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Chartered Financial Analyst Level 1

Test Prep CFA-Level-1

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Topic Break Down

Topic	No. of Questions
Topic 1, Ethics	462
Topic 2, Quantitative Methods	744
Topic 3, Economics	264
Topic 4, Financial reporting and Analysis	1035
Topic 5, Corporate Finance	575
Topic 6, Portfolio Management	93
Topic 7, Alternative Investments	147
Topic 8, Equity Investment	640
Total	3960

QUESTION NO: 1

Use the table below to choose the correct answer.

Time Period Actual Inflation

14 percent

24 percent

36 percent

48 percent

According to the adaptive expectations hypothesis, at the beginning of period 3, decision makers would expect inflation during period 3 to be _____.

A. 6 percent

B. 5 percent

C. 8 percent

D. 4 percent

ANSWER: D**Explanation:**

Under the adaptive expectations hypothesis economic agents base their future expectations on actual outcomes observed during recent periods. Thus, the most recent periods suggest an inflation rate of 4 percent will persist in the future.

QUESTION NO: 2

If the debit balances in brokerage accounts increase, the smart money technicians interpret it as:

A. none of these answers.

B. a bullish signal.

C. a hold signal.

D. a bearish signal.

ANSWER: B**Explanation:**

Debit balances in brokerage accounts represent margin debt i.e. borrowings by investors from the brokerages for investment in the market. Smart money technicians consider margin investors as a group of astute investors and hence interpret large leveraged investments as a bullish signal. Therefore, an large increase in the debit balances is considered a bullish sign while a decline is considered a bearish sign.

QUESTION NO: 3

Which of the following best describes a statement of cash flows?

- A.** A statement of cash flows details the cash inflows and outflows that are related to a company's operating, investing, and financing activities over a period of time.
- B.** A statement of cash flows summarizes the financial position of a company at a given point in time.
- C.** A statement of cash flows measures a company's financial performance over a specified period of time.
- D.** A statement of cash flows reports changes over a period of time in component accounts that comprise the ownership of a firm.
- E.** None of these answers.

ANSWER: A**Explanation:**

Under accrual accounting, net income does not typically equal net cash flow. While net income is important to identify, accrued income does not pay wages, payables, or dividends. Cash flows are important to identify since it is cash that repays loans, etc.

QUESTION NO: 4

The venture capital industry now funds investments such as

- A.** companies seeking leveraged buyouts.
- B.** none of these answers.
- C.** hedged funds.
- D.** companies in the mature stage of their life cycle.
- E.** all of these answers are correct.
- F.** companies emerging from bankruptcy.

ANSWER: A D F**Explanation:**

Recently, the venture capital industry has begun to cover a broader range of investments including funding for:

1. Established businesses that are in the process of expanding, just prior to the IPO stage.
2. Companies in "turnaround" situations.
3. Management seeking LBOs, also referred to MBOs of their companies.

QUESTION NO: 5

Which of the following statements about contrary-opinion and smart money technicians is INCORRECT?

- A. When margin balances in brokerages accounts increase, contrary-opinion technicians are bearish.
- B. The investment advisory ratio is at 0.65. Contrary-opinion technicians are bullish.
- C. The OTC volume is less than 87% of the NYSE volume. Investors are bearish.
- D. A narrowing of the T-bill - Eurodollar futures spread is a signal for a smart-money technician to buy.

ANSWER: A**Explanation:**

Although an increase in margin (debit) balances in brokerages accounts means investors are bullish, it is not an indicator used by contrary-opinion technicians. This would be a bullish sign to smart-money technicians.

The other statements are correct. When the investment advisory ratio (bearish opinions/total opinions) is equal to or greater than 0.60, it means that investors are bearish, and contrary-opinion technicians are bullish. Investors are considered bullish if the OTC volume is greater than 112% of the NYSE volume.

Summary of the indicators for contrary-opinion and smart money technicians:

Contrary-opinion technicians (trade the opposite of the mass of general investor): Smart-money technicians (follow the professional investors):

QUESTION NO: 6

Which of the following items is deducted from net income to arrive at cash flow from operations when using the indirect method?

- A. depreciation expense
- B. decrease in accounts receivable
- C. decrease in accounts payable
- D. amortization expense

ANSWER: C**Explanation:**

A decrease in accounts payable is an outflow.

