

# CFA-LEVEL-1<sup>Q&As</sup>

CFA Level I Chartered Financial Analyst

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**QUESTION 1**

According to the FASB conceptual framework, which of the following situations violates the concept of reliability?

- A. Financial statements include property with a carrying amount increased to management's estimate of market value.
- B. None of these answers.
- C. Financial statements are issued 9 months late.
- D. Data on segments having the same expected risks and growth rates are reported to analysts estimating future profits.
- E. Management reports to stockholders regularly refer to new projects undertaken, but that financial statements never report project results.

Correct Answer: A

Reliability has 3 primary qualities: verifiability, neutrality and representational faithfulness. Neutrality is violated here as information should not be prepared or reported to obtain a predetermined result, and should be free from bias.

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**QUESTION 2**

Assume the following information for the common stock of Clay Industries, a large industrial firm: Required rate of return on equity: 14.5% per year Expected growth rate: 12.50% per year Dividend at t<sub>0</sub>: \$0.70

Assuming that the growth rate will remain constant, what is the projected value of Clay Industries common stock?

- A. \$39.38
- B. None of these answers
- C. \$32.78
- D. The answer cannot be calculated from the information provided
- E. \$30.76
- F. \$35.34

Correct Answer: A

In this example, the growth rate of dividends is assumed to remain stable, allowing the use of the Gordon Model. The Gordon Model is also known as the "constant growth dividend discount model" and takes the following form:

$$P_0 = [D_1 / (r - g)]$$

Where P<sub>0</sub> = the price of common stock X at time 0 D<sub>1</sub> = the expected dividend at t<sub>1</sub> r = the required rate of return on equity investments and g = the expected growth rate of dividends.

Since the dividend at t<sub>1</sub> is not provided, we must calculate it manually by multiplying the dividend at t<sub>0</sub> by (1 + g). This will produce an answer of \$0.7875 at t<sub>1</sub>.

Now that the dividend at  $t_1$  has been determined, the given information can be put into the equation provided, leading to the following series of calculations:

$$P_0 = [\$0.7875 / (.145 - .125)] = \$39.38.$$

When using the Gordon model, remember that the required rate of return "r" must be greater than the expected growth rate "g." Otherwise, this equation will produce a nonsensical answer.

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**QUESTION 3**

Under the indirect method, when reporting the cash flow from operations the starting point is

- A. the net changes of the operating asset and liability accounts.
- B. cost of goods sold.
- C. net income.
- D. all noncash expenses.
- E. cash collections.

Correct Answer: C

Under the indirect method the starting point is the period's net income.

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**QUESTION 4**

Which of the following statements about the positions of the clearinghouse is CORRECT? The clearinghouse:

- A. takes no position.
- B. only takes short position to buyers.
- C. only takes long positions to sellers.
- D. takes short positions to buyers and long positions to sellers.

Correct Answer: D

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**QUESTION 5**

Which of the following factors will cause country A's currency to appreciate relative to the currency of country B, all else equal?

- I. A has higher income growth.
- II. A has higher inflation.
- III.

B has higher real interest rate.

A.

II and III

B.

None of them

C.

I, II and III

D.

I only

E.

II only

F.

III only

G.

I and III

Correct Answer: B

A country's currency will appreciate relative to those of its trading partners if it has lower income growth (which will cause the increase in imports to lag behind the increase in exports), has a lower inflation rate or offers higher real interest rates.

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## QUESTION 6

One of the discretionary accounts managed by Farnsworth is the Jones Corporation employee profit-sharing plan. Jones, the company president, recently asked Farnsworth to vote the shares in the profit-sharing plan in favor of the company-nominated slate of directors and against the directors sponsored by a dissident stockholder group. Farnsworth does not want to lose this account because he directs all the account's trades to a brokerage firm that provides Farnsworth with useful information about tax-free investments. Although this information is not of value in managing the Jones Corporation account, it does help managing several other accounts. The brokerage firm providing this information also offers the lowest commissions for trades and best execution. Farnsworth investigates the directors' issue, concludes that management's slate is better for the long-run performance of the firm than the dissident group's slate and votes accordingly. Farnsworth:

A. Did not violate the Standards in voting the share in the manner requested by Jones or in directing the trades to the brokerage firm.

B. Violated the Standards in directing the trades to the brokerage firm but not in voting the shares as requested by Jones.

C. Violated the Standard in voting the shares in the manner requested by Jones and in directing trades to the brokerage

firm.

D. Violated the Standards in voting the shares in the manner requested by Jones but not in directing trades to the brokerage firm.

Correct Answer: A

This question pertains to Standard IV (B.1) Fiduciary Duties, in particular members' responsibilities for voting proxies and the use of client brokerage. Because Farnsworth investigated the issue and concluded independently the best way to vote, he was not in violation of his fiduciary duties even though the company president asked him to vote the shares of the profit-sharing plan a certain way. Moreover because the brokerage firm provides the lowest commissions and best executions, he has met his fiduciary duties to the client in using this brokerage firm. Since he's not paying any extra money of the client for the information he's receiving from the brokerage firm, it does not matter.

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### QUESTION 7

Consider the following argument: "The cost of common stock should decrease as the dividend payout is increased because investors are more certain of receiving these dividends than the capital gains which are supposed to be derived from retained earnings." This statement applies best to which of the following financial theories? Choose the best answer.

- A. Tax Preference Theory
- B. Dividend Irrelevance Theory
- C. Tax Irrelevance Theory
- D. Dividend Relevance Theory
- E. Bird-in-hand Theory

Correct Answer: E

The Bird-in-the-Hand Theory came about as a refutation of Modigliani and Miller's Dividend Irrelevance Theory. The founders of the Bird-in-the-Hand Theory, Myron Gordon and John Lintner, stated that investors are more confident in the fact that they will receive dividends versus capital gains. So said, the cost of common stock should decrease as the payout ratio is increased. The Tax Preference Theory states that investors prefer capital gains to dividends, and this is due to the structure of tax rates. Specifically, dividends are typically taxed at a higher rate than capital gains, and are in this respect less attractive.

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### QUESTION 8

What does FASB refer to?

- A. The Financial Analysts Standards Board.
- B. The Federal Accounting Society Board of Directors.
- C. The Financial Accounting Standards Board.
- D. None of these answers.

Correct Answer: C

The Financial Accounting Standards Board.

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**QUESTION 9**

Typical features attached to preferred stock include all of the following except:

- A. Demand redemption rights.
- B. Dividend distribution preferences.
- C. Liquidation priorities.
- D. Non-voting rights.

Correct Answer: A

Preferred shareholders hold a security that looks very similar to a bond, but they are very rarely allowed to demand redemption of their shares. On the other hand, many bonds are callable.

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**QUESTION 10**

Makeover Inc. believes that at its current stock price of \$16.00 the firm is undervalued in the market. Makeover plans to repurchase 2.4 million of its 20 million shares outstanding. The firm's managers expect that they can repurchase the entire 2.4 million shares at the expected equilibrium price after repurchase. The firm's current earnings are \$44 million. If management's assumptions hold, what is the expected market price after repurchase?

- A. \$16.00
- B. \$17.26
- C. \$20.00
- D. \$18.18
- E. \$24.40

Correct Answer: D

Step 1: Current EPS = \$44 million/20 million = \$2.20 per share.

Step 2: P/E ratio = \$16.00/\$2.20 = 7.27x.

Step 3: EPS after repurchase = \$44 million/17.6 million = \$2.50.

Step 4: Expected market price after repurchase: 7.27 x \$2.50 = \$18.18 per share.

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**QUESTION 11**

Which of the following is/are FALSE about Basic EPS and Diluted EPS?

- I. Basic EPS excludes anti-dilutive securities but Diluted EPS must include these.

II. Basic EPS ignores instruments like convertible bonds and warrants but Diluted EPS does not.

III.

