Introduction to Business Valuation and Restructuring

Learning Problems

Answer Keys

**CFA Research Standards**

1. Policies should be developed so equity analysts remain at arm’s length with the subject company. Jacobson needs to freely communicate with Delta in conference calls or company visits, but she or her family cannot accept gifts or paid travel to attend these events. Employment for her spouse is most certainly unacceptable.
2. Analysts are encouraged to invest in shares they recommend, but Dreyfus is engaging in “front-running” by purchasing shares before his clients based on new information in the research report. A restricted period when analysts cannot trade in specific shares before their clients when in possession of new information would have prevented this abuse. He also sold shares contrary to his firm’s strong buy recommendation and sold before the normal 60-day holding period expired. This holding period helps to prevent short-term speculation. Equity analysts may be allowed to sell early if financial hardship can be demonstrated, but that does not appear to be the case with Dreyfuss and his partner. Financial hardship should be strictly interpreted to prevent abuse.
3. Harrison Investments should have policies to encourage analyst independence and objectivity. Approving all trades, receiving a record of each equity analyst’s holdings monthly, and having restricted periods will help to prevent front-running, short-term speculation, and insider trading.
4. When Willington attended the seminar, she should have supplied enough information so participants could have made an informed judgment about the objectivity of the research report and the suitability of the investment based on each investor’s circumstances and constraints. She should have also indicated that a full research report was available for review at a reasonable cost or for free. In addition to giving the strong buy, the recommendation’s time horizon and an estimate of the riskiness of the investment must be provided. She needs to disclose her conflicts of interest which included the investment banking relationship, engaging in marketing activities, and pay linked to the success of the issue. These conflicts of interest should be disclosed in the research report or on the company’s website.
5. Jenkins did not exercise diligence, independence, and thoroughness or show a reasonable and adequate basis for her conclusions by plagiarizing the report. The report should disclose the investment process followed along with any significant limitations or risks and differentiate between fact and opinion. Proper records to support the research should be maintained. Hoboken should have policies that ensure there is a reasonable and adequate basis for the recommendations. A due diligence review should be conducted by a supervisor or review committee before the research report is distributed.
6. Aloha’s research unit should not report to the investment banking unit, and that unit’s head should not be involved in any research. Williams should not be involved in marketing the securities or have his compensation linked to the success of the issue. He should be free of all conflicts of interest to ensure his independence and objectivity. If conflicts do exist, they should be clearly disclosed to clients. Williams compensation should be based on the quality of his research. Stock ownership is encouraged, but he should only be allowed to purchase shares once clients have had an opportunity to invest. Derivative securities like stock options should not be awarded or purchased.
7. Baxter has received material, non-public or insider information about the new product. She should notify her compliance department at once and they should work with Great Plains Manufacturing to make this information public as soon as possible through a press release. No trading should take place until this occurs.
8. The expert did not have material, non-public information about Mandalay as they were never employed by the company. Placement services refer research analysts to experts who help them better understand industry developments. These experts are briefed on the importance of not disclosing insider information.
9. “Firewalls” are procedures to prevent the movement of information between the investment banking and research units of a company that may lead to conflicts of interest and insider trading.
10. Ranson Securities should issue a final report and recommendation before ceasing coverage and provide a written rationale for its decision.
11. Toews is part of a group of analysts that prepared a research report for Agassi Enterprises and made their recommendation by consensus. She can sign the report even if she does not agree with the recommendation if she feels proper research methods were used.
12. Bracken has written a report that follows the research standards of independence and objectivity and diligence and reasonable basis and is free of any conflicts, misrepresentations, and insider information.
13. Patel’s research report was completed when she was employed by CCR so it belongs to that firm. She cannot take the report with her and publish it under her new firm’s name. Patel cannot use the published research report even if it has been made public because the supporting records are not available. She can only recreate records using disclosures made directly by the subject company and any other public information. An analyst’s memory of what was included in the supporting records cannot be used.
