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SAMPLE QUESTION SET

CFA LEVEL I SAMPLE QUESTIONS & ANSWERS (2026)

50 original practice questions with answer key and brief solutions

50

QUESTIONS

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DIFFICULTY LEVELS

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PART 1 • QUESTIONS

50 questions grouped by topic, weighted to the official 2026 topic weights. Answers and brief solutions start after the last question.

QUANTITATIVE METHODS

Exam weight 6–9%

Question 1 EASY

Which of the following best describes a Monte Carlo simulation?

- A. A method that uses historical data exclusively to forecast future returns without any random component
- B. A technique that generates random scenarios based on assumed probability distributions to model uncertainty in outcomes
- C. A regression-based approach that fits a linear model to observed data points to estimate parameters

Question 2 MEDIUM

In hypothesis testing, a Type I error occurs when:

- A. The null hypothesis is not rejected when it is actually false
- B. The test statistic falls within the acceptance region and the null is true
- C. The null hypothesis is rejected when it is actually true

Question 3 MEDIUM

An analyst applies PCA to 20 macroeconomic variables. The first principal component explains 45% of total variance, and the second explains 22%. Which statement about using PCA in this analysis is most accurate?

- A. All 20 principal components should be retained in the model to avoid any potential loss of explanatory information in the original dataset.
- B. PCA is generally inappropriate for this application because macroeconomic variables are typically not normally distributed in practice.
- C. The first two components capture 67% of total variance and can substantially reduce dimensionality while retaining most information.

Question 4 HARD

Marisol opens a margin account and purchases 1,000 shares of Tregaron Industries at $\$80.00$ per share. The initial margin requirement is 60%, and her broker charges 5.5% annual interest on the margin loan. Over the next 12 months, Tregaron pays a single dividend of $\$1.20$ per share, and Marisol sells all shares at $\$96.00$ per share. Her marginal tax rate is 24%. Marisol's leveraged (pre-tax) holding-period return on equity for the 12-month period is closest to:

- A. 35.8%
- B. 32.2%
- C. 29.7%

Question 5 (EASY)

The price of Product X rises from $\$50.00$ to $\$55.00$, and the quantity demanded per week falls from 200 units to 184 units. Using the simple percent-change method, the own-price elasticity of demand for Product X is closest to:

- A. +0.80
- B. -1.25
- C. -0.80

Question 6 (MEDIUM)

A leading economic indicator is best described as a variable that:

- A. Changes direction at the same time as the overall economy
- B. Changes direction after the overall economy has already turned
- C. Tends to change direction before the overall economy changes direction

Question 7 (MEDIUM)

A country that imposes an import quota on steel will most likely experience:

- A. No change in domestic steel prices if the quota is set above current import levels
- B. Lower domestic steel prices due to reduced demand for steel
- C. Higher domestic steel prices and increased domestic steel production

Question 8 (HARD)

Banks in Avoral are required to hold reserves equal to 8% of deposits. In addition, banks voluntarily hold excess reserves equal to 2% of deposits as a precautionary buffer. Households and firms hold currency outside the banking system equal to 20% of deposits (the currency-to-deposit ratio). The central bank conducts an open-market purchase of $\$2$ billion in government securities directly from commercial banks, expanding the monetary base by that amount. Assuming the banking system fully utilizes its lending capacity and the currency and reserve ratios remain stable, the maximum eventual increase in the broad money supply (currency plus deposits) is closest to:

- A. $\$6.7$ billion
- B. $\$20.0$ billion
- C. $\$8.0$ billion

Question 9 (EASY)

According to the pecking order theory of capital structure, when a profitable firm requires external financing for a new project, it will most likely prefer:

- A. issuing new equity before issuing debt.
- B. issuing debt before issuing new equity.
- C. issuing convertible securities before either straight debt or equity.

Question 10 MEDIUM

A company has a cost of equity of 12%, a before-tax cost of debt of 6%, a marginal tax rate of 25%, and a target debt-to-capital ratio of 40%. The company's WACC is closest to:

- A. 9.0%
- B. 9.6%
- C. 9.0% if the firm uses book-value weights instead of market-value weights

Question 11 MEDIUM

A company must choose between two working capital strategies. Strategy A uses aggressive short-term financing with lower costs but higher rollover risk. Strategy B uses conservative long-term financing at higher cost but with stable funding. Compared to Strategy B, Strategy A will most likely result in:

- A. Higher profitability and lower risk due to lower interest expense
- B. Lower profitability but greater financial flexibility
- C. Higher profitability but greater liquidity risk

Question 12 HARD

Maplewood Bistro purchases \$4 million of food and supplies annually from its primary supplier on terms of 2/15, net 60. The bistro currently pays all invoices on day 60. Maplewood can draw on a short-term line of credit at a 14% annual rate. Assuming any early payment would be financed with the line of credit, which policy is most appropriate?

- A. Forgo the discount; the 2% saving over 60 days annualizes to ~12.2%, under 14%.
- B. Take the discount; forgoing it implicitly costs ~17.8%, above the 14% rate.
- C. Forgo the discount; trade credit is free, so paying early with bank debt loses value.

