

Chartered Financial Analyst (CFA) Level 1 Practice Exam (Sample)

Study Guide



Everything you need from our exam experts!

This is a sample study guide. To access the full version with hundreds of questions,

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Introduction

Preparing for a certification exam can feel overwhelming, but with the right tools, it becomes an opportunity to build confidence, sharpen your skills, and move one step closer to your goals. At Examzify, we believe that effective exam preparation isn't just about memorization, it's about understanding the material, identifying knowledge gaps, and building the test-taking strategies that lead to success.

This guide was designed to help you do exactly that.

Whether you're preparing for a licensing exam, professional certification, or entry-level qualification, this book offers structured practice to reinforce key concepts. You'll find a wide range of multiple-choice questions, each followed by clear explanations to help you understand not just the right answer, but why it's correct.

The content in this guide is based on real-world exam objectives and aligned with the types of questions and topics commonly found on official tests. It's ideal for learners who want to:

- Practice answering questions under realistic conditions,
- Improve accuracy and speed,
- Review explanations to strengthen weak areas, and
- Approach the exam with greater confidence.

We recommend using this book not as a stand-alone study tool, but alongside other resources like flashcards, textbooks, or hands-on training. For best results, we recommend working through each question, reflecting on the explanation provided, and revisiting the topics that challenge you most.

Remember: successful test preparation isn't about getting every question right the first time, it's about learning from your mistakes and improving over time. Stay focused, trust the process, and know that every page you turn brings you closer to success.

Let's begin.

How to Use This Guide

This guide is designed to help you study more effectively and approach your exam with confidence. Whether you're reviewing for the first time or doing a final refresh, here's how to get the most out of your Examzify study guide:

1. Start with a Diagnostic Review

Skim through the questions to get a sense of what you know and what you need to focus on. Don't worry about getting everything right, your goal is to identify knowledge gaps early.

2. Study in Short, Focused Sessions

Break your study time into manageable blocks (e.g. 30 - 45 minutes). Review a handful of questions, reflect on the explanations, and take breaks to retain information better.

3. Learn from the Explanations

After answering a question, always read the explanation, even if you got it right. It reinforces key points, corrects misunderstandings, and teaches subtle distinctions between similar answers.

4. Track Your Progress

Use bookmarks or notes (if reading digitally) to mark difficult questions. Revisit these regularly and track improvements over time.

5. Simulate the Real Exam

Once you're comfortable, try taking a full set of questions without pausing. Set a timer and simulate test-day conditions to build confidence and time management skills.

6. Repeat and Review

Don't just study once, repetition builds retention. Re-attempt questions after a few days and revisit explanations to reinforce learning.

7. Use Other Tools

Pair this guide with other Examzify tools like flashcards, and digital practice tests to strengthen your preparation across formats.

There's no single right way to study, but consistent, thoughtful effort always wins. Use this guide flexibly — adapt the tips above to fit your pace and learning style. You've got this!

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Questions

- 1. What is the relationship between risk and return in finance?**
 - A. Lower risk is always associated with higher returns**
 - B. Risk has no impact on potential returns**
 - C. Higher risk is generally associated with the potential for higher returns**
 - D. Risk only affects fixed-income investments**
- 2. What is the "marginal cost of capital"?**
 - A. The total cost of raising capital for the business**
 - B. The cost of issuing new equity shares in the market**
 - C. The cost of raising one more unit of capital**
 - D. The fixed cost of maintaining existing capital**
- 3. Which method is appropriate for calculating the cash flow available to all capital providers?**
 - A. Free cash flow to equity**
 - B. Free cash flow to the firm**
 - C. Operating cash flow**
 - D. Net cash flow**
- 4. What is the formula for Return on Total Capital?**
 - A. $\text{EBIT} / (\text{Debt} + \text{Equity})$**
 - B. $\text{Net Income} / \text{Average Total Assets}$**
 - C. $\text{Profit Margin} / \text{Sales}$**
 - D. $\text{Operating Income} / \text{Total Debt}$**
- 5. Which of the following factors does NOT influence foreign exchange rates?**
 - A. Interest rates**
 - B. Political stability**
 - C. Supply and demand**
 - D. Inflation rates**

