CFA-LEVEL-1 Q&As

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QUESTION 1

Jim Williams, a financial analyst with Churn Brothers Brokerage, is attempting to value share of Intelligent Semiconductor. In his calculation, Jim calculates the following for each subperiod: [Net income + Depreciation - Capital Expenditures - Increases in Working Capital - Principal Repayments

+ New Debt Issues]. The results of this calculation will be referred to as "X."

The second step in the process is the determination of the "multiple" of X that shares of Intelligent will trade for in three years. This figure will be referred to as "M." Finally, Jim determines the required equity rate of return for shares of Intelligent Semiconductor. This

figure will be referred to as "r."

These calculations are inputted into the following equation:

Price of Intelligent Semiconductor = {[X during year 1 / (1 + r)] + [X during year 2 / (1 + r)(1 + r)] + [X in year

3 / (1 + r)(1 + r)(1 + r)] + [M * X in year 3/ (1 + r)(1 + r)(1 + r)]}

The results of this calculation are used as the value of Intelligent shares.

Which of the following best characterized the valuation method employed by Jim Williams?

A. Free cash flow to equity method

B. Arbitrage-pricing model

C. Supernormal growth model

D. None of these answers

E. Multi-period dividend discount model

Correct Answer: A

The method illustrated in this example is the free cash flow to equity method.

QUESTION 2

When a composite of international portfolios is created, firms should separate portfolios that are allowed to

use currency ________ from portfolios that may not use ________, unless the use of currency ________

is considered immaterial.

(Same answer for all three spaces)

A. selection

B. hedging

C. exchanges

D. swaps

E. strategy

Correct Answer: B

If a firm makes significant use of currency hedging when allowed, it should separate portfolios that do not allow such hedging into a different composite and use a different benchmark for the highly hedged and unhedged composites. Similarly, portfolios with materially different risk exposures do not belong in the same composite.

QUESTION 3

Following an internal investigation into her professional business activities, a financial analyst with Smith,

Kleen and Beetchnutty admits that in her NPV and IRR calculations, she has failed to index all cash flows for

the effects of anticipated inflation. However, the analyst claims that the discount rate she has used in her

calculations does take into effect anticipated inflation.

Which of the following correctly describes the effects this will have on the NPV and IRR calculations?

A. NPV will be biased downward, IRR will be biased upward

B. NPV will be biased upward, IRR will be biased downward

C. Both NPV and IRR will be biased downward

D. Both NPV and IRR will remain unaffected

E. NPV will be biased downward, IRR will be unaffected

F. Both NPV and IRR will be biased upward

Correct Answer: C

By failing to index the cash flows of projects in her NPV analysis, while at the same time including an adjustment for inflation into the discount rate, this analyst has biased the NPV calculation downward. This is because the cash inflows are being understated by the inflation-adjusted discounting. This phenomenon will skew the NPV figure downward. Remember that while the Internal Rate of Return calculation does not specify an explicit discount rate, rather calculates the discount rate that equates the cash inflows of a project with its cash outflows, the fact remains that the cash flows in the calculation have not been indexed for the effects of positive inflation. What has happened here is that cash flows have been understated, and this will bias the IRR calculation downward.

QUESTION 4

When examining a capital project with non-normal cash flows from the perspective of IRR, some distinct problems can arise, which of the following choices best describes the problems that can occur when examining projects with non-normal cash flows using IRR?

A. No IRR, an IRR which leads to an incorrect accept reject decision, concave MIRR profile

B. Multiple IRRs, an IRR which leads to an incorrect accept/reject decision, convex MIRR profile

C. Multiple IRRs, no IRR

D. Multiple IRRs, no IRR, an IRR which leads to an incorrect accept/reject decision

E. Timing differences, project scale differences, multiple IRRs

Correct Answer: D

When examining capital projects with non-normal cash flows, three distinct problems can occur: the project can have multiple IRRs, no IRR, or the calculation can lead to the production of an IRR figure which leads to an incorrect accept/reject decision. Thus, the second choice represents the most correct answer. "Timing differences" and "project scale differences" are two reasons for a conflict in the NPV and IRR calculations, and "MIRR profile" is a fictitious term.

QUESTION 5

Which of the following types of receivables is generally the most liquid?

A. Trade receivables

B. Receivables due from affiliated companies

C. None of these answers

D. Notes receivable

E. Receivables due from corporate officers

Correct Answer: A

Trade receivables are generally the most liquid type of receivable because they are generated from the sale of the firm\\'s goods or services. Other forms of receivables are less liquid because the terms of repayment may vary such as the case with those due from corporate officers and/or affiliated companies. Of particular interest is notes receivable. The analyst should take care to understand the terms of these arrangements.