FINANCIAL STATEMENT ANALYSIS

Exam weight 11-14%

Question 13 EASY

In a common-size income statement, each line item is expressed as a percentage of:

- A. Total assets
- B. Net income
- C. Revenue

Question 14 EASY

Under IFRS, interest paid on debt may be classified in the statement of cash flows as either:

- A. operating or financing activities
- B. operating or investing activities
- C. investing or financing activities

Question 15 MEDIUM

Under the five-step revenue recognition model (IFRS 15 / ASC 606), the first step is to:

- A. Determine the transaction price
- B. Identify the performance obligations in the contract
- C. Identify the contract with the customer

Question 16 MEDIUM

A company has a valuation allowance against its deferred tax asset. If management subsequently determines that it is more likely than not that the deferred tax asset will be realized, the reversal of the valuation allowance will:

- A. Have no effect on net income because it only affects the balance sheet
- B. Increase income tax expense and decrease net income in the period of reversal
- C. Decrease income tax expense and increase net income in the period of reversal

Question 17 HARD

A company reports net income of \$50 million, revenue of \$500 million, total assets of \$400 million, and shareholders' equity of \$200 million. Using the three-component DuPont decomposition, the return on equity (ROE) and the equity multiplier are closest to:

- A. ROE = 12.5%; equity multiplier = 2.5
- B. ROE = 20.0%; equity multiplier = 1.5
- C. ROE = 25.0%; equity multiplier = 2.0

Question 18 HARD

Halberd Corp. reports under IFRS. On 1 January 20X1, the company tested a machine for impairment with the following data: carrying amount \$480,000, fair value less costs to sell \$310,000, and value in use \$340,000. The machine had 5 years of remaining useful life on the test date and is depreciated straight-line to zero residual value. The company recognized the appropriate impairment loss on 1 January 20X1 and continued straight-line depreciation thereafter. On 31 December 20X2, after two additional years of depreciation, an independent valuation indicated a recoverable amount of \$290,000. What carrying amount should Halberd report for the machine on its 31 December 20X2 balance sheet?

- A. \$204,000
- B. \$290,000
- C. \$288,000

EQUITY INVESTMENTS

Exam weight 11–14%

Question 19 EASY

Cumulative preferred shares differ from non-cumulative preferred shares in that if a dividend is skipped, cumulative shares:

- A. Accumulate unpaid dividends as arrears that must be fully paid before any common dividend is declared
- B. Convert automatically into common shares and receive full voting rights in proportion to the arrears owed
- C. Pay a higher dividend rate in subsequent years to compensate investors for the delay and time value lost during the skip

Question 20 EASY

An analyst evaluates a stable mature firm with the following data: ROE = 15%, required return on equity = 11%, and sustainable dividend growth rate = 5%. Using the single-stage justified price-to-book formula, the justified P/B is closest to:

- A. 1.36
- B. 2.50
- C. 1.67

Question 21 MEDIUM

A market maker most likely generates profit by:

- A. Earning the bid-ask spread on securities it quotes
- B. Earning management fees on pooled investment vehicles
- C. Charging commissions to execute client orders on an exchange

Question 22 MEDIUM

Rebalancing an equal-weighted index most likely involves:

- A. Adjusting the divisor to account for stock splits and dividend distributions
- B. Selling stocks that have appreciated and buying stocks that have declined
- C. Adding new securities that have the highest market capitalization weights

Question 23 HARD

Company X has ROE of 15%, a retention ratio of 40%, and pays a current dividend of 3.00. If the required return is 11%, the justified leading P/E ratio using the Gordon growth model is closest to:

- A. 12.0
- B. 15.0
- C. 9.1

Question 24 HARD

A price-weighted equity index currently contains four stocks priced as follows: Stock A at \$100, Stock B at \$60, Stock C at \$45, and Stock D at \$80. The current divisor is 3.50. After the close of trading, two events occur on the same day: (i) Stock A undergoes a 4-for-1 split, leaving its price at \$25, and (ii) Stock B is removed from the index and immediately replaced with Stock E, priced at \$110. The new divisor required to keep the index value unchanged at the close-to-open transition is closest to:

- A. 2.58
- B. 3.19
- C. 4.11

FIXED INCOME

Exam weight 11-14%

Question 25 EASY

A bond with an annual coupon rate of 5.0% and a par value of 1,000 is trading at a market price of 950. The bond's current yield is closest to:

- A. 5.50%
- B. 5.26%
- C. 5.00%

Question 26 (EASY)

A 5-year, 6.00% annual-coupon bond with a par value of 100 currently trades at 105.40 per 100 of par. Compared with the bond's coupon rate, the bond's yield to maturity is most likely:

- A. lower than the coupon rate.
- B. equal to the coupon rate.
- C. higher than the coupon rate.

Question 27 (MEDIUM)

Bonds are primarily issued in the primary market through which process?

- A. Underwriting by investment banks
- B. Trading on organized stock exchanges
- C. Auction by the existing bondholders

Question 28 (MEDIUM)

A sequential-pay CMO has three tranches: Tranche A (200M), Tranche B (150M), and Tranche C (100M). All principal payments (both scheduled and prepayments) go to Tranche A until it is fully retired, then to Tranche B, then to Tranche C. If prepayment speeds increase dramatically, which tranche is most adversely affected and why?

- A. Tranche A, because it receives all principal first and is therefore exposed to the highest prepayment and extension risk
- B. Tranche C, because rapid prepayments retire Tranche A and B quickly, exposing Tranche C to contraction risk as it receives principal much sooner than expected at lower prevailing yields
- C. Tranche C, because it receives principal payments last and is exposed to the highest extension risk if prepayments slow, but in a fast prepayment scenario all tranches are affected equally

Question 29 (HARD)

A 10-year Treasury Inflation-Protected Security (TIPS) was issued with an original face value of 1,000 and a real coupon rate of 2.00% paid semiannually. Realized semiannual inflation rates for the first three coupon periods were 1.5%, 1.0%, and -0.5% (deflation). At the third coupon date, the sum of the third coupon payment plus the inflation-adjusted principal balance is closest to:

- A. 1,040.58
- B. 1,030.22
- C. 1,010.00

Question 30 (HARD)

An option-free corporate bond currently trades at 98.50 per 100 of par. To estimate the bond's sensitivity to yield changes, a fixed-income analyst shifts the benchmark yield curve down by 30 basis points and reprices the bond at 100.65; shifting the curve up by 30 basis points produces a price of 96.45. The bond's annual coupon rate is 4.50% paid semiannually. Using effective duration and effective convexity estimated from these two scenarios, the analyst's full-price estimate for the bond following a 100 basis point parallel increase in yields is closest to:

- A. 90.94
- B. 92.05
- C. 91.50

Question 31 EASY

A non-dividend-paying stock is currently priced at 100. The continuously compounded risk-free rate is 4%. The no-arbitrage price of a 6-month forward contract on the stock is closest to:

- A. 102.00
- B. 102.02
- C. 104.08

Question 32 MEDIUM

An investor writes a covered call by holding 100 shares of stock at 55 and selling a call with a strike of 60 for a premium of 3. What is the maximum profit per share from this position?

