

CHARTERED FINANCIAL ANALYST (CFA) PRACTICE EXAM LEVEL 2 (SAMPLE)

STUDY GUIDE



**SAMPLE STUDY GUIDE
WITH LIMITED QUESTIONS**

**VISIT US ONLINE FOR
THE FULL VERSION STUDY GUIDE**

<https://cfa-level2.examzify.com>



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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. 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

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- 1. In the context of option pricing, which of the following factors increases the call option price?**
 - A. Stock Price
 - B. Exercise Price
 - C. Time to Expiration
 - D. Risk-Free Rate
- 2. The Likelihood Ratio Test is used to compare what?**
 - A. Two independent variables
 - B. Fit of reduced and full models
 - C. Variance of different models
 - D. Hypothesis testing between two groups
- 3. What does Net Profit Margin (NPM) measure?**
 - A. Sales / Net Profit
 - B. Net Profit / Sales
 - C. Gross Profit / Sales
 - D. Operating Income / Sales
- 4. What formula is used to calculate Effective Duration (ED) of a bond?**
 - A. $ED = (P_- + P_+)/[2(P_0)(\text{Change } Y)]$
 - B. $ED = (\text{Change in Price})/(\text{Change in Yield})$
 - C. $ED = \text{Macaulay Duration} / (1 + YTM)$
 - D. $ED = (\text{Present Value of Cash Flows})/(\text{Price of Bond})$
- 5. What does the Arbitrage Pricing Theory (APT) primarily focus on?**
 - A. Risk-return relationships
 - B. Market volatility analysis
 - C. Investor behavioral finance
 - D. Asset pricing models
- 6. Which of the following best describes the Dornbusch Overshooting Model?**
 - A. It focuses solely on long-term price adjustments
 - B. It explains exchange rate dynamics and short run policy responses
 - C. It predicts the stability of currency values
 - D. It ignores sticky prices in exchange rates

- 7. What financial metric would be most relevant for assessing a company's ability to cover its obligations?**
- A. Adjusted FFO
 - B. PEG Ratio
 - C. Trailing PE
 - D. Leading PE
- 8. In Inter-Corporate Investment Accounting, which method is used for investments with less than 20% ownership?**
- A. Equity Method
 - B. Acquisition Method
 - C. Cost Method
 - D. Fair Value Method
- 9. In a multi-stage Dividend Discount Model (DDM), what determines the dividends in the growth phases?**
- A. Constant growth rate over the long term
 - B. Proportional change based on retained earnings
 - C. Historical dividend payout ratio
 - D. Market price adjustments
- 10. Which method requires creating the Income Statement first?**
- A. Temporal Method
 - B. All Current Method
 - C. Direct Quote Method
 - D. Indirect Quote Method

Answers

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

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Explanations

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1. In the context of option pricing, which of the following factors increases the call option price?

- A. Stock Price**
- B. Exercise Price
- C. Time to Expiration
- D. Risk-Free Rate

Increasing the stock price directly influences the intrinsic value of a call option, making it worth more. A call option gives its holder the right to purchase the underlying stock at a predetermined exercise price. When the stock price rises above the exercise price, the call option is considered "in the money," leading to an increase in its price. This relationship is fundamental to the valuation of options: as the stock price increases, the likelihood that the option will end up being exercised increases, which in turn raises its market price. Other factors like the exercise price, time to expiration, and risk-free rate have nuanced impacts on option pricing. For instance, an increase in the exercise price would generally decrease the call option price, as it would require the stock to rise higher to be profitable for the holder. Time to expiration can either increase or decrease the option price depending on other variables, as it influences the time value of the option, while the risk-free rate can have varying effects depending on market conditions and sentiments. However, in the context of this question, the increase in stock price is the clear factor that elevates the call option price.

2. The Likelihood Ratio Test is used to compare what?

- A. Two independent variables
- B. Fit of reduced and full models**
- C. Variance of different models
- D. Hypothesis testing between two groups

The Likelihood Ratio Test is utilized to compare the fit of reduced and full statistical models. In this context, a "full model" includes all the variables of interest and provides a comprehensive representation of the data, while a "reduced model" is a simpler version that typically omits one or more variables. The test assesses whether the additional parameters in the full model significantly improve the model's fit compared to the reduced model. The likelihood ratio itself is calculated by taking the ratio of the maximum likelihoods of the two models. If the ratio indicates that the full model provides a significantly better fit, this would support the inclusion of the additional parameters. This process helps determine if complexities in the data warrant the added variables or if a simpler model suffices, contributing to more parsimonious model development. In this scenario, other options do not accurately represent the primary use of the Likelihood Ratio Test. The test is not specifically meant for comparing independent variables or assessing variances between models, nor is it designed for hypothesis testing strictly between two groups. Its core application lies in evaluating model specifications against each other.

3. 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.

4. What formula is used to calculate Effective Duration (ED) of a bond?

- A. $ED = (P_- + P_+)/[2(P_0)(\text{Change } Y)]$**
- B. $ED = (\text{Change in Price})/(\text{Change in Yield})$
- C. $ED = \text{Macaulay Duration} / (1 + \text{YTM})$
- D. $ED = (\text{Present Value of Cash Flows})/(\text{Price of Bond})$

Effective Duration (ED) is a measure that assesses the sensitivity of a bond's price to changes in yield, taking into account the possibility of cash flow changes due to embedded options. The correct formula emphasizes how bond pricing reacts to shifts in interest rates, making it suitable for bonds that may not have fixed cash flows. The formula for Effective Duration is as follows: $ED = (P_- + P_+)/[2(P_0)(\text{Change } Y)]$. Here, P_- denotes the price of the bond when yield decreases, P_+ is the price when yield increases, P_0 is the initial price of the bond, and Change Y reflects the change in yield. This formula effectively captures the asymmetrical relationship between price changes and yield changes in a bond that may have option-like features. This approach considers both directions of yield change, providing a more accurate measure of the bond's risk exposure relative to interest rate fluctuations. Taking the average of the price changes (P_- and P_+) while normalizing it against the initial price and the change in yield yields a comprehensive perspective that is particularly beneficial for managing fixed income portfolios.

