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QUESTION 1

Shannon Industries is considering a project, which has the following cash flows: Time Cash Flow 0? 1\$2,000 23,000 33,000 41,500 The project has a payback of 2.5 years. The firm's cost of capital is 12 percent. What is the project's net present value NPV?

- A. \$3,765.91
- B. \$765.91
- C. \$577.68
- D. \$1,049.80
- E. \$2,761.32

Correct Answer: B

First, find the missing $t = 0$ cash flow. If payback = 2.5 years, this implies $t = 0$ cash flow must be $-\$2,000 + \$3,000 + (0.5) \$3,000 = -\$6,500$. Enter the cash flows and the firm's cost of capital of 12%, then $NPV = \$765.91$.

QUESTION 2

If the money velocity is 5, the amount of money in circulation \$200 million and real GDP \$10 million, then prices are _____.

- A. 4
- B. 400
- C. 42
- D. 100

Correct Answer: D

According to the equation of exchange which is defined as $MV = PY$ we must solve for P in the following way: $(\$200 \text{ million} \times 5) = (\$10 \text{ million} \times P)$. This implies that $P=100$.

QUESTION 3

A firm needs to raise \$123 million for a proposed capital expansion project. Its earnings breakpoint is \$178 million and it is committed to maintaining a debt-to-equity ratio of 1.2. Its after-tax cost of debt is 6.2% and the required rate of return on its equity is 13.2%. The firm's marginal cost of capital for the project equals _____.

- A. 7.12%
- B. 6.89%
- C. 9.38%

D. 12.19%

Correct Answer: C

Since the proposed capital requirement of \$123 million is less than the earnings breakpoint, the firm's marginal cost of capital for the project equals its WACC. With $D/E = 1.2$, $E/(D+E) = 1/(1+1.2) = 0.455$. The WACC then equals $0.455 \times 13.2\% + 0.545 \times 6.2\% = 9.38\%$.

QUESTION 4

In the context of the security market line (SML), the expected (or required) return will decrease in the following situations EXCEPT:

- A. The U.S. Federal Reserve takes action that tightens the capital markets.
- B. Leading market indicators decrease, causing consumers to expect lower inflation levels.
- C. A firm announces that it has won a major product-liability lawsuit.
- D. The growth in the U.S. economy is expected to slow from 2.7% last year to 1.5% this year.

Correct Answer: A

If the capital markets tighten, the SML will shift upward in a parallel manner, resulting in a higher required return. If the capital markets loosen, the SML will shift downward in a parallel fashion, resulting in a decrease in expected return. All other choices result in a downward shift in the SML. After the lawsuit is "won," investors would likely view a firm as less risky and would move down along the SML to require a lower return. If economic growth decreases or if inflation decreases, the SML will shift downward in a parallel fashion. Investment growth opportunities are determined by the economy's long-term growth rate and factor into the real risk-free rate, which is a component of required return. When the growth rate decreases, investors who supply capital require a lower rate of return.

QUESTION 5

Standard IV (A.3) relates to two major components, Independence and Objectivity. Under this Standard, modest gifts that do not exceed _____ and entertainment are acceptable, without disclosure.

- A. \$100
- B. one-twentieth of your annual salary and bonus
- C. one-tenth of your annual salary and bonus
- D. \$500
- E. none of these answers
- F. \$1,000

Correct Answer: A

External sources may try to influence the investment process by offering analysts and portfolio managers a variety of "perks." The perks may include gifts, invitations to lavish functions, tickets and so on. Modest gifts that do not exceed \$100 and entertainment are acceptable, but special care should be taken by member analysts and investment

managers to resist subtle and not-so-subtle pressures to act in a manner possibly detrimental to their clients.

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