- 6. Which margin is usually most focused on investors in assessing company performance?**
- A. Operating Margin**
 - B. Pretax Margin**
 - C. Net Profit Margin**
 - D. Gross Profit Margin**
- 7. What is the efficient market hypothesis (EMH)?**
- A. The theory that markets are always in balance**
 - B. The theory that all known information is already reflected in stock prices, making it impossible to consistently achieve higher returns than the market average**
 - C. The principle that stock prices fluctuate randomly**
 - D. The idea that only fundamental analysis can predict stock performance**
- 8. Which of the following is a key factor affecting inflation rates?**
- A. Government regulations**
 - B. Market competition**
 - C. Consumer spending**
 - D. Trade deficits**
- 9. Which financial metric assesses a company's overall cash flow health?**
- A. Cash flow per share**
 - B. Dividend payout ratio**
 - C. Return on Capital**
 - D. EBITDA per share**
- 10. What does the defensive interval ratio indicate?**
- A. Long-term financial stability**
 - B. Ability to cover daily cash expenditures**
 - C. Return on assets**
 - D. Debt repayment capacity**

Answers

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1. C
2. C
3. B
4. A
5. C
6. C
7. B
8. C
9. A
10. B

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Explanations

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1. What is the relationship between risk and return in finance?

- A. Lower risk is always associated with higher returns
- B. Risk has no impact on potential returns
- C. Higher risk is generally associated with the potential for higher returns**
- D. Risk only affects fixed-income investments

In finance, the relationship between risk and return is typically characterized by the principle that higher risk is generally associated with the potential for higher returns. This means that investments that carry a greater degree of uncertainty or volatility (such as stocks, commodities, or real estate) often have the potential to yield higher returns compared to more stable investments, like government bonds or savings accounts, which tend to offer lower returns. This relationship is crucial in investment decision-making, as it informs investors about the trade-offs they must consider when constructing their portfolios. Investors seeking higher returns must be willing to take on more risk, including the possibility of losing some or all of their investment. Conversely, those who prefer safety and stability will likely accept lower returns in exchange for reduced risk. This understanding is foundational in finance and helps explain why risk premiums exist for various asset classes, where investors demand a higher expected return for bearing additional risk. It reflects the idea that successful investing often requires balancing risk and return in accordance with one's financial goals and risk tolerance.

2. What is the "marginal cost of capital"?

- A. The total cost of raising capital for the business
- B. The cost of issuing new equity shares in the market
- C. The cost of raising one more unit of capital**
- D. The fixed cost of maintaining existing capital

The marginal cost of capital refers specifically to the cost associated with raising an additional unit of capital. This concept is important for firms when making investment decisions, as it helps assess the cost-effectiveness of funding new projects or initiatives. When a company evaluates potential investments, it can compare the expected return on those investments to the marginal cost of capital. If the expected return exceeds the marginal cost, the investment is likely worth pursuing. It reflects the incremental increase in financing costs for the next dollar raised, taking into account the mix of debt and equity the company might use. In contrast, the other options represent different aspects of capital finance but do not capture the essence of the marginal cost of capital. The total cost of raising capital is more general and includes all costs rather than focusing on an incremental increase. The cost of issuing new equity shares pertains specifically to equity financing and does not include debt considerations. The fixed cost of maintaining existing capital relates to ongoing operational costs rather than the incremental cost related to new capital.

3. Which method is appropriate for calculating the cash flow available to all capital providers?

- A. Free cash flow to equity
- B. Free cash flow to the firm**
- C. Operating cash flow
- D. Net cash flow

The appropriate method for calculating the cash flow available to all capital providers is the measure known as Free Cash Flow to the Firm (FCFF). This metric represents the cash generated by a company's operations that is available to both debt and equity holders. FCFF is calculated by taking the operating cash flow and adjusting it for capital expenditures and changes in working capital, while also considering taxes. The significance of FCFF lies in its comprehensive nature; it provides insight into the total cash flow generated by the firm that can be used to repay creditors, reinvest in the business, or distribute to shareholders. This makes it an essential metric for assessing the overall financial health and viability of the firm from the perspective of all capital providers. In contrast, Free Cash Flow to Equity specifically focuses on the cash available to equity shareholders after accounting for all expenses, reinvestments, and debt repayments. Operating cash flow represents the cash generated from daily business operations, without considering capital expenditures or the financing activities of the firm. Net cash flow usually reflects the overall cash movement in and out of a company but does not specifically delineate the availability of cash for capital providers in the way that FCFF does. Therefore, FCFF provides the most relevant metric for understanding the cash flow landscape available