- A. 8
- B. 5
- C. 3

Question 33 HARD

A trader is valuing a 2-period European call option on a non-dividend-paying stock currently priced at 60. Over each period, the stock can move up by a factor of $u = 1.25$ or down by a factor of $d = 0.80$. The continuously compounded risk-free rate is 4% per period, the option strike is 63, and the stock's historical volatility over the past year was 22%. Using the risk-neutral binomial framework, the value today of the European call is closest to:

- A. 8.13
- B. 7.10
- C. 8.46

Question 34 EASY

Which of the following best describes a hedge fund?

- A. A fund that exclusively invests in fixed-income securities to hedge against interest rate risk for its investors
- B. A pooled investment vehicle that uses various strategies and is typically open to a limited number of qualified investors
- C. A government-regulated mutual fund that is registered with securities regulators and available to all retail investors

Question 35 MEDIUM

Which of the following best describes a 'side pocket' in a hedge fund?

- A. A separate account holding solely the fund manager's personal co-investment capital, ring-fenced from outside investors for alignment.
- B. A segregated portion of the fund holding illiquid or hard-to-value assets from which investors cannot redeem until those assets are liquidated.
- C. A reserve account that accumulates earned management fees and incentive fees, released to the manager only at the fund's fiscal year end.

Question 36 HARD

A hedge fund opens with \$100 million of capital and a high-water mark equal to that initial NAV. The fund charges a 2% management fee on year-end AUM (after gross return) plus a 20% incentive fee, calculated only on the portion of NAV that exceeds the high-water mark after the management fee is deducted. Gross returns are -10% in Year 1 and +20% in Year 2. Assuming no contributions or redemptions, what is the ending NAV at the end of Year 2?

- A. \$102.98 million
- B. \$100.62 million
- C. \$105.84 million

PORTFOLIO MANAGEMENT

Exam weight 8-12%

Question 37 EASY

An investor maintains a 'safe' retirement account invested entirely in Treasury bonds and a separate 'play money' brokerage account holding highly speculative small-cap stocks. She evaluates each account in isolation and refuses to consider them together when assessing her overall portfolio risk. This pattern most likely illustrates:

- A. loss aversion.
- B. mental accounting bias.
- C. confirmation bias.

Question 38 MEDIUM

An investor treats gambling winnings differently than earned income, spending the winnings freely while carefully saving her salary. Which behavioral bias best explains this investor's behavior?

- A. Representativeness, because the investor categorizes gambling income as different from earned income based on superficial characteristics.
- B. Mental accounting, because the investor assigns different behavioral rules to money based on its source rather than treating all wealth as fungible.
- C. Loss aversion, because gambling winnings feel like a gain relative to the reference point of zero.

Question 39 MEDIUM

A portfolio earned 13% over the past year. The portfolio's beta versus its benchmark is 1.2, the risk-free rate was 3%, and the benchmark returned 10%. The portfolio's Jensen's alpha is closest to:

- A. 0.6%
- B. 3.0%
- C. 1.6%

Question 40 HARD

Portfolio M has a standard deviation of 25.0% and a correlation of 0.70 with the broad market index. Over the past year, Portfolio M earned 13.0%, the market index returned 10.0% with a standard deviation of 15.0%, and the risk-free rate was 3.0%. Based on its M^2 alpha relative to the market, Portfolio M:

- A. outperformed the market by approximately 1.0% on a risk-adjusted basis.
- B. underperformed the market by approximately 1.0% on a risk-adjusted basis.
- C. delivered approximately the same risk-adjusted return as the market.

Question 41 HARD

An equity analyst issued a Buy recommendation for ZetaTech six months ago based on her thesis that the firm would expand operating margins. Since then, ZetaTech has released three quarterly earnings reports: one report modestly beat consensus, while the other two missed consensus and revealed deteriorating fundamentals across the firm's largest segment. The analyst has written extensive notes that cite the favorable report in client calls, dismissed the two unfavorable reports as 'one-time issues,' and maintained her Buy recommendation throughout. Which behavioral bias does the analyst's research process most likely exhibit?

- A. Anchoring bias
- B. Conservatism bias
- C. Confirmation bias

ETHICAL AND PROFESSIONAL STANDARDS

Exam weight 15–20%

Question 42 EASY

David Kim, CFA, is a portfolio manager who receives an expensive bottle of wine as a holiday gift from a broker who regularly executes trades for Kim's clients. According to the CFA Institute Standards, which of the following best describes the appropriate course of action?

- A. Kim should disclose the gift to his employer and comply with his firm's policy on accepting gifts from third parties
- B. Kim may keep the gift without disclosure since holiday gifts are customary in the industry
- C. Kim must immediately return the gift to the broker to avoid any appearance of a conflict of interest

Question 43 EASY

Priya Sharma, CFA, manages an existing client's brokerage account on a fee basis. After a profitable year, the client gives Priya a \$200 gift basket of locally produced foods as a token of appreciation. Priya does not notify her supervisor. Under the CFA Institute Standards of Professional Conduct, Priya has most likely:

- A. not violated any Standard because the gift came from an existing client.
- B. violated Standard IV(B) Additional Compensation Arrangements.
- C. violated Standard I(B) Independence and Objectivity.

