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# **CFA Institute**

## **CFA-Level-II**

### **CFA Level II Chartered Financial Analyst**



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## Question: 1

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The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha Witt, who manages the Koons' account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Later that afternoon, Garvey attends a company meeting on the ethics of money management. She listens to a lecture in which John Bloomquist, a veteran portfolio manager, talks about his

job responsibilities. Garvey takes notes that include the following three statements made by Bloomquist:

Statement 1: I'm not a bond expert, and I've turned to a colleague for advice on how to manage the fixed-income portion of client portfolios.

Statement 2: I strive not to favor either the remaindermen or the current-income beneficiaries, instead I work to serve both of their interests.

Statement 3: All of my portfolios have target growth rates sufficient to keep ahead of inflation.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1: I'm a CFA Level 3 candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part, graduate-level course, and passage requires an expertise in a variety of financial instruments as well as knowledge of the forces that drive our economy and financial markets.

Statement 1: I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

During the lunch conversation, which CFA Institute Standard of Professional Conduct was most likely violated?

- A. III(B) Fair Dealing.
- B. IV(A) Loyalty.
- C. V(A) Reasonable Basis.

**Answer: B**

Explanation:

Topel recommended the stock to his superiors, but they chose not to buy it. While Topel should not buy the stock in advance of his recommendation, he is not prohibited from purchasing it for himself should the company choose not to act. Kennedy's research may have been thorough, and there is no evidence that she violated the reasonable-basis Standard. However, the loyalty Standard requires that Kennedy put Samson Securities' interest before her own and not deprive her employer of her skills and abilities. Since Kennedy spent five days of company time researching Koral Koatings, the company has a right to benefit from her research. (Study Session 1, LOS 2.a)

## Question: 2

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Does Garvey's acceptance of the gifts from Koons and Jones violate Standard 1(B) Independence and Objectivity?

- A. Accepting Koons' gift was a violation.
- B. Accepting Jones\* gift was a violation.
- C. Neither gift would result in a violation.

**Answer: C**

Explanation:

The Koons' gift does not violate Standard 1(B). According to the standard, gifts from clients are different from gifts from other parties because the potential for obtaining influence to the detriment of other clients is not as great. Therefore, according to the standard, Garvey may accept the Koons' gift as long as she discloses it to her employer, which she did. See Example 7 on pages 22 and 23 of the Standards of Practice Handbook, 9th edition^ for an example of how the standard was applied in a similar situation.

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Did Garvey violate Standard 11(A) Material Nonpublic Information when she purchased Vallo and Metrona?

- A. Buying Vallo was a violation.
- B. Buying Metrona was a violation.
- C. Neither purchase was a violation.

<b>Answer: C</b>
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Explanation:

Topels purchases of Vallo do not violate Standard 11(A) because it was not based on material nonpublic information, and he has no duty to keep the information to himself. Therefore, Garvey's purchase of Vallo for her own account is also consistent with Standard 11(A).

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In her estimation of Zenith's future growth rate, what standard did Garvey violate?

- A. Standard 1(C) Misrepresentation regarding plagiarism.
- B. Standard V(A) Diligence and Reasonable Basis.
- C. Both 1(C) and V(A).

**Answer: B**

Explanation:

Garvey's idea for a growth estimate is interesting, but a number of factors affect the growth rate of a beverage company, many arguably more so than GDP growth. In addition, it is not sufficient to use two years worth of quarterly data (eight observations) to estimate a regression model and forecast growth over the following three years. The research was not thorough enough to satisfy Standard V(A).

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Which of Bloomquist's statements most likely applies to both the Prudent Man Rule and the Prudent Investor Rule?

- A. Statement 1.
- B. Statement 2.
- C. Statement 3.

<b>Answer: B</b>
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Explanation:

The impartiality standard requires prudent handling of different interests, such as those of different beneficiaries. This standard changed very little with the adoption of the Prudent Investor Rule. All of the other statements reflect provisions of the Prudent Investor Rule that would not have been permitted under the old Prudent Man Rule. Under the old Prudent Man Rule:

- The trustee was not allowed to delegate any duties to others.
- The preservation of the principal and purchasing power by earning a return sufficient to offset inflation was required. Under the new Prudent Investor Rule, growth in the real value of the principal (returns in excess of inflation) is permissible.

(Study Session 2, LOS IO.c)

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Did the two statements in Garvey's biography violate Standard VII(B) Reference to CFA Institute, the CFA designation, and the CFA program?

- A. Statement 1 is a violation.
- B. Statement 2 is a violation.
- C. Both statements are violations.

**Answer: C**

Explanation:

In the first statement, Garvey accurately calls herself a CFA Level 3 candidate, but she is not permitted to project when she will receive the charter, as she must still meet the work and eligibility restrictions and pass the Level 3 exam. Therefore, the first statement violates Standard VII(B).

In the second statement, the use of the CFA mark as a noun also violates the Standard VII(B). (Study Session 1, LOS 2.a)

## Question: 7

Maria Harris is a CFA® Level 3 candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains

a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company owned by her brother-in-law, for which she receives \$2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Julian Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels' firm is about to bring shares of an OTC firm to market in an

IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

By accepting the trip from Quadrangle, has Harris complied with the CFA Institute Code and Standards?

- A. Harris may accept the trip since she maintains a significant relationship with Quadrangle that contributes to the performance of client accounts.
- B. Harris may accept the trip since she disclosed the trip to her supervisor and compliance officer and accepted based on their approval.
- C. Harris may not accept the trip since the offer from Quadrangle could impede her ability to make objective investment decisions on behalf of the client.

**Answer: C**

Explanation:

Standard I(B) Professionalism: Independence and Objectivity prohibits members and candidates from accepting any gift that reasonably could be expected to compromise their independence and objectivity. The purpose of the gift appears to be to ensure that Islandwide continues to do business with Quadrangle and can be seen, therefore, as a clear attempt to influence her choice of brokers in the future. (Study Session 1, LOS 2.a)

## Question: 8

Maria Harris is a CFA® Level 3 candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company owned by her brother-in-law, for which she receives \$2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Julian Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at

Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels' firm is about to bring shares of an OTC firm to market in an

IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

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Has either Harris or Clark violated Standard 11(A) Integrity of Capital Markets: Material Nonpublic Information?

- A. Harris is in violation.
- B. Clark is in violation.
- C. Both are in violation.

<b>Answer: C</b>
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Explanation:

Standard 11(A) Integrity of Capital Markets: Material Nonpublic Information prohibits members who possess material nonpublic information to act on or cause others to act on that information. Information disclosed to a select group of analysts is not made "public" by that fact. (Study Session 1, LOS 2.a)

## Question: 9

Maria Harris is a CFA® Level 3 candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

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According to the Standards of Practice, with respect to the two offers from Adams and Baker, Harris:

- A. may accept both offers if she discloses them to her employer.
- B. may accept both gifts only if she discloses them to her employer and receives permission.
- C. must disclose the offer from Adams to her employer if she accepts it but must receive her employer's permission to accept the offer from Baker.

<b>Answer: C</b>
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Explanation:

Standard 1(B) Professionalism: Independence and Objectivity indicates that gifts from clients are seen to less likely affect a member's independence and objectivity, and only disclosure is required. The offer from Baker is based on future performance and is seen to carry greater risk of affecting objectivity because preferential treatment for one client could be detrimental to others. Thus, according to Standard IV (B) Duties to Employer: Additional Compensation Arrangements, Harris must disclose the offer to her employer (in writing) and receive the employer's permission before accepting the offer from Baker. (Study Session 1, LOS 2.a)

## Question: 10

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Has Michaels violated Standard 11(B) Integrity of Capital Markets: Manipulation with respect to any of the following?

- A. The buy program is a violation.
- B. The liquidity activity is a violation.
- C. There is no violation.

<b>Answer: C</b>
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Explanation:

Michaels has not violated Standard 11(B) Integrity of Capital Markets: Market Manipulation by either of these actions. In neither case is there the intent to mislead market participants. A large buy program may well increase the price of a stock. The trading desk has informed market participants that they will create additional liquidity for a period of 90 days after the offering and created no expectation that the liquidity of the stock will permanently remain at that level. (Study Session 1, LOS 2.a)

## Question: 11

Stanley Bostwick, CFA, is a business services industry analyst with Mortonworld Financial. Currently, his attention is focused on the 2008 financial statements of Global Oilfield Supply, particularly the footnote disclosures related to the company's employee benefit plans. Bostwick would like to adjust the financial statements to reflect the actual economic status of the pension plans and analyze the effect on the reported results of changes in assumptions the company used to estimate the projected benefit obligation (PBO) and net pension cost. But first, Bostwick must familiarize himself with the differences in the accounting for defined contribution and defined benefit pension plans.

Global Oilfield's financial statements are prepared in accordance with International Financial Reporting Standards (IFRS). Excerpts from the company's annual report are shown in the following exhibits.

**Exhibit 1: Reconciliation of Projected Benefit Obligation**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Change in projected benefit obligation:			
Benefit obligation at beginning of year	€64,230	€50,534	€39,132
Service cost	8,298	7,290	5,926
Interest cost	4,128	3,906	3,322
Actuarial loss (gain)	(1,932)	5,034	4,590
Benefits paid	<u>(3,824)</u>	<u>(2,534)</u>	<u>(2,436)</u>
Projected benefit obligation at end of year	€70,900	€64,230	€50,534

**Exhibit 2: Reconciliation of Fair Value of Plan Assets**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Change in plan assets:			
Fair value of plan assets at beginning of year	€65,164	€44,296	€35,796
Actual return on plan assets	7,084	9,916	(1,868)
Employer contributions	5,000	13,486	12,804
Benefits paid	<u>(3,824)</u>	<u>(2,534)</u>	<u>(2,436)</u>
Fair value of plan assets at end of year	€73,424	€65,164	€44,296

**Exhibit 3: Reconciliation of Funded Status and Prepaid Benefit Cost**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Funded status at December 31:	€2,524	€934	(€6,238)
Unrecognized transition asset	—	(76)	(224)
Unrecognized prior service cost	126	88	2
Unrecognized net actuarial loss	<u>4,572</u>	<u>8,980</u>	<u>11,496</u>
Net pension asset	€7,222	€9,926	€5,036

**Exhibit 4: Components of Pension Cost**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Service cost	€8,298	€7,290	€5,926
Interest cost	4,128	3,906	3,322
Expected return on plan assets	(4,608)	(3,086)	(2,886)
Amortization of past service cost	(38)	(88)	(88)
Amortization of transition asset	(76)	(148)	(148)
Recognized net actuarial gain	—	<u>724</u>	<u>212</u>
Net pension cost	€7,704	€8,598	€6,338

**Exhibit 5: Weighted Average Pension Assumptions**

	<b>2008</b>	<b>2007</b>	<b>2006</b>
Discount rate	6.75%	6.25%	6.75%
Rate of compensation growth	5.00%	5.00%	5.00%
Expected return on plan assets	7.50%	7.50%	9.00%

If Global Oilfield were to adopt U.S. pension accounting standards, what adjustment, if any, is necessary to its balance sheet at the end of 2008 assuming no taxes?

- A. Decrease assets by €7,222, decrease liabilities €2,524, and decrease equity by \$4,698.  
B. Decrease assets by €4,698 and decrease equity by €4,698.  
C. No adjustment is necessary.

**Answer: B**

Explanation:

At the end of 2008, Global Oilfield reported a net pension asset of €7,222 in accordance with IFRS. Under SFAS No. 158, Global Oilfield's funded status of €2,524 should be reported on the balance sheet. Thus, it is necessary to reduce the net pension asset by €4,698 (€7,222 as reported - €2,524 funded status). In order for the accounting equation to balance, it is also necessary to reduce equity by €4,698. (Study Session 6, LOS22.d)

## Question: 12

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**Exhibit 5: Weighted Average Pension Assumptions**

	<b>2008</b>	<b>2007</b>	<b>2006</b>
Discount rate	6.75%	6.25%	6.75%
Rate of compensation growth	5.00%	5.00%	5.00%
Expected return on plan assets	7.50%	7.50%	9.00%

What was the most likely cause of the actuarial gain reported in the reconciliation of the projected benefit obligation for the year ended 2008?

- A. Increase in the average life expectancy of the participating employees.
- B. Decrease in the expected rate of return.
- C. Increase in the discount rate.

**Answer: B**

Explanation:

At the end of 2008, Global Oilfield reported a net pension asset of €7,222 in accordance with IFRS. Under SFAS No. 158, Global Oilfields funded status of €2,524 should be reported on the balance sheet. Thus, it is necessary to reduce the net pension asset by €4,698 (€7,222 as reported - €2,524 funded status). In order for the accounting equation to balance, it is also necessary to reduce equity by €4,698. (Study Session 6, LOS22.d)



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Expected return on plan assets	7.50%	7.50%	9.00%

Which of the following best describes the effects of a decrease in the rate of compensation growth during 2009 all else equal? Global Oilfield's:

- A. service cost is lower and the accumulated benefit obligation is higher.
- B. pension expense is lower and the plan assets are higher.
- C. net income is higher and the funded status is higher.

**Answer: C**

Explanation:

A decrease in the compensation growth rate will reduce service cost. Lower service cost will result in lower pension expense and, thus, higher net income. Lowering the compensation growth rate will also reduce the PBO. A lower PBO will increase the funded status of the plan (make the plan appear more funded). The compensation growth rate has no effect on the ABO and plan assets. (Study Session 6, LOS 22.c)

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Rate of compensation growth	5.00%	5.00%	5.00%
Expected return on plan assets	7.50%	7.50%	9.00%

As compared to Global Oilfield's reported pension expense, economic pension expense for the year ended 2008 is:

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

**Answer: B**

Explanation:

For the year-ended 2008, Global Oilfield's reported pension expense was €7,704 (Exhibit 4), and its economic pension expense was €3,410 (€8,298 service cost + €4,128 interest cost — €1,932 actuarial gain — €7,084 actual return). Alternatively, economic pension expense can be calculated as the change in the funded status excluding contributions (€2,524 funded status for 2008 - €934 funded status for 2007 - €5,000 contributions for 2008). (Study Session 6, LOS 22.f)

## Question: 15

Stanley Bostwick, CFA, is a business services industry analyst with Mortonworld Financial. Currently, his attention is focused on the 2008 financial statements of Global Oilfield Supply, particularly the footnote disclosures related to the company's employee benefit plans. Bostwick would like to adjust the financial statements to reflect the actual economic status of the pension plans and analyze the effect on the reported results of changes in assumptions the company used to estimate the projected benefit obligation (PBO) and net pension cost. But first, Bostwick must familiarize himself with the differences in the accounting for defined contribution and defined benefit pension plans.

Global Oilfield's financial statements are prepared in accordance with International Financial Reporting Standards (IFRS). Excerpts from the company's annual report are shown in the following exhibits.



**Exhibit 1: Reconciliation of Projected Benefit Obligation**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Change in projected benefit obligation:			
Benefit obligation at beginning of year	€64,230	€50,534	€39,132
Service cost	8,298	7,290	5,926
Interest cost	4,128	3,906	3,322
Actuarial loss (gain)	(1,932)	5,034	4,590
Benefits paid	<u>(3,824)</u>	<u>(2,534)</u>	<u>(2,436)</u>
Projected benefit obligation at end of year	€70,900	€64,230	€50,534

**Exhibit 2: Reconciliation of Fair Value of Plan Assets**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Change in plan assets:			
Fair value of plan assets at beginning of year	€65,164	€44,296	€35,796
Actual return on plan assets	7,084	9,916	(1,868)
Employer contributions	5,000	13,486	12,804
Benefits paid	<u>(3,824)</u>	<u>(2,534)</u>	<u>(2,436)</u>
Fair value of plan assets at end of year	€73,424	€65,164	€44,296

**Exhibit 3: Reconciliation of Funded Status and Prepaid Benefit Cost**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Funded status at December 31:	€2,524	€934	(€6,238)
Unrecognized transition asset	—	(76)	(224)
Unrecognized prior service cost	126	88	2
Unrecognized net actuarial loss	<u>4,572</u>	<u>8,980</u>	<u>11,496</u>
Net pension asset	€7,222	€9,926	€5,036

**Exhibit 4: Components of Pension Cost**

<i>(in thousands)</i>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Service cost	€8,298	€7,290	€5,926
Interest cost	4,128	3,906	3,322
Expected return on plan assets	(4,608)	(3,086)	(2,886)
Amortization of past service cost	(38)	(88)	(88)
Amortization of transition asset	(76)	(148)	(148)
Recognized net actuarial gain	—	<u>724</u>	<u>212</u>
Net pension cost	€7,704	€8,598	€6,338

**Exhibit 5: Weighted Average Pension Assumptions**

	<b>2008</b>	<b>2007</b>	<b>2006</b>
Discount rate	6.75%	6.25%	6.75%
Rate of compensation growth	5.00%	5.00%	5.00%
Expected return on plan assets	7.50%	7.50%	9.00%

Assume for this question only that economic pension expense for the year ended 2008 was €4,250. Ignoring income taxes, which of the following statements best describes the adjustment necessary for analyzing Global Oilfield's cash flow statement?

- A. Increase operating cash flow €750 and decrease financing cash flow €750.
- B. Decrease operating cash flow €2,084 and increase investing cash flow €2,084.
- C. Increase operating cash flow €5,000 and decrease financing cash flow €5,000.

**Answer: A**

Explanation:

Economic pension expense represents the true cost of the pension. If the firm's contributions exceed its economic pension expense, the difference can be viewed as a reduction in the overall pension obligation similar to an excess principal payment on a loan. Pension contributions are reported as operating activities in the cash flow statement while principal payments are reported as financing activities. Thus, the adjustment involves increasing operating cash flow by

€750 (€5.000 employer contributions - €4,250 economic pension expense) and decreasing financing cash flow by the same amount. (Study Session 6, LOS 22.e)

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