The Treasury stock method, when applied to Basic EPS, compares the average stock price during the period to the strike price in determining conversion.

A.

III only

B.

I and III

C.

I, II and III

D.

II only

Correct Answer: B

Note that the questions asks for false statements. (I) is false since both methods exclude anti-dilutive securities from computations. Further, since the Basic EPS ignores all potentially dilutive securities and takes into account only simple capital structure instruments (stocks, bonds, preferred equity), it has no need for the Treasury Stock method i.e. the Treasury stock method is never used in the computation of Basic EPS.

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## QUESTION 12

Hercules Poirot has just received the AIMR letter, informing him that he has passed the Level III exam in the CFA program. He changes his resume to reflect this information. The header now says, "Hercules Poirot, CFA," the "CFA" written in a smaller font. With respect to Standard II (A) - Use of Professional Designation - if Hercules circulates this resume, he will:

A. have violated Standard II (A). He cannot use the CFA designation till AIMR informs him that he has earned the charter.

B. have violated Standard II (A). He cannot put the CFA designation on his business card immediately after his name.

C. have violated Standard II (A). He cannot claim to be a CFA till he obtains the final diploma from AIMR.

D. not have violated Standard II (A).

Correct Answer: A

A candidate earns a CFA charter only after he has passed all 3 exams and has accumulated sufficient professional experience to satisfy the requirements of the program. Till the ICFA Board approves his candidacy, Hercules cannot use the designation, "CFA."

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## QUESTION 13

Which of the following methods of evaluating capital projects incorporate an explicit discount rate into the equation?

- A. Net Present Value, Payback Period
- B. Internal Rate of Return, Modified Internal Rate of Return
- C. Discounted Payback Period, Net Present Value, Payback Period
- D. Discounted Payback Period, Net Present Value, Modified Internal Rate of Return
- E. Discounted Payback Period, Net Present Value, Internal Rate of Return

Correct Answer: D

Of the methods for evaluating capital projects, the Net Present Value, Modified Internal Rate of Return, and Discounted Payback Period Methods incorporate an explicit discount rate into their equations. This discount rate is often referred to as the "cost of capital" for the project being examined. Remember that the Internal Rate of Return equation does not involve the incorporation of an explicit discount rate, rather solves to find that rate which equates the present value of a project's cash inflows with that of its cash outflows. Additionally, the "Payback Period" method does not involve an explicit discount rate, rather fails to incorporate any form of discounting into its calculation. The Payback Period is an overtly simplistic method, and as such, the figures produced by this method should be viewed with a degree of caution.

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#### QUESTION 14

Which of the following rules apply for calculations under the Performance Presentation Standards?

- A. Accrual accounting must be used for fixed-income securities.
- B. All of these answers.
- C. Total return, including realized and unrealized gains and losses, must be used.
- D. Time-weighted rate of return must be used.

Correct Answer: B

All of these answers are general rules applying to calculation of returns under the PPS.

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#### QUESTION 15

Simone Girau holds a callable bond and Chi Rigazio holds a putable bond. Which of the following statements about the two investors is TRUE?

- A. As the yield volatility increases, the value of both Girau's bond and the underlying option increases.
- B. Both investors calculate the value of the bond held by adding the value of the option to the value of a similar straight bond.
- C. Girau's bond has less potential for price appreciation.
- D. If yield volatility increases, the value of Rigazio's option will decrease.

Correct Answer: C



When a bond has a call provision, the potential for price appreciation is reduced, because the call caps the price of the bond near the call price. Even if interest rates fall considerably, it is unlikely that investors would pay a price that exceeds the call price. The other statements are false. To calculate the value of a puttable bond, it is correct to add the option value to the value of a similar straight bond. However, to calculate the callable bond value, subtract the option value from that of a similar straight bond. As a result, when yield volatility increases (thus increasing the option value), the value of a callable bond decreases and the value of a puttable bond increases. A call option does benefit the issuer, but a put option benefits the holder. Embedded options (puts and calls) increase in value when volatility increases.

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