Question 44 EASY

Priya Sharma, CFA, recently left Crestline Advisors to join Summit Capital. At Summit she wants to include in her marketing materials the GIPS-compliant composite returns she personally generated while at Crestline. Crestline retains all underlying performance records and has not provided written authorization. Under the CFA Institute Code and Standards, Sharma should:

- A. include the composite returns because she personally generated them at Crestline
- B. not present the prior returns until she obtains written permission from Crestline
- C. present the returns provided she footnotes that they were generated at her prior firm

Question 45 MEDIUM

Rohan Desai has passed Levels I and II of the CFA Program and is registered to sit for Level III next year. He is updating his LinkedIn profile and wants to note his status. Which of the following references is most consistent with Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program?

- A. CFA (Candidate), Level III pending; Levels I and II previously passed
- B. CFA Level III — awaiting final exam; Levels I and II completed with distinction
- C. Candidate in the CFA Program; passed Levels I and II of the CFA exam

Question 46 MEDIUM

George Tannenbaum, CFA, works at an investment bank. His firm provides him with a written policy requiring pre-clearance of all personal securities transactions. He purchases shares in a small company without seeking pre-clearance because he believes the policy applies only to trades exceeding 10,000, though the policy contains no such threshold. Has Tannenbaum violated the Standards?

- A. No, because pre-clearance requirements are internal firm policies and non-compliance with them is an employment matter, not a violation of the CFA Standards
- B. Yes, because Standard I(A) Knowledge of the Law and Standard IV(A) Loyalty require members to know and comply with their employer's compliance policies
- C. No, because a de minimis trade below 10,000 would be considered immaterial under Standard VI(B) Priority of Transactions

Question 47 MEDIUM

Alex Cooper, CFA, manages institutional portfolios at Vanguard Capital. He uses soft dollar commissions from client trades to purchase expensive research software that he uses to analyze investment opportunities for all his clients. He does not disclose the soft dollar arrangement to clients. Which of the following best describes Cooper's situation?

- A. Cooper has violated Standard VI(B) Priority of Transactions because client commission dollars are being directed to a purchase that personally benefits the portfolio manager
- B. Cooper has violated Standard III(A) Loyalty, Prudence, and Care because he must disclose the soft dollar arrangement and ensure the commissions benefit clients
- C. Cooper has not violated any Standard because the research software is used to benefit all client portfolios and soft dollars are a permissible use of brokerage

Question 48 MEDIUM

The CFA Institute Code of Ethics is composed of how many components, and the Standards of Professional Conduct comprise how many standards?

- A. Six components and seven standards
- B. Five components and six standards
- C. Seven components and seven standards

Question 49 HARD

Stefan Brandt, CFA, is head of research at an investment bank. He learns that his firm's equity trading desk has been systematically trading in the same direction as the firm's research recommendations — but before those recommendations are published — profiting at the expense of clients who rely on the research. Brandt discusses the matter with the compliance department, which declines to act on his concerns. Which course of action is most consistent with the Standards?

- A. Accept the compliance department's decision as final and continue his normal research activities, having fulfilled his obligation by raising the concern
- B. Escalate the issue to senior management or the board, and if the activity continues, consider disassociating from it or, depending on jurisdiction, reporting it to regulators
- C. Immediately resign from the firm and report the activity to regulators without any further internal escalation

Question 50

HARD

Selma Abadi, CFA, is a portfolio manager at Cedar Asset Management. She discovers that the firm's marketing department has been distributing a client brochure that (i) overstates firm assets under management by roughly 30%, (ii) presents a back-tested hypothetical record alongside live performance without labeling the hypothetical as such, and (iii) omits that the lead manager of the flagship strategy departed six months ago. Selma raises the issues with her supervisor, who tells her to "drop it" because the brochure is already in circulation. Selma takes no further action and continues to work on the flagship strategy. Under the CFA Institute Code and Standards, Selma's conduct has most likely violated:

- A. Standard I(C) Misrepresentation only; she is associated with the brochure's false claims.
 - B. Standard I(A) Knowledge of the Law only; misrepresentation requires personal authorship of the false statements.
 - C. both Standard I(A) Knowledge of the Law and Standard I(C) Misrepresentation; she must dissociate from the ongoing violation.
-

PART 2 · ANSWER KEY & BRIEF SOLUTIONS

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Question 1 **B** QUANTITATIVE METHODS

Monte Carlo simulation generates a large number of random scenarios based on assumed probability distributions for key input variables, producing a distribution of possible outcomes. This allows analysts to assess the range and likelihood of different results under uncertainty.

Question 2 **C** QUANTITATIVE METHODS

A Type I error is the rejection of a true null hypothesis. The probability of committing a Type I error is equal to the significance level (alpha) of the test.

Question 3 **C** QUANTITATIVE METHODS

PCA transforms correlated variables into uncorrelated principal components ordered by the variance they explain. The first two components together explain $45\% + 22\% = 67\%$ of total variation. Using only these two components instead of all 20 dramatically reduces dimensionality while retaining most of the information -- which is the primary purpose of PCA.

Question 4 **B** QUANTITATIVE METHODS

The leveraged return on equity isolates the gain on the investor's own capital after paying margin interest. Step 1: Total purchase amount: $1,000 \times 80.00 = 80,000$. Step 2: Marisol's initial equity is 60% of the purchase: $80,000 \times 0.60 = 48,000$; the margin loan is $80,000 \times 0.40 = 32,000$. Step 3: Interest cost on the loan over 12 months: $32,000 \times 0.055 = 1,760$. Step 4: Total dividends received: $1,000 \times 1.20 = 1,200$. Step 5: Sale proceeds: $1,000 \times 96.00 = 96,000$. After repaying the loan principal of 32,000 and paying interest of 1,760, then adding the 1,200 in dividends, the net amount delivered to Marisol's equity account is $96,000 - 32,000 - 1,760 + 1,200 = 63,440$. Step 6: Holding-period return on equity is $(63,440 - 48,000)/48,000 = 15,440/48,000 \approx 0.3217 \approx 32.2\%$. The 24% marginal tax rate is irrelevant to the pre-tax return calculation. Note the leveraged return of 32.2% is well above the unlevered HPR of 21.5%, illustrating the magnification effect of borrowing when the asset return exceeds the borrowing cost.

