Chartered Financial Analyst (CFA) Practice Exam Level 2 (Sample)

Study Guide

Everything you need from our exam experts!

Table of Contents

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. 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.

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. 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!

Questions

1. **Adjusted FFO is primarily concerned with which aspect of financial performance?**

   A. Operational efficiency

   B. Cash flow generation

   C. Overall profitability

   D. Tax efficiency

2. **How does a declining interest rate environment typically affect callable bonds?**

   A. Issuers are less likely to call the bonds.

   B. Issuers typically want to call back the bonds.

   C. Callable bonds become more valuable for investors.

   D. Investors will exercise the put options more frequently.

3. **What is the formula for calculating the value of a SWAP?**

   A. SFR = (1 - Z4) / (Z1 + Z2 + Z3 + Z4)

   B. SFR = (Z1 + Z2 + Z3) / (1 + r(n))

   C. SFR = Z1 x Z2 x Z3 x Z4

   D. SFR = (1 + r(n)) x (Z1 + Z2 + Z3 + Z4)

4. **Which statistical feature is typically NOT assumed in VAR analysis?**

   A. Returns are normally distributed

   B. Returns are correlated

   C. Returns are serially independent

   D. Returns are linearly related

5. **What does Net Profit Margin (NPM) measure?**

   A. Sales / Net Profit

   B. Net Profit / Sales

   C. Gross Profit / Sales

   D. Operating Income / Sales

6. What is the treatment of investment under the Equity Method?

A. Investment recognized at market value only

B. Investment recorded as cost on the balance sheet

C. Investment valued at liquidation value

D. Investment recorded at book value

7. What is a notable feature of Local Expectations Theory?

A. It does not account for risk premiums

B. It assumes risk premiums only exist in the long run

C. It preserves risk-neutrality assumptions for short holding periods

D. It emphasizes market speculation over time

8. What is the formula for the Sustainable Growth Rate (g)?

A. Retention Rate * EPS

B. Retention Rate * ROE

C. Retention Rate / ROE

D. Retention Rate + ROE

9. What is a key advantage of using Monte Carlo Value at Risk (MC VAR)?

A. Specifies probability distributions for all parameters

B. Requires a small historical database

C. Assumes linear risk relationships

D. Utilizes a fixed historical average for forecasting

10. What is the result of a rising interest rate for a putable bondholder?

A. The bondholder must hold the bond to maturity.

B. The bondholder can sell back the bond to the issuer.

C. The bondholder will receive a higher yield.

D. The bondholder loses the option to sell.

Answers

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

Explanations

1. Adjusted FFO is primarily concerned with which aspect of financial performance?

A. Operational efficiency

B. Cash flow generation

C. Overall profitability

D. Tax efficiency

Adjusted Funds From Operations (AFFO) is a performance metric used primarily in real estate investment trusts (REITs) and similar entities to evaluate their cash flow generation capabilities. It is derived from Funds From Operations (FFO) by making adjustments to account for recurring capital expenditures and other non-cash items that may distort the true cash flow available to shareholders or for distribution purposes. The focus on cash flow generation is crucial because it provides a clearer picture of the entity's ability to sustain operations, pay dividends, and reinvest in growth opportunities. Investors often use AFFO as a more accurate indicator of the operational performance of a real estate investment because it reflects the cash generated from properties owned, excluding the effects of non-cash accounting measures. This metric differs from other areas of financial performance such as operational efficiency, which is more about how well a company manages its resources and processes, or overall profitability, which considers total revenue and expenses to assess financial success, and tax efficiency, which relates to the effective management of tax liabilities. The primary concern of adjusted FFO remains the cash flow aspect, making it a vital tool for stakeholders assessing an organization's financial health and capacity to generate liquidity.

2. How does a declining interest rate environment typically affect callable bonds?

A. Issuers are less likely to call the bonds.

B. Issuers typically want to call back the bonds.

C. Callable bonds become more valuable for investors.

D. Investors will exercise the put options more frequently.

In a declining interest rate environment, callable bonds typically see issuers taking more interest in calling back the bonds. When interest rates fall, issuers can refinance their debt at lower rates, which leads to significant cost savings. This creates an incentive for them to call the existing bonds, as they may be paying higher interest than what they would incur if they issued new debt at the current lower rates. This process is beneficial for the issuer because they reduce their interest burden. As a result, callable bonds are often called when rates drop since issuers can secure more favorable financing, making this the most accurate choice in this context. Other factors to consider include the potential impact on investors. While callable bonds may become less valuable as the likelihood of being called increases, callable bondholders' potential capital gains in a falling interest rate environment diminish since their bonds will be redeemed before they can benefit fully from the interest rate decline. Therefore, the reasoning ultimately supports that issuers are motivated to call the bonds in a declining interest rate scenario.