4. What is the formula for Return on Total Capital?

- A. EBIT / (Debt + Equity)**
- B. Net Income / Average Total Assets
- C. Profit Margin / Sales
- D. Operating Income / Total Debt

The formula for Return on Total Capital is indeed represented as EBIT (Earnings Before Interest and Taxes) divided by the sum of Debt and Equity. This measure, often referred to as the Return on Capital Employed (ROCE), indicates how well a company is utilizing its total capital to generate earnings before considering the costs of financing. Using EBIT in this formula allows for a focus on the operational performance of the business without the impact of capital structure decisions (i.e., how much debt or equity is used), giving a clearer picture of the operational efficiency and profitability generated from all available capital. In contrast, the other options focus on different aspects of financial performance. For example, net income divided by average total assets measures Return on Assets (ROA), which assesses profitability relative to total assets rather than total capital. Profit margin divided by sales looks at efficiency in generating profit from sales, and operating income divided by total debt assesses how effectively a company's operating income covers its debt obligations, which is not the same as evaluating total capital efficiency.

5. Which of the following factors does NOT influence foreign exchange rates?

- A. Interest rates**
- B. Political stability**
- C. Supply and demand**
- D. Inflation rates**

Foreign exchange rates are influenced by a variety of factors that govern economic interactions between countries. Among those factors, interest rates, political stability, and inflation rates play critical roles in determining the value of one currency relative to another. Interest rates impact forex rates because higher interest rates offer lenders in an economy a higher return relative to other countries. Consequently, if a country's interest rates rise, it might attract foreign capital, leading to an appreciation of that country's currency. Political stability is another key factor, as it affects investor confidence. Countries with stable governments are seen as safer investments, which can lead to increased demand for their currency, increasing its value. Inflation rates also hold significant importance. Generally, lower inflation rates in a country compared to others can lead to an appreciation of that country's currency. This is because lower inflation indicates a stronger purchasing power relative to other currencies, attracting international investors. While supply and demand certainly influence foreign exchange rates, the statement implies a misunderstanding. The principles of supply and demand are fundamental to all market-driven environments, suggesting that transaction volume and liquidity directly affect currency values. However, for the purpose of the question, the answer indicated as correct does not adequately capture the complexity of foreign exchange market dynamics. Therefore, supply and demand should indeed be

6. Which margin is usually most focused on investors in assessing company performance?

- A. Operating Margin**
- B. Pretax Margin**
- C. Net Profit Margin**
- D. Gross Profit Margin**

Investors often focus on the net profit margin when assessing a company's performance because it provides a comprehensive view of a company's profitability after all expenses, taxes, and costs have been deducted from total revenue. This margin reflects how much profit a company makes for every dollar of revenue, giving insight into its overall efficiency and cost management. A high net profit margin indicates that a company is effectively controlling its expenses and maximizing its returns, which is crucial for long-term financial health and performance. In contrast, while operating margin, pretax margin, and gross profit margin provide useful information about specific aspects of a company's operations, they do not capture the entire profit picture. The operating margin focuses on operational efficiency but does not account for interest and taxes. Pretax margin looks at profitability before tax implications, while gross profit margin only considers the cost of goods sold, excluding overhead and other expenses. Therefore, the net profit margin is the most holistic measure that investors often prioritize when evaluating overall company performance.