Question 5 **C** ECONOMICS

The own-price elasticity of demand equals the percent change in quantity demanded divided by the percent change in price. The price change is $(55 - 50)/50 = 10.0\%$. The quantity change is $(184 - 200)/200 = -8.0\%$. Elasticity = $-8.0\%/10.0\% = -0.80$. Because $|-0.80| < 1$, demand for Product X is inelastic over this price range.

Question 6 **C** ECONOMICS

Leading indicators are economic variables that tend to change before the economy as a whole changes direction. They are used to forecast future economic activity. Examples include stock market indices, building permits, and the yield curve.

Question 7 **C** ECONOMICS

An import quota restricts the quantity of foreign steel entering the domestic market, reducing supply. With less foreign competition, domestic prices rise, and domestic steel producers increase output to fill the gap. Consumers pay higher prices and may have fewer choices.

Question 8 **C** ECONOMICS

Money multiplier with leakages: when the public holds currency and banks hold excess reserves, use $m = \frac{1+c}{r+e+c}$ and apply it to the change in the monetary base ΔMB .

| Step | Calculation | Result |

| ---|---|---|

| Required reserve ratio r | 8% of deposits | 0.08 |

| Excess reserve ratio e | 2% of deposits | 0.02 |

| Currency-to-deposit ratio c | 20% of deposits | 0.20 |

| Money multiplier | $(1 + 0.20)/(0.08 + 0.02 + 0.20) = 1.20/0.30$ | 4.0 |

| Change in monetary base | Open-market purchase from banks | $\$2$ billion |

| **Change in money supply** | **4.0 x $\$2$ B** | **$\$8$ billion** |

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Question 9 **B** CORPORATE ISSUERS

The pecking order theory (Myers and Majluf) ranks financing choices according to the costs imposed by asymmetric information between managers and outside investors. Internally generated funds are used first because they bear no information cost. When external funds are required, debt is preferred to equity because debt is less sensitive to information asymmetry; equity issuance can signal that managers believe the stock is overvalued, depressing the share price. Therefore, after exhausting retained earnings, a firm prefers debt over new equity.

Question 10 **A** CORPORATE ISSUERS

$WACC = w_d \times r_d \times (1 - t) + w_e \times r_e = 0.40 \times 0.06 \times (1 - 0.25) + 0.60 \times 0.12 = 0.018 + 0.072 = 0.090$ or 9.0%.

Question 11 **C** CORPORATE ISSUERS

Aggressive working capital strategies rely on cheaper short-term financing, boosting profitability through lower interest costs. However, they expose the firm to rollover risk (inability to refinance maturing obligations) and potential liquidity crises.

Question 12 **B** CORPORATE ISSUERS

The implicit annualized cost of forgoing a cash discount is computed over the days of credit given up, not over the full net period.

Step 1: Identify the relevant time window. The 2% discount is captured by paying on day 15; the alternative is to pay on day 60. By forgoing the discount, the buyer keeps cash an additional $60 - 15 = 45$ days but pays $\$100$ instead of $\$98$ for every $\$100$ of invoice.

Step 2: Compute the per-period cost. The premium paid is $2/98 = 2.041\%$ over those 45 days.

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Question 13 **C** FINANCIAL STATEMENT ANALYSIS

A common-size income statement expresses each line item as a percentage of revenue (net sales), facilitating comparison across companies of different sizes and over time.

Question 14 **A** FINANCIAL STATEMENT ANALYSIS

Under IFRS (IAS 7), interest paid may be classified as either an operating activity or a financing activity, provided the classification is applied consistently from period to period. Under US GAAP, interest paid must be classified as an operating activity.

Question 15 **C** FINANCIAL STATEMENT ANALYSIS

The five steps are: (1) Identify the contract, (2) Identify performance obligations, (3) Determine the transaction price, (4) Allocate the price to obligations, (5) Recognize revenue as obligations are satisfied. The first step is identifying a valid contract.

Question 16 C FINANCIAL STATEMENT ANALYSIS

A valuation allowance reduces the net deferred tax asset on the balance sheet. When the allowance is reversed (because realization is now considered more likely than not), the DTA increases, and the offsetting entry reduces income tax expense on the income statement, thereby increasing net income.

Question 17 C FINANCIAL STATEMENT ANALYSIS

The three-component DuPont decomposition is:

$$ROE = \text{Profit Margin} \times \text{Asset Turnover} \times \text{Equity Multiplier}$$

Profit margin: $\frac{50}{500} = 10\%$

Asset turnover: $\frac{500}{400} = 1.25$

Equity multiplier: $\frac{400}{200} = 2.0$

$$ROE = 0.10 \times 1.25 \times 2.0 = 0.25 = 25\%$$

Verification: $ROE = 50/200 = 25\%$. Confirmed.