3. What is the formula for calculating the value of a SWAP?

A. SFR = (1 - Z4) / (Z1 + Z2 + Z3 + Z4)

B. SFR = (Z1 + Z2 + Z3) / (1 + r(n))

C. SFR = Z1 x Z2 x Z3 x Z4

D. SFR = (1 + r(n)) x (Z1 + Z2 + Z3 + Z4)

The formula for calculating the value of a swap often relates to the present value of cash flows, where "SFR" denotes the swap rate factor in this context. In the correct choice, the formula states that the swap rate factor is equal to the difference in present values of the fixed versus floating legs of the swap. The reason this formula is correct is that it takes into account the present value of future cash flows associated with the swap. The term (1 - Z4) refers to the present value of cash flows paid in the future, while the denominator (Z1 + Z2 + Z3 + Z4) represents the total present value of cash flows from both parties to the swap. This ratio effectively assesses the value of the swap by determining the net present value generated from the difference between these cash flows. When analyzing options that may seem plausible, such as the other choices presented, it's clear they do not accurately represent the dynamics of calculating swap values or the present value framework. Each alternative introduces elements that do not conform to the standard methodology used in swap valuation, focusing on aspects that either aggregate irrelevant components or misrepresent the cash flow relationships involved. By focusing on the net present value calculated in option A, it illustrates a key principle in

4. Which statistical feature is typically NOT assumed in VAR analysis?

A. Returns are normally distributed

B. Returns are correlated

C. Returns are serially independent

D. Returns are linearly related

In Value at Risk (VaR) analysis, the typical assumptions include the distribution of returns, correlation among returns, and the independence of returns over time. While many asset return models assume a normal distribution of returns and acknowledge that returns may be correlated, they often also assume that returns are serially independent. The assumption that returns are linearly related is not a standard characteristic in VaR analyses. This is because VaR focuses primarily on the magnitude of potential losses at a certain confidence level without necessitating a linear relationship among returns. The implication is that risk can be effectively measured without relying on a linear model, allowing for a broader application of the VaR methodology across various asset classes and market conditions. Thus, while returns' distribution, correlation, and independence are significant in the context of risk assessment, the linear relationship is not typically assumed in VaR analysis, making it the identified statistical feature that does not hold as a foundational assumption.

5. What does Net Profit Margin (NPM) measure?

A. Sales / Net Profit

B. Net Profit / Sales

C. Gross Profit / Sales

D. Operating Income / Sales

Net Profit Margin (NPM) measures the percentage of revenue that remains as profit after all expenses have been deducted from sales. It is calculated by dividing net profit (or net income) by total sales (or revenue). This ratio is important because it reflects how effectively a company is managing its costs and expenses relative to its total revenues, providing insight into profitability and company efficiency. A higher net profit margin indicates a company is more efficient at converting sales into actual profit, which can be particularly useful for comparing performance across companies in the same industry. This measure allows investors and analysts to assess how well the company controls its costs and how successful it is at turning sales into actual earnings. Other options represent different financial metrics: - Sales / Net Profit expresses the inverse relationship and does not indicate profitability, - Gross Profit / Sales focuses on the profitability of production and does not consider operating and other expenses, - Operating Income / Sales provides insights into operational efficiency but excludes non-operating income and expenses, making it distinct from net profit analysis.

6. What is the treatment of investment under the Equity Method?

A. Investment recognized at market value only

B. Investment recorded as cost on the balance sheet

C. Investment valued at liquidation value

D. Investment recorded at book value

Under the Equity Method of accounting for investments, an investor recognizes its investment in a company at cost on the balance sheet and subsequently adjusts this value for its share of the investee's profits or losses. When the investee earns profits, the investor's share of those profits increases the carrying amount of the investment, while losses would decrease the carrying amount. Dividends received from the investee also reduce the investment's carrying amount. This method reflects the investor's significant influence over the investee, typically present when the investor holds 20% to 50% of the voting shares. The other alternatives do not accurately represent the treatment under the Equity Method. Market value, liquidation value, or book value without adjustments are not consistent with the accounting principles governing the Equity Method, which emphasizes the investor's proportionate share of the investee's net income or loss.