14. Dove’s estimate of reserves at Big Pit Mines is his opinion and should not be presented as a fact to clients.
15. Mantel should have given her colleague credit for the model she used to value Smithson Ltd. and ensure that she understood the best-case scenario.
16. Willow and his employer violated a number of research standards. The supervisor should review the report thoroughly before distributing it to clients. Willow needs to provide the valuation model’s source and include all relevant variables. He must not manipulate the model to give the investment banking unit the results they want. Willow should correct any errors in the report and immediately disclose them to clients. He must not exaggerate his experience and performance as a research analysis. Performance information must be accurately disclosed using an appropriate benchmark.
17. Dolson should indicate the source of the investment reports that where purchased. Analysts must understand the reports before distributing them to clients and not indicate that returns are guaranteed. All returns are subject to some risk.
18. Radisson Wealth Management has introduced a written policy relating to research objectivity and has properly addressed the relationship between the investment banking and research units and research analyst compensation.
19. Riley cannot just say she used a proprietary business valuation model that was updated this year. Models must be thoroughly described including all assumptions. Changes in methodology since the last report must be disclosed.
20. Crawford should follow the same research standards as large investment firms including independence and objectivity, misrepresentation, material non-public information, diligence and reasonable basis, communications with clients, record retention, and disclosure of conflicts. Churchill Industries does not determine the investment recommendation—all recommendations are the unbiased opinion of the research analyst. Crawford must stipulate that the research report was paid for by the issuer and not try to deceive clients into thinking it was written by a major investment firm. She should receive a flat fee only to eliminate a potential conflict of interest.
21. Pascal can accept the chartered flights and lodgings from Sparkling as there are no other reasonable travel alternatives.
22. Meadows can promise Skylark Investments will cover the client if it is hired to manage the IPO, but he cannot promise a strong buy recommendation.
23. Robbins has a serious conflict of interest as he sits on Dolson Industries’ board of directors while covering the company for his investment firm. His wife is also a member of a family trust that owns 40% of the company.
24. Selma is carefully monitoring the personal trading of each analyst and their immediate family members to prevent front-running, short-term speculation, insider trading, and other conflicts of interest that may impact the analyst’s independence and objectivity.
25. Willobey did not demonstrate diligence and reasonable basis when preparing the research report for Twilight.
26. Ramos concerns are unfounded. She can manage the investment portfolios of her parents, aunts, and uncles as regular clients and does not have to report their trading and investment holdings each year. They are not immediate family members residing at the same principal residence. Also, Ramos does not have to disclose trades in the company’s defined contribution pension plan made on her behalf as these investments are in well-diversified equity and fixed-income funds and not specific companies.
27. The compliance system at Portsmouth appears very weak. A firm should have a written policy governing research objectivity and independence and distribute it to all its employees and clients. Employees should receive regular training as to their responsibilities under the policy. A firm should have an effective compliance system that clearly outlines all potential violations and the appropriate disciplinary actions to be taken including dismissal. Supervisors ensure employees comply with the policy and senior officers attest that it is being followed. The system is monitored and audited on an ongoing basis and proper records are maintained. All types of violations and their corresponding penalties are disclosed to clients.
28. Practice 1 at Augusta Investments violates research standards. Analysts are encouraged to purchase shares in the companies they recommend to better align their financial interests with those of their clients, but they are not allowed to trade before them. Practice 2 maintains the independence of the research unit and carefully monitors any communications between the research and investment units. Practice 3 requires analysts to follow a 30-day quiet period to help them remain independent and objective and avoid disclosing insider information when making recommendations.
29. Reese Investments should write a final research report and indicate that it has stopped coverage of Braxton because it is no longer an investment banking client.
30. Walsh should not be compensated based on the success of the investment banking unit’s stock offerings. This will help him remain independent and objective and avoid conflicts of interest when making investment recommendations.