



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

CFA Level I Chartered Financial Analyst

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**QUESTION 1**

Suppose you were given \$4,000 today and deposited it into an account paying 8% per year, compounded monthly. If you know that you will need \$5,000 in the account 6 years from now, what monthly withdrawal can you make from the account, beginning one month from now, that will leave the account with exactly \$5,000 in it in 6 years?

- A. \$204.45
- B. \$15.80
- C. Can't be done
- D. \$123.45
- E. \$1.23

Correct Answer: B

On the BAII Plus, press 72 N, 8 divide 12 = I/Y, 4000 PV, 5000 +/- FV, CPT PMT. On the HP12C, press 72 n, 8 ENTER 12 divide i, 4000 PV, 5000 CHS FV, PMT. Note that the answer is a negative number. This is because it is a withdrawal from the account balance, just as the \$5,000 is. It is a very small value because most of the \$4,000 is needed to ensure there is \$5,000 in the account in 6 years! Make sure the BAII Plus has the value of P/Y set to 1.

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**QUESTION 2**

An acceptable method for recognizing profit when the collection of cash is in doubt is the \_\_\_\_\_.

- A. installment method
- B. percentage-of-completion method
- C. consignment method
- D. production method
- E. completed-contract method

Correct Answer: A

Revenue is recognized when the conditions of "realized" or "realizable" and earned are met. If the collectibility of assets to be received for products or services is in doubt, revenues may be recognized when cash is received, as in the installment method.

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**QUESTION 3**

New Gestalt, Inc., a software firm had a net income of 1.7 million last year. It has 200,000 common shares and 300,000 convertible bonds with face value of 100 outstanding. The convertible bonds carry a coupon of 4% and can be converted one-for-one. The average stock price last year was 39 and the maximum price was 57. The effective interest rate on the convertible debt is 8%. New Gestalt issued 100,000 preferred shares with face value 100 and a coupon of 5% on March 31st of last year. Assume the convertible bonds are dilutive and that New Gestalt faces a 30% tax rate. Given the above, if New Gestalt had 300,000 warrants with a strike of 36 outstanding instead of the convertible bonds,



the number of shares used in Diluted EPS would equal \_\_\_\_\_.

- A. 200,000
- B. 223,077
- C. 312,648
- D. 500,000

Correct Answer: B

Since the strike price of 36 on the warrants is less than the average stock price of 39, the warrants are dilutive. Using the Treasury stock method, the additional shares due to warrant exercise =  $300,000 \times (1 - 36/39) = 23,077$ . Total number of shares used in Diluted EPS =  $200,000 + 23,077 = 223,077$ .

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#### QUESTION 4

Which of the following best describes the relationship between the relative maturation of an industry and the retention ratio of companies within the industry? Further, what is the proposed relationship between expected growth and the relative maturity of an industry?

- A. Negative relationship; no correlation
- B. Negative relationship; negative relationship
- C. Positive relationship; negative relationship
- D. Positive relationship; positive relationship
- E. Negative relationship; positive relationship

Correct Answer: B

As an industry advances in maturity, growth of the overall industry will decline. As growth opportunities diminish, companies within the industry will be forced to pay out a larger proportion of their earnings as dividends; i.e. the dividend payout ratio will increase. Remember that the retention ratio is equal to  $(1 - \text{the dividend payout ratio})$ . Thus, the retention ratio of companies will likely decline as the industry advances in maturity. The relationship between the dividend payout ratio and the maturity of the industry is negative and loosely linear.

As an industry becomes more mature, growth opportunities decline. This relationship is also loosely linear.

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#### QUESTION 5

Cepeda Corporation requires a computer system for the next ten years, and is in the process of choosing among two mutually exclusive alternatives. System A costs \$50,000 today, and will produce positive net cash flows of \$12,000 a year for the next ten years ( $t = 1$  through  $t = 10$ ). System B costs \$30,000 today and will produce positive net cash flows of \$11,000 a year for the next five years. After five years, System B can be replaced under the same terms. The company's cost of capital is 10 percent. What is the equivalent annual annuity (EAA) of the best system?

- A. \$6,261.18
- B. \$3,862.73



C. \$5,002.39

D. \$3,086.07

E. \$2,373.48

Correct Answer: B

First find the NPV's of each system over its initial life.

System A:  $CF(0) = -50,000$ ;  $CF(1-10) = 12,000$ ;  $I = 10$ ; solve for  $NPV = \$23,734.81$ . System B:  $CF(0) = 30,000$ ;  $CF(1-5) = 11,000$ ;  $I = 10$ , solve for  $NPV = \$11,698.65$ . Second, find the value of the EAA of each

system. System A:  $N = 10$ ;  $I = 10$ ;  $PV = -23,734.81$ ;  $FV = 0$ ; solve for  $PMT = EAA = \$3,862.73$ . System B:

$N = 5$ ;  $I = 10$ ;  $PV = -11,698.65$ ;  $FV = 0$ ; solve for  $PMT = EAA = \$3,086.07$ . Given System A has a higher

EAA, it is the better of the two systems.

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