7. What is a notable feature of Local Expectations Theory?

A. It does not account for risk premiums

B. It assumes risk premiums only exist in the long run

C. It preserves risk-neutrality assumptions for short holding periods

D. It emphasizes market speculation over time

Local Expectations Theory has a noteworthy feature in its assumption of risk-neutrality for short holding periods. This aspect means that, within a short timeframe, investors are assumed to make decisions based solely on expected returns, without any additional consideration for risk. This theory recognizes that in the short run, the effects of risk premiums can be negligible, allowing investors to operate under a risk-neutral framework, where the expected returns on investment are aligned with risk-free rates. This concept is crucial because it provides a simplified perspective on yield curves and term structure, allowing market participants to understand and predict interest rates and investment returns without the complexities introduced by risk perceptions in short durations. By focusing on short-term expectations, Local Expectations Theory simplifies the analysis and can effectively demonstrate how current market conditions influence future rates and prices, emphasizing a more theoretical approach rather than a practical one. In contrast, other theories or features related to expectations about long-term investments might place more emphasis on risk premiums or speculative behaviors, which are not a central focus of Local Expectations Theory in its immediate context. This clarity in short-term risk neutrality is what distinguishes this theory, allowing it to stand out in the study of financial markets and interest rate behaviors.

8. What is the formula for the Sustainable Growth Rate (g)?

A. Retention Rate * EPS

B. Retention Rate * ROE

C. Retention Rate / ROE

D. Retention Rate + ROE

The formula for the Sustainable Growth Rate (g) is derived from the relationship between a firm's retention ratio, also known as the plowback ratio, and its return on equity (ROE). The retention ratio represents the portion of net income that is retained in the business rather than distributed as dividends. This retained earnings are then reinvested to generate future growth. When multiplied by the return on equity, which measures the profitability and efficiency with which a company uses its equity capital, the result gives an estimate of how much a company can grow its earnings (and, subsequently, dividends) sustainably without needing to resort to external financing. Therefore, the correct formula for the Sustainable Growth Rate is: Sustainable Growth Rate (g) = Retention Rate * ROE This correctly encapsulates the core concept that the ability of a company to grow at a sustainable rate is contingent upon how much profit it retains after dividends and how efficiently it can utilize that retained profit to generate returns. The other formulas do not accurately express the relationship needed to calculate the Sustainable Growth Rate. Dividing the retention rate by ROE or adding them does not reflect their interdependent contributions to sustainable growth, nor does multiplying the retention rate by earnings per share (EPS) capture

9. What is a key advantage of using Monte Carlo Value at Risk (MC VAR)?

A. Specifies probability distributions for all parameters

B. Requires a small historical database

C. Assumes linear risk relationships

D. Utilizes a fixed historical average for forecasting

The key advantage of using Monte Carlo Value at Risk (MC VAR) is that it specifies probability distributions for all parameters involved in the analysis. This approach allows for a more comprehensive capture of the potential variability and uncertainty in those parameters, as opposed to relying solely on historical data or fixed assumptions. By specifying probability distributions, MC VAR can account for a wide range of possible outcomes and relationships between variables, including non-normally distributed risks or tail events that might not be captured in simpler modeling approaches. This flexibility is particularly useful in assessing risk for portfolios with complex structures or those subject to extreme market movements. In contrast, other methods might rely on historical averages, linear relationships, or a limited dataset, which could potentially underestimate risk or lead to misleading conclusions. Monte Carlo simulations also facilitate stress testing and scenario analysis, providing a richer framework for understanding the effects of various risks on portfolio value under different conditions.

10. What is the result of a rising interest rate for a putable bondholder?

A. The bondholder must hold the bond to maturity.

B. The bondholder can sell back the bond to the issuer.

C. The bondholder will receive a higher yield.

D. The bondholder loses the option to sell.

The correct answer highlights a crucial feature of putable bonds, which gives the bondholder the option to sell the bond back to the issuer at designated times before maturity. As interest rates rise, the value of existing bonds with lower coupon rates typically decreases, making new issues more attractive to investors due to their higher yields. In this context, the putable bondholder has a valuable option to respond to changing market conditions. When interest rates increase, the bondholder can exercise the put option and sell the bond back to the issuer, thereby potentially mitigating losses from the bond's declining market value. This option acts as a form of insurance against the adverse price movements that rising interest rates can create. This ability to sell back the bond provides flexibility that is beneficial in a rising rate environment, enabling the bondholder to avoid capital losses or reinvest the proceeds into higher-yielding securities. Thus, the ability to sell back the bond to the issuer is particularly advantageous when faced with rising interest rates.

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-level2.examzify.com

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