QUESTION NO: 7

In a period of falling prices, the FIFO inventory method

- A. neither of these answers is correct
- B. both of these answers are correct
- C. magnifies the effects of the business cycle on income
- D. gives the lowest possible value for ending inventory

ANSWER: B**Explanation:**

The first-in-first-out (FIFO) method is based on the assumption that the costs of the first items acquired should be assigned to the first items sold, therefore ending inventory on hand is based on the most recent prices.

QUESTION NO: 8

Which of the following factors is not an underlying assumption of technical analysis?

- A. Supply and demand is driven by rational and irrational behavior.
- B. Prices move in trends that persist for long periods of time.
- C. The actual shifts in supply and demand cannot be observed in market behavior.
- D. Prices are determined by supply and demand.

ANSWER: C**Explanation:**

Shifts in supply and demand CAN be observed in market behavior.

QUESTION NO: 9

Which of the following will result in an insider trading prosecution?

- I. A tippee trades based on inside information, not knowing that the source of the information has actually received the information illegally and has breached fiduciary duty to the shareholders by leaking it. He has no reasons to suspect such a behavior.

II. A corporate outsider who has absolutely no connections to any of the insiders misappropriates inside information and trades for profit based on that information.

III. A tippee trades based on inside information about an impending tender offer after verifying that the source of the information has not breached any fiduciary duty to the company.

A. I only

B. III only

C. I, II and III

D. II and III only

E. A tippee trades based on inside information, not knowing that the source of the information has actually received the information illegally and has breached fiduciary duty to the shareholders by leaking it. He has no reasons to suspect such a behavior.

II. A corporate outsider who has absolutely no connections to any of the insiders misappropriates inside information and trades for profit based on that information.

III. A tippee trades based on inside information about an impending tender offer after verifying that the source of the information has not breached any fiduciary duty to the company.

ANSWER: D

Explanation:

A "Tippee" is any person who learns inside information from a corporate insider. A tippee can be held liable under SEC's section 10b and rule 10(b)-5 only if he knows or should know that the insider has behaved improperly and breached fiduciary duty in revealing the information. Otherwise, the tippee is not held responsible for insider trading. One exception to this rule is information about tender offers, in which tippee liability results automatically under SEC Rule 14e3, even if the insider has not breached any fiduciary duty. Under the Misappropriation Theory of insider trading, a person who misappropriates inside information and trades or abets trading in it is committing securities fraud and can be so charged, even if the person is a complete corporate outsider. The Topical Study, "Insider Trading," is probably the most important (and the trickiest) section in the handbook and you can expect at least one question from it.

QUESTION NO: 10

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; negative relationship

B. Positive relationship; negative relationship

C. Negative relationship; positive relationship

D. Negative relationship; no correlation

E. Positive relationship; positive relationship

ANSWER: A

Explanation:

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.

QUESTION NO: 11

Venture capital has proved to impact economic development in the following ways:

- A. all of these are correct
- B. job development
- C. competitive adaptation
- D. formation of capital
- E. none of these is correct
- F. technological innovation

ANSWER: B C D F**Explanation:**

Several researchers have concluded that venture capital investments are critical to the economy in terms of capital formation, local development, economic expansion, technological growth and innovation, employment growth, and competitive adaptation in global markets.

Besides adding jobs, venture capital investments have resulted in development of medical diagnostic and treatment equipment, and scientific improvements.

Venture capital investments have developed entrepreneurs and have contributed to innovation and competitiveness.

QUESTION NO: 12

A decrease in a firm's willingness to pay dividends is likely to result from an increase in its

_____.

- A. collection of accounts receivable
- B. earnings stability
- C. access to capital markets
- D. stock price

E. profitable investment opportunities

ANSWER: E

Explanation:

Two points must be kept in mind when deciding how much cash should be distributed to stockholders:

1. The main objective is to maximize shareholder value.
2. The cash flows generated by the firm belong to its shareholders. The optimal payout ratio is a function of 4 factors:
 1. Investors' preferences for dividends versus capital gains.
 2. The firm's investment opportunities.
 3. The firm's target capital structure.
 4. The availability and cost of external capital.

The last 3 steps are combined in the residual dividend model, which is a model in which the dividend paid is set equal to the actual earnings minus the amount of retained earnings necessary to finance the firm's optimal capital budget.