Question 18 C FINANCIAL STATEMENT ANALYSIS

IAS 36 impairment-and-reversal: write the asset down to recoverable amount (the higher of fair value less costs to sell and value in use), depreciate over remaining life, then on reversal cap the carrying amount at what it would have been absent the original impairment.

| Step | Calculation | Result |

|---|---|---|

| Recoverable amount, 1/1/X1 | $\max(310,000, 340,000)$ | $\$340,000$ |

| Impairment loss, 1/1/X1 | $\$480,000 - \$340,000$ | $\$140,000$ |

| Revised annual depreciation | $\$340,000 / 5 \text{ years}$ | $\$68,000$ |

| Carrying amount, 12/31/X2 (pre-reversal) | $\$340,000 - 2 \times \$68,000$ | $\$204,000$ |

| Reversal cap (counterfactual CV) | $\$480,000 - 2 \times (\$480,000 / 5)$ | $\$288,000$ |

| Reversal recognized | $\$288,000 - \$204,000$ | $\$84,000$ |

| **Carrying amount, 12/31/X2** | **$\$288,000$** | Recoverable $\$290,000$ exceeds cap |

Full worked solution free at freefellow.org/free/cfa-level-1/

Question 19 A EQUITY INVESTMENTS

Cumulative preferred stock requires that all unpaid (passed) dividends accumulate as arrears and must be paid in full before the company can pay any common dividend. This provides stronger protection for preferred investors.

Question 20 C EQUITY INVESTMENTS

The single-stage justified price-to-book ratio is $P/B = (ROE - g)/(r - g)$. Substituting: $P/B = (0.15 - 0.05)/(0.11 - 0.05) = 0.10/0.06 = 1.67$.

Question 21 A EQUITY INVESTMENTS

Market makers provide liquidity by quoting both bid and ask prices and profit from the spread between these prices.

Question 22 B EQUITY INVESTMENTS

Rebalancing an equal-weighted index requires restoring equal dollar weights to all constituents. Stocks that have risen in price will have above-average weights and must be partially sold, while stocks that have declined will have below-average weights and must be purchased. This creates an implicit contrarian tilt.

Question 23 A EQUITY INVESTMENTS

Sustainable growth rate: $g = ROE \times b = 0.15 \times 0.40 = 0.06 = 6\%$. Payout ratio $= 1 - b = 1 - 0.40 = 0.60$. Justified leading P/E = Payout ratio / $(r - g) = 0.60 / (0.11 - 0.06) = 0.60 / 0.05 = 12.0$.

Question 24 B EQUITY INVESTMENTS

Step 1: compute the current index value. The sum of constituent prices is $100 + 60 + 45 + 80 = 285$. With a divisor of 3.50, the index value is $285 / 3.50 = 81.43$. Step 2: determine the post-event sum of constituent prices. The 4-for-1 split takes Stock A from $\$100$ to $\$25$ (the index now reflects the post-split price). The constituent swap replaces Stock B ($\$60$) with Stock E ($\110). New sum: $25 + 110 + 45 + 80 = 260$. Step 3: solve for the new divisor that keeps the index value unchanged. Setting $260 / d_{new} = 81.43$ gives $d_{new} = 260 / 81.43 \approx 3.193$. Step 4: confirm the direction. Both corporate actions reduced the price sum (split alone takes the sum from 285 to 210; swap alone takes it from 285 to 335). The net effect of both is a fall from 285 to 260, so the divisor falls from 3.50 to about 3.19. Step 5: the key trap is recognizing that BOTH events require divisor adjustments. A divisor adjustment is needed any time a non-market-driven change alters the sum of constituent prices, including stock splits AND constituent substitutions.

Question 25 B FIXED INCOME

Current yield equals the annual coupon payment divided by the current market price: $CY = 50 / 950 = 0.05263$, or approximately 5.26%.

Question 26 A FIXED INCOME

A bond trading at a premium has a price greater than par ($105.40 > 100$), which arises only when the yield to maturity is below the coupon rate. The investor pays extra today to receive coupon payments that are above the prevailing market yield, and that premium is amortized over the life of the bond so that the realized yield equals the YTM, which must therefore be lower than the 6.00% coupon.

Question 27 A FIXED INCOME

In the primary market, new bonds are issued and sold to investors, typically through an underwriting process managed by investment banks. The underwriters help price the issue, market it to investors, and may guarantee the sale.

Question 28 B FIXED INCOME

In a sequential-pay CMO structure, the longest tranche (Tranche C) is designed to receive principal payments last, giving it the longest expected life. However, when prepayments accelerate dramatically, Tranches A and B are retired much faster than expected, and principal then flows to Tranche C far sooner than projected. This is contraction risk: Tranche C's average life shortens unexpectedly. Since fast prepayments typically occur in falling interest rate environments (homeowners refinancing), Tranche C investors are forced to reinvest at lower rates.

Question 29 B FIXED INCOME

The inflation-adjusted principal compounds each period by the realized inflation factor. After period 1: $1,000 \times 1.015 = 1,015.00$. After period 2: $1,015.00 \times 1.010 = 1,025.15$. After period 3 (deflation of 0.5%): $1,025.15 \times 0.995 = 1,020.02$. The third coupon applies the periodic real rate to the latest adjusted principal: $1,020.02 \times \frac{0.02}{2} = 1,020.02 \times 0.01 = 10.20$. Adding the coupon to the adjusted principal gives $1,020.02 + 10.20 = 1,030.22$.

Question 30 B FIXED INCOME

Step 1: compute effective duration from the two scenario prices. $ED = (P_- - P_+) / (2 \times P_0 \times \Delta y) = (100.65 - 96.45) / (2 \times 98.50 \times 0.0030) = 4.20 / 0.5910 = 7.107$. Step 2: compute effective convexity. $EC = (P_- + P_+ - 2P_0) / (P_0 \times (\Delta y)^2) = (100.65 + 96.45 - 197.00) / (98.50 \times (0.0030)^2) = 0.10 / 0.00088650 = 112.81$. Step 3: apply the duration plus convexity approximation for $\Delta y = +0.0100$. The duration term is $-ED \times \Delta y = -7.107 \times 0.0100 = -0.07107$. Step 4: the convexity adjustment is $\frac{1}{2} \times EC \times (\Delta y)^2 = 0.5 \times 112.81 \times (0.0100)^2 = +0.005640$. For both yield increases and decreases, this convexity term is added, partially offsetting the duration estimate. Step 5: total estimated percentage price change is $-0.07107 + 0.005640 = -0.06543$, so the new full price is $98.50 \times (1 - 0.06543) \approx 92.05$. The coupon rate is not needed because effective duration and convexity already capture the full sensitivity of the priced bond.