5. What does the Arbitrage Pricing Theory (APT) primarily focus on?

- A. Risk-return relationships**
- B. Market volatility analysis
- C. Investor behavioral finance
- D. Asset pricing models

The Arbitrage Pricing Theory (APT) primarily focuses on the relationships between risk and return in the context of asset pricing. It posits that the return on an asset can be modeled as a linear function of various macroeconomic factors or theoretical risks, akin to the risk-return framework established in the Capital Asset Pricing Model (CAPM) but with greater flexibility regarding the number of factors used. APT introduces several systematic risk factors that influence the returns on assets, thus allowing investors to assess expected returns based on the risk exposure to those factors. This theory underscores the importance of understanding how the returns are affected not just by the market risk but also by specific risk factors that can impact asset performance. While other concepts such as market volatility analysis, behavioral finance, and various asset pricing models might be related to or incorporate elements of risk and return, the central theme of APT is its direct concern with establishing a relationship between the returns on securities and their sensitivities to multiple sources of systematic risk. This foundational aspect is what makes APT a crucial concept in finance, particularly in portfolio management and risk assessment.

6. Which of the following best describes the Dornbusch Overshooting Model?

- A. It focuses solely on long-term price adjustments
- B. It explains exchange rate dynamics and short run policy responses**
- C. It predicts the stability of currency values
- D. It ignores sticky prices in exchange rates

The Dornbusch Overshooting Model is primarily centered on the dynamics of exchange rates and how they react to changes in monetary policy and economic conditions in the short run. The model suggests that due to sticky prices in the short term, exchange rates can deviate significantly from their long-term equilibrium values as markets adjust to new information. In this model, when there is a change in monetary policy, such as an increase in the money supply, the immediate effect is a depreciation of the currency due to higher inflation expectations. However, due to the stickiness of prices, this depreciation may overshoot the level that would be expected at equilibrium, leading to excessive fluctuations in currency value before stabilizing eventually at a new long-term equilibrium. This behavior highlights the complexity of exchange rate adjustments and illustrates how short-run responses can be significant in the context of economic policy. Other descriptions, such as focusing solely on long-term price adjustments, do not capture the essence of the model, which emphasizes the short-run dynamics that can lead to overshooting. Similarly, predicting the stability of currency values or ignoring sticky prices would miss critical components of the model's application and implications in real-world scenarios. Therefore, the characterization that it explains exchange rate dynamics and short run policy responses accurately captures

7. What financial metric would be most relevant for assessing a company's ability to cover its obligations?

A. Adjusted FFO

B. PEG Ratio

C. Trailing PE

D. Leading PE

The chosen answer of Adjusted FFO (Funds from Operations) is particularly relevant for assessing a company's ability to cover its obligations because it provides a clear view of the cash flow generated by a company's operations, especially in real estate investment trusts (REITs) and other income-producing assets. Adjusted FFO adjusts the standard FFO by excluding certain non-recurring items and providing a more accurate reflection of operational performance, thereby offering insight into the cash available for financing costs, dividend payments, and other obligations. Due to its focus on cash generated from core operations, Adjusted FFO helps stakeholders evaluate liquidity and a company's ability to meet short-term obligations and service its debt. This makes it a vital metric for creditors and investors concerned about financial stability and cash flow sufficiency. In contrast, the other metrics listed focus more on stock valuation rather than cash flow and liquidity. The PEG Ratio, for example, incorporates growth rates in its assessment but does not address immediate cash obligations. Trailing and Leading PE ratios (Price-to-Earnings) provide insights into a company's valuation relative to its earnings, but they do not account for cash flows and consequently do not give a complete picture of a company's ability to support its obligations. Thus, while useful for investment

8. In Inter-Corporate Investment Accounting, which method is used for investments with less than 20% ownership?

A. Equity Method

B. Acquisition Method

C. Cost Method

D. Fair Value Method

The correct method for accounting for investments with less than 20% ownership is the Cost Method. This approach reflects the initial investment cost on the balance sheet and does not account for fluctuations in the investee's net assets or earnings unless there is an impairment. Under the Cost Method, dividends received from the investment may be recognized as income, but there is typically no adjustment to the carrying amount of the investment unless specific conditions arise, such as impairment. In the context of inter-corporate investments, ownership percentages significantly influence the accounting treatment. When an investor holds less than 20% of the shares, it is typically presumed that they do not exert significant influence over the investee, which is why the Cost Method is employed. The other methods mentioned (Equity Method, Acquisition Method, and Fair Value Method) are appropriate for different ownership levels or scenarios, such as significant influence or control, which is not the case when ownership falls below the 20% threshold.

9. In a multi-stage Dividend Discount Model (DDM), what determines the dividends in the growth phases?

- A. Constant growth rate over the long term
- B. Proportional change based on retained earnings**
- C. Historical dividend payout ratