CFA-LEVEL-1 Q&As

CFA Level I Chartered Financial Analyst

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QUESTION 1

What is a listing of all possible outcomes of an experiment and their corresponding probability of occurrence called?

A. Random variable

B. Frequency distribution

C. Subjective probability

D. None of these answers

E. Probability distribution

Correct Answer: E

The probability distribution shows the outcomes with corresponding probabilities.

QUESTION 2

Which of the following statements about asset valuation is TRUE?

A. The bottom-up stock picking approach is: first, stock analysis, second, industry analysis, and third, economic analysis

B. The absolute value of economic value added (EVA? is less important than the trend.

C. Earnings are considered the variable least likely to be manipulated.

D. A domestic steel firm and a foreign steel firm will have similar earnings per share (EPS) levels and price/earnings (P/E) ratios.

Correct Answer: B

Management\\'s performance over time is most important. The other statements are false. The bottom-up stock picking approach consists of one step ?pick the stocks you believe are underpriced, regardless of the state of the economy or the industry. The choices given here for picking stocks are the steps of the top-down approach in reverse order. Sales are considered the variable least likely to be manipulated. Although the basic methodologies for international stock valuation and domestic stock valuation (dividend discount model [DDM], EPS, P/E) are the same, the analyst must be aware of and consider differences in accounting practices and factor in the impact of exchange rate movements. It is also important to consider the absolute performance of foreign firms and their relative performance against local firms.

QUESTION 3

Form 10-K is filed with the SEC to update the information a company supplied when filing a registration

statement under the Securities Exchange Act of 1934. Form 10-K is a report that is filed

A. semiannually within 30 days of the end of a company\\'s second and fourth fiscal quarters.

B. quarterly within 45 days of the end of each quarter.

C. within 15 days of the occurrence of significant events.

D. none of these answers.

E. annually within 90 days of the end of a company\\'s fiscal year.

Correct Answer: E

Form 10-K is the annual report to the SEC. It must be filed within 90 days after the corporation\\'s yearend. It must contain audited statements.

QUESTION 4

Which of the following is/are true about liquidity ratios, all else equal?

I. The cash ratio increases as average receivables increase.

II. The quick ratio is a more conservative liquidity ratio than the current ratio.

III.

Liquidity ratios decrease as total liabilities decrease.

A.

III only

B.

II only

C.

I, II and III

D.

I and III

Correct Answer: B

Receivables are not part of the cash ratio and hence, changes in receivables do not directly affect the cash

ratio. The quick ratio does consider receivables in addition to cash and marketable securities but ignores

all other current assets.

Thus, it is more conservative than the current ratio.

QUESTION 5

What annual interest rate, compounded quarterly, would cause a series of 30 quarterly deposits of $500 to accumulate to $25,000, if the first deposit is made three months from today?

A. 3.31%

B. 12.78%

C. 9.94%

D. 13.22%

E. 8.15%

Correct Answer: D

The value returned by the calculator will be the periodic interest rate which must be multiplied by the number of periods per year to have the correct answer. On the BAII Plus, press 30 N, 0 PV, 500 PMT, 25000 +/- FV, CPT I/Y. Then press x 4 = to see the answer. On the HP12C, press 30 n, 0 PV, 500 PMT, 25000 CHS FV, i. Then press 4 x to see the answer. Make sure the BAII Plus has the P/Y value set to 1.

QUESTION 6

Which of the following is NOT a deferred credit item?

A. Deferred gain on installment sales

B. None of these answers

C. Deferred tax credits

D. Advance rental payments

Correct Answer: B

All of the responses qualify as deferred credit items.

QUESTION 7

You are examining a group of 20 mutual funds. You find that 10 have a 5% cash position, 4 have a 10% cash position, and 6 have a 2% cash position. What is the weighted average cash position of these 20 mutual funds?

A. 4.80%.

B. 5.10%.

C. 5.00%.

D. 4.90%.

Correct Answer: B

A weighted-average is equal to the sum (as i goes from 1 to n) of w_i * X_i, where w_i is the percentage weight of the ith item, and X_i is the value of the ith item. Here, we get a weighted mean of 10/20 * 0.05 + 4/20 * 0.10 + 6/20 * 0.02 = 5.10%.

QUESTION 8

A net advance on an advance-decline series for the NYSE, coupled with a declining SandP 500 would, according to technical analysts,

A. signal a market trough.

B. signal a period of market unpredictability.

C. signal a market peak.

D. signal a temporary reprieve from the bear market.

Correct Answer: A

Technical analysts predict that when a market index is declining, but most stocks post price increases, the market is near its trough. Conversely, they predict that when a market index is increasing, but most stocks post price declines, the market is near its peak.

QUESTION 9

A project has the following cash flows over the next 5 years: $800, $300, $400, $900 and $1,200. Assume all cash flows occur at the end of a year. The project requires an initial cash outlay of $1,750. The firm faces a marginal borrowing rate of 8%. The payback period for the project equals ________.

A. 3.86 year

B. 4.19 years

C. 4 years

D. 3.28 years

Correct Answer: D

The payback period is defined as the expected number of years that would be required to recover the original investment. In particular, Payback period = Years before full recovery + (unrecovered cost at the start of payback year)/(net cash flow in the payback year) In this case, the recovery occurs in the 4th year. At the beginning of the 4th year, the unrecovered cost equals 1,750 - 800 300 - 400 = 250. Total cash flow in the 4th year equals 900. Therefore, payback period = 3 + 250/900 =

3.28 years. Note that the discount rate does not figure in the calculation of payback period.

QUESTION 10

Under the accrual basis of accounting, which of the following statements is true?

I. Reported net income provides a measure of operating performance.

II. Revenue is recognized when cash is received, and expenses are recognized when payment is made.

III.

Cash inflows are recognized when they are received, and cash outflows are recognized when they are made.

A.

I only

B.

I, II and III

C.

III only

D.

I and III

Correct Answer: D

QUESTION 11

Lascheid Enterprises is an all-equity firm with 175,000 shares outstanding. The company\\'s stock price is currently $80 a share. The company\\'s EBIT is $2,000,000 and is expected to remain constant over time. The company pays out all of its earning each year--so its earnings per share equals its dividends per share. The firm\\'s tax rate is 30 percent. The company is considering issuing $800,000 worth of bonds and using the proceeds for a stock repurchase. If issued the bonds would have an estimated yield to maturity of 8 percent. The risk-free rate is 5 percent and the market risk premium is also 5 percent. The company\\'s beta is currently 1.0, but its investment banker\\'s estimate that the company\\'s beta would rise to 1.2 if they proceeded with the recapitalization. What would be the company\\'s stock price following the repurchase transaction.

A. $102.63

B. $106.67

C. $77.14

D. $74.67

E. $70.40

Correct Answer: D

The bonds used in the repurchase will create a new interest expense for the company. This will change net

income. Dividends per share will change because net income changes and the number of shares

outstanding changes.

New interest expense: $800,000 x 8% = $64,000.

New net income: ($2,000,000 - $64,000)(1 - 0.3) = $1,355,200.

Shares repurchased: $800,000/80 = 10,000 shares.

New shares outstanding: 175,000 - 10,000 = 165,000 shares.

New dividends per share: $1,355,200/165,000 = $8.21.

We must also calculate a new cost of equity: 5% + (5%)1.2 = 11%.

New stock price: $8.21/11% = $74.67.

QUESTION 12

Firm A issues convertible bonds to raise capital in the amount of a million dollars. An identical Firm B issues debt with warrants attached to raise the same amount. Which of the following statements is/are true in this situation?

I. Firm A ignores the convertibility feature completely while recording the bonds.

II. Firm B\\'s interest expense is higher than that of Firm A.

III.

Both the firms recognize the dilutive effects of the debt while calculating EPS.

A.

I, II and III

B.

II and III

C.

I only

D.

II only

Correct Answer: A

While both convertible bonds and bonds with attached warrants derive significant value from the possibility of conversion to common stock, the accounting treatments for the two are quite different. With convertible bonds, the conversion feature is completely ignored and the bond is recorded as an ordinary bond. On the other hand, the proceeds from a bond-with-warrant issue are divided into two groups: those related to the bond and those related to the warrant. The former is recorded as a liability while the latter is directly added to equity, without any income statement effects. This leads to a bigger amortization of a discount (or a smaller amortization of premium) with a warrant-debt than with a convertible bond. This effect offsets the fact that a higher liability is recognized with a convertible bond. Hence, the interest expense is higher in general when debt-with-warrant is issued.

QUESTION 13

Given that the risk-free rate of return is 5%, what is the value of a zero-coupon bond with a principal payment of $15,000 in 15 years, and a risk-premium of 5%?

A. $7,864

B. $3,591

C. $6,415

D. $9,249

E. Not enough information

F. $11,358

Correct Answer: B

The value of a zero-coupon bond is the present value of its principal payments. The required rate of return is the risk-free rate of return plus the risk premium (5 + 5 = 10%). Using appendix C in the book by Reilly and Brown, the present value of the bond is $15,000 x 0.2394 = $3,591, or $15,000/(1.1^15).

QUESTION 14

Which standard deals with the Prohibition against Use of Material Nonpublic Information?

A. III

B. III (B.4)

C. IV (B.4)

D. IV (B.5)

E. V (A)

F. III (B.2)

Correct Answer: E

Standard V (A) - Prohibition against Use of Material Nonpublic Information, states that "members who possess material nonpublic information related to the value of a security shall not trade in that security if such trading would breach a duty or if the information was misappropriated or relates to a tender offer."

QUESTION 15

An economic researcher publishes evidence that the consensus inflation estimation for the following year

has no correlation with the actual inflation level the year before. The estimation error is often very large, but

does not display a pattern.

Which of the following theories would this evidence support?

A. rational ignorance

B. mean reversion

C. heteroskedasticity

D. monetarist theory

E. rational expectations hypothesis

F. adaptive expectations hypothesis

Correct Answer: E

Under the rational expectations hypothesis, individuals will form inflation expectations based on all relevant information available. Therefore a comparison of expected and realized inflation would show a random estimation error and no correlation with past estimates. The adaptive expectations hypothesis suggests that individuals will base their views of the future on their recent experience. Under this theory, estimations would show a pattern in the error. Expected inflation would tend to be too high following a period of high inflation, and then too low follow a period of limited inflation.