Question 31 B DERIVATIVES

For a non-dividend-paying asset, the no-arbitrage forward price under continuous compounding is $F_0 = S_0 e^{rT}$. With $S_0 = 100$, $r = 0.04$, and $T = 0.5$: $F_0 = 100 \cdot e^{0.04 \times 0.5} = 100 \cdot e^{0.02} = 100 \cdot 1.02020 = 102.02$.

Question 32 A DERIVATIVES

The maximum profit from a covered call occurs when the stock price reaches or exceeds the strike price. The profit is: (Strike - Purchase Price) + Premium = (60 - 55) + 3 = 8 per share. The stock gain is capped at 5 (from 55 to 60) because the call will be exercised at 60, and the premium of 3 is retained.

Question 33 A DERIVATIVES

The terminal stock prices are $S_{uu} = 60 \times 1.25^2 = 93.75$, $S_{ud} = 60 \times 1.25 \times 0.80 = 60.00$, and $S_{dd} = 60 \times 0.80^2 = 38.40$. The corresponding European call payoffs at expiration are $C_{uu} = \max(93.75 - 63, 0) = 30.75$, $C_{ud} = \max(60 - 63, 0) = 0$, and $C_{dd} = \max(38.40 - 63, 0) = 0$. The risk-neutral probability of an up move uses continuous compounding: $p = (e^{0.04} - 0.80)/(1.25 - 0.80) = (1.0408 - 0.80)/0.45 = 0.5351$. Working back one node, $C_u = (0.5351 \times 30.75 + 0.4649 \times 0) \times e^{-0.04} = 16.455 \times 0.9608 = 15.808$. The down-node has $C_d = 0$ since both C_{ud} and C_{dd} are zero. Discounting one more period: $C_0 = (0.5351 \times 15.808 + 0.4649 \times 0) \times e^{-0.04} = 8.458 \times 0.9608 = 8.13$. The historical volatility is a red herring: once u, d, and r are specified, risk-neutral probabilities and option values follow directly without reference to realized volatility.

Question 34 B ALTERNATIVE INVESTMENTS

Hedge funds are privately organized, pooled investment vehicles that employ diverse strategies (long/short equity, derivatives, leverage, etc.) and are generally available only to accredited or qualified investors due to their complexity and risk.

Question 35 B ALTERNATIVE INVESTMENTS

A side pocket segregates illiquid, hard-to-value, or distressed assets from the main liquid portfolio. Investors allocated to the side pocket cannot redeem that portion until those assets are sold or otherwise realized, preventing forced sales at depressed prices and treating all investors equitably regardless of redemption timing.

Question 36 A ALTERNATIVE INVESTMENTS

Track the NAV through both fee layers and respect the high-water mark.

Year 1 (gross -10%, starting NAV \$100m, HWM \$100m):

$$\text{Pre-fee NAV} = 100 \times 0.90 = 90.00.$$

Management fee: $90.00 \times 0.02 = 1.80$, so post-management NAV = $90.00 - 1.80 = 88.20$. Post-management NAV is below the \$100m HWM, so no incentive fee is paid. Year-end NAV = \$88.20m; HWM unchanged at \$100m.

Year 2 (gross +20%, starting NAV \$88.20m, HWM \$100m):

$$\text{Pre-fee NAV} = 88.20 \times 1.20 = 105.84.$$

Management fee: $105.84 \times 0.02 = 2.1168$, so post-management NAV = $105.84 - 2.1168 = 103.7232$. Now post-management NAV exceeds the HWM, so the incentive fee is charged on the excess only:

$$0.20 \times (103.7232 - 100) = 0.20 \times 3.7232 = 0.7446.$$

Ending NAV = $103.7232 - 0.7446 \approx \102.98 million. The high-water mark resets to this new level.

Question 37 B PORTFOLIO MANAGEMENT

Mental accounting bias occurs when investors treat funds differently based on the account or source rather than evaluating wealth holistically. Segregating money into 'safe' and 'speculative' buckets and refusing to assess overall portfolio risk across them is the textbook manifestation of this bias, and it can lead to suboptimal asset allocation relative to a single, integrated portfolio framework.

Question 38 B PORTFOLIO MANAGEMENT

Mental accounting is the cognitive tendency to categorize money into separate 'accounts' and apply different spending or saving rules based on the money's origin or intended purpose, even though money is fungible (interchangeable) from a rational economic perspective. The investor's differential treatment of gambling winnings vs. salary is a textbook illustration.

Question 39 C PORTFOLIO MANAGEMENT

Jensen's alpha is the difference between actual return and the CAPM-required return: $\alpha_p = R_p - [R_f + \beta_p(R_m - R_f)]$. The required return is $3\% + 1.2 \times (10\% - 3\%) = 3\% + 8.4\% = 11.4\%$. Alpha equals $13\% - 11.4\% = 1.6\%$.

Question 40 B PORTFOLIO MANAGEMENT

M^2 alpha equals $M^2 - R_m$, where M^2 is the return the portfolio would have earned at the market's volatility. First compute the portfolio's Sharpe ratio: $(13.0\% - 3.0\%)/25.0\% = 0.40$. The market's Sharpe ratio is $(10.0\% - 3.0\%)/15.0\% = 0.4667$. Because the portfolio's Sharpe ratio is below the market's, M^2 alpha must be negative. Compute it directly: $M^2 = R_f + \text{Sharpe}_p \times \sigma_m = 3.0\% + 0.40 \times 15.0\% = 9.0\%$, so M^2 alpha = $9.0\% - 10.0\% = -1.0\%$. The portfolio underperformed the market by approximately 1.0% on a risk-adjusted basis. The 0.70 correlation is a distractor — M^2 uses total risk, not systematic risk.

