

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

CFA Level I Chartered Financial Analyst

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### **QUESTION 1**

Which of the following companies has the highest degree of financial leverage? Choose the best answer. Firm A EBIT: \$10,000,000 Interest Paid: \$750,000 Total Operating Expenses: \$25,000,000 Fixed Operating Expenses: \$19,750,000 Firm B EBIT: \$8,970,000 Interest Paid: \$88,000 Total Operating Expenses: \$20,050,000 Fixed Operating Expenses: \$17,000,000 Firm C EBIT: \$10,500,000 Interest Paid: \$1,050,000 Total Operating Expenses: \$50,000,000 Fixed Operating Expenses: \$50,000,000 Firm D EBIT: \$10,000,000 Interest Paid: \$750,000 Total Operating Expenses: \$50,000,000 Fixed Operating Expenses: \$50,000,000 Firm D EBIT: \$10,000,000 Firm E EBIT: \$5,195,000 Interest Paid: \$400,000 Total Operating Expenses: \$35,000,000 Fixed Operating Expenses: \$9,875,000

- A. Firm A
- B. Firm E
- C. Firm B
- D. Firm C
- E. Firm D
- F. Firm A and D have identical DFL\\'s

Correct Answer: D

The Degree of Financial Leverage (DFL) measures the percentage change in EPS that results from a given percentage change in EBIT. Financial Leverage is the second component of total leverage, along with Operating Leverage. The equation used to calculate the Degree of Financial Leverage is as follows: {DFL = [EBIT/(EBIT - Interest Paid)]}.

In this example, Firm C has the highest DFL, with a figure of 1.11. While Firm A and D do have identical Degree of Financial Leverage calculations, the question asks which firm has the highest DFL, which is firm

C. When calculating the DFL figure, remember that the answer can never be less than one, and can never be negative. In a situation where the company under examination has zero interest expense, the DFL would be equal to one; i.e. the EBIT is equal to the EBIT minus the interest expense. Another important note to remember is that in calculating the Degree of Financial Leverage, dividend payments to preferred stockholders should be included in the interest expense figure. Operating expenses are not factored into the DFL calculation, rather are used in the determination of Operating Leverage.

#### **QUESTION 2**

Flood Motors is an all-equity firm with 200,000 shares outstanding. The company\\'s EBIT is \$2,000,000 and is expected to remain constant over time. The company pays out all of its earnings each year, so its earnings per share equals its dividends per share. The company\\'s tax rate is 40 percent. The company is considering issuing \$2 million worth of bonds (at par) and using the proceeds for a stock repurchase. If issued, the bonds would have an estimated yield to maturity of 10 percent. The risk-free rate in the economy is 6.6 percent, and the market risk premium is 6 percent. The company\\'s beta is currently 0.9, but its investment banker\\'s estimate that the company\\'s beta would rise to 1.1 if they proceed with the recapitalization. Assume that the shares are repurchased at a price equal to the stock market price prior to the recapitalization. What would be the company\\'s stock price following the recapitalization?

A. \$53.85

B. \$51.14



- C. \$76.03
- D. \$56.02
- E. \$68.97
- Correct Answer: B

First, find the company\\'s current cost of capital, dividends per share, and stock price: k = 0.066 + (0.06)0.9 = 12%. To find the stock price, you still need the dividends per share or DPS =  $(\$2,000,000 (1 \ 0.4))/200,000 = \$6.00$ . Thus, the stock price is Po = \$6.00/0.12 = \$50.00. Thus, by issuing \$2,000,000 in new debt the company can repurchase \$2,000,000/\$50.00 = 40,000 shares. Now after recapitalization, the new cost of capital, DPS, and stock price can be found: k = 0.066 + (0.06)1.1 = 13.20%. DPS for the remaining (200,000 - 40,000) = 160,000 shares are thus  $[(\$2,000,000 - (\$2,000,000 \times 0.10))(1 \ 0.4)]/160,000 = \$6.75$ . And, finally, Po = \$6.75/0.132 = \$51.14.

#### **QUESTION 3**

Which of the following statements is true?

- A. Recognition is concerned with recognizing a liability from a current cash receipt.
- B. The Accrual process would reduce an asset that is recorded as a result of a cash payment.
- C. Realization is the process of converting non-cash resources and rights into money.
- D. All of these are true.
- E. Allocation is the process of formally recording or incorporating an item in the financial statements of an entity.

Correct Answer: C

Realization is the process of converting non-cash resources and rights into money and is most precisely used in accounting and financial reporting to refer to sales of assets for cash or claims to cash.

#### **QUESTION 4**

Which of the following is true regarding probability?

I. 0

II. The sum of the probabilities of any group of mutually exclusive events equals 1.

III.

0