7. What is the efficient market hypothesis (EMH)?

- A. The theory that markets are always in balance
- B. The theory that all known information is already reflected in stock prices, making it impossible to consistently achieve higher returns than the market average**
- C. The principle that stock prices fluctuate randomly
- D. The idea that only fundamental analysis can predict stock performance

The efficient market hypothesis (EMH) asserts that financial markets are efficient in reflecting all known information in the pricing of securities. This means that at any given time, stock prices incorporate and reflect all relevant information available to investors. Consequently, since all known information is priced into the stocks, it becomes impossible for investors to consistently achieve returns that outperform the market average on a risk-adjusted basis, as any potential advantage is quickly exploited by other market participants. This concept is fundamental in understanding how market dynamics work and suggests that active trading strategies or attempts to time the market will likely not yield returns superior to simply holding a diversified portfolio. It challenges the notion that investors can "beat the market" consistently through either technical or fundamental analysis, thus emphasizing the randomness of price movements based on new information entering the market. While other choices touch on aspects related to market behavior or analysis techniques, they do not encapsulate the core premise of the efficient market hypothesis as thoroughly as the correct answer does.

8. Which of the following is a key factor affecting inflation rates?

- A. Government regulations
- B. Market competition
- C. Consumer spending**
- D. Trade deficits

Consumer spending plays a crucial role in determining inflation rates. When consumer spending increases, demand for goods and services rises. If this demand outstrips supply, it can lead to higher prices, thereby contributing to inflation. The relationship is grounded in the principles of supply and demand; when more consumers are willing to purchase products, businesses may respond by raising prices, especially if they are unable to increase production quickly enough to meet that demand. In economic terms, this increase in demand can create a "demand-pull" inflation scenario, where the rising demand directly influences price levels. Factors such as consumer confidence, disposable income, and access to credit can all affect consumer spending levels, which in turn impact inflation rates significantly. While government regulations, market competition, and trade deficits can influence inflation, they do so in more indirect or varying ways, and thus are not considered as direct key drivers in the same immediate manner as consumer spending.

9. Which financial metric assesses a company's overall cash flow health?

- A. Cash flow per share**
- B. Dividend payout ratio**
- C. Return on Capital**
- D. EBITDA per share**

The metric that best assesses a company's overall cash flow health is cash flow per share. This measure gives investors insight into the amount of cash generated by a company's operations on a per-share basis. It reflects the company's ability to generate cash which is crucial for sustaining operations, paying dividends, and funding future growth. By focusing on cash rather than earnings, it provides a clearer picture of financial health, especially since cash is more readily available for operational needs than accrual-based accounting income. While dividend payout ratio, return on capital, and EBITDA per share are also important metrics in evaluating financial performance, they do not directly measure cash flow health as effectively. The dividend payout ratio indicates how much of a company's earnings are being returned to shareholders but does not provide a complete view of cash generated from operations. Return on capital focuses on the efficiency with which a company uses its capital to generate profits but again does not specifically address cash flow. EBITDA per share provides insight into earnings before interest, taxes, depreciation, and amortization, but it does not represent actual cash flow and may include non-cash items. Therefore, cash flow per share stands out as the most appropriate metric for assessing a company's cash flow health, making it the correct choice in this context.

10. What does the defensive interval ratio indicate?

- A. Long-term financial stability**
- B. Ability to cover daily cash expenditures**
- C. Return on assets**
- D. Debt repayment capacity**

The defensive interval ratio is a financial metric that measures a company's ability to cover its cash expenditures over a specified period, typically focusing on its liquidity position. This ratio is particularly important for assessing how well a company can sustain its operations without relying on external financing or generating income, especially during periods of financial stress. By using the defensive interval ratio, analysts determine how many days a business can operate using its liquid assets and available cash in comparison to its daily cash outflows. This provides insights into the company's short-term financial health and can indicate how well it can manage its immediate liabilities and operational costs. Understanding this ratio is crucial for investors and analysts assessing a company's risk profile, particularly in volatile markets or during economic downturns, where liquidity can become a significant concern. It reflects a company's preparedness to handle its cash needs without immediate sales or income, thereby highlighting its operational resilience.

Next Steps

Congratulations on reaching the final section of this guide. You've taken a meaningful step toward passing your certification exam and advancing your career.

As you continue preparing, remember that consistent practice, review, and self-reflection are key to success. Make time to revisit difficult topics, simulate exam conditions, and track your progress along the way.

If you need help, have suggestions, or want to share feedback, we'd love to hear from you. Reach out to our team at hello@examzify.com.

Or visit your dedicated course page for more study tools and resources:

<https://cfa-level1.examzify.com>

We wish you the very best on your exam journey. You've got this!