Question 41 C PORTFOLIO MANAGEMENT

Confirmation bias is the tendency to seek out, weight, and remember evidence that supports an existing belief while discounting or ignoring evidence that contradicts it. Step 1: Identify the prior belief. The analyst issued a Buy recommendation six months ago based on a margin-expansion thesis. Step 2: Classify the new evidence. One earnings report supports the thesis (modest beat); two reports contradict it (missed consensus, deteriorating fundamentals in the largest segment). Step 3: Observe how each type of evidence is processed. The supportive report receives disproportionate attention (extensive notes, repeated citation in client calls). The contradictory reports are minimized as 'one-time issues' without substantive engagement. Step 4: Compare the asymmetric processing to the defining feature of confirmation bias. Selective attention to confirming evidence and active discounting of disconfirming evidence is exactly what confirmation bias produces. Step 5: Rule out the close competitors. Conservatism would have the analyst under-weight ALL new evidence (including the favorable report) and update her view slowly; her enthusiastic embrace of the favorable report is inconsistent with conservatism. Anchoring typically involves a specific numerical reference point (such as a purchase price or 52-week high) that distorts subsequent value judgments; the fact pattern describes selective processing of qualitative evidence, not a price anchor.

Question 42 A ETHICAL AND PROFESSIONAL STANDARDS

Standard I(B) Independence and Objectivity and Standard VI(A) Disclosure of Conflicts require members to be mindful of gifts that could compromise their independence and to disclose potential conflicts. The Standards require members to disclose gifts from parties that could influence their professional judgment. Kim should report the gift to his employer and follow the firm's gift policy, which may set a monetary threshold for acceptable gifts or require prior approval.

Question 43 B ETHICAL AND PROFESSIONAL STANDARDS

Standard IV(B) Additional Compensation Arrangements requires members to obtain written consent from their employer before accepting any compensation, gift, or benefit that might reasonably be expected to create a conflict of interest with the employer's interests. Even modest gifts from existing clients should be disclosed in writing to the employer because they may be perceived as influencing future treatment of that account. Because Priya did not notify her supervisor of the \$200 gift, she has violated Standard IV(B).

Question 44 B ETHICAL AND PROFESSIONAL STANDARDS

Performance records are the property of the firm where they were generated. Standard III(D) Performance Presentation, together with Standard V(C) Record Retention, requires that members obtain written permission from the prior employer before using performance information produced at that firm. The records, supporting documentation, and the right to use them all belong to the prior firm, not the individual analyst.

Question 45 **C** ETHICAL AND PROFESSIONAL STANDARDS

Standard VII(B) permits a candidate to state factually that they are a "Candidate in the CFA Program" and to note which levels have been passed. The CFA marks and the abbreviation "CFA" may not be used in any form until the charter has been awarded, and candidacy may never be written in a way that implies a partial designation or any form of the charter.

Question 46 **B** ETHICAL AND PROFESSIONAL STANDARDS

Tannenbaum has violated the Standards. Standard I(A) Knowledge of the Law requires members to understand and comply with applicable rules, including their employer's compliance policies. Standard IV(A) Loyalty includes compliance with legitimate employer policies. The pre-clearance policy contained no 10,000 threshold — Tannenbaum simply assumed one existed.

Question 47 **B** ETHICAL AND PROFESSIONAL STANDARDS

Standard III(A) Loyalty, Prudence, and Care and the CFA Institute Soft Dollar Standards require disclosure and client benefit when using soft dollar arrangements.

Question 48 **A** ETHICAL AND PROFESSIONAL STANDARDS

The Code of Ethics consists of six components, addressing integrity, placing client and profession interests first, exercising independent professional judgment, practicing in a professional and ethical manner, promoting capital-market integrity, and maintaining and improving professional competence. The Standards of Professional Conduct contain seven standards, numbered I through VII (Professionalism; Integrity of Capital Markets; Duties to Clients; Duties to Employers; Investment Analysis, Recommendations, and Actions; Conflicts of Interest; and Responsibilities as a Member or Candidate).

Question 49 **B** ETHICAL AND PROFESSIONAL STANDARDS

Brandt should escalate the issue to senior management or the board, and if the illegal trading activity continues, consider disassociation or regulatory reporting as circumstances warrant. Standard I(A) Knowledge of the Law and Standard IV(C) Responsibilities of Supervisors require that members escalate known illegal activities through all available internal channels before concluding that internal remedies are exhausted. Accepting the compliance department's decision as final — when that decision is to allow illegal activity to continue — is not sufficient. Immediate resignation and regulatory reporting as a first response is not required; exhausting internal channels first is the recommended approach under the Standards.

Question 50 **C** ETHICAL AND PROFESSIONAL STANDARDS

Standard I(A) Knowledge of the Law requires members and candidates to comply with applicable rules and the Code and Standards, and explicitly to dissociate from any known violation. Acceptable dissociation steps include refusing to participate, urging the firm to correct the misconduct, and, if necessary, escalating beyond the supervisor or resigning. Simply raising the issue once and accepting a "drop it" instruction is not adequate dissociation while the violation is ongoing. Standard I(C) Misrepresentation prohibits making any misrepresentation in investment analysis, recommendations, or other professional activities; the standard captures both authoring and knowingly being associated with materially false or misleading communications. The brochure's overstated AUM, unlabeled hypothetical performance, and omitted manager departure each constitute misrepresentation, and Selma's continued association with the flagship strategy and silence after escalation implicate her under I(C). Both Standards therefore apply.

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