likely* lead to a company having high pricing power?

A) Low threat of substitute products.

B) High bargaining power of customers.

C) High intensity of industry rivalry.

Explanation

Pricing power is low when there are high levels of competition in the industry, when it is easy for customers to switch between products or have high bargaining power. Given a low threat of substitute products, the company is likely to have higher pricing power as there are fewer alternatives for the customers to choose from.

(Module 40.1, LOS 40.c)

Question #20 of 21

Question ID: 1573803

A portfolio has a 17% annual turnover. For a buy-side analyst, what would be an appropriate time horizon to use when forecasting performance?

A) 10 years.

B) 1 year.

C) 6 years.

Explanation

The expected holding period for a stock would be a sensible length of time to forecast the performance of the firm in question. An annual turnover of 17% gives an average holding period of approximately six years (100 / 17 = 5.88).

(Module 40.1, LOS 40.e)

Question #21 of 21

Question ID: 1573795

An analyst is trying to compare the returns of two different firms, both operating in Europe. Why would the analyst *most likely* choose to use return on invested capital (ROIC) over return on equity (ROE)?

A) The two firms operate in different industries.

B) The two firms have differing capital structures.

C) The two firms operate in different countries.

Explanation

ROIC is the return to both equity and debt as opposed to ROE, which only looks at the return to equity. ROIC can be helpful in analyzing firms with different capital structures. The industry or country that the firm operates in is less likely to make a difference to the choice of ROIC or ROE.

(Module 40.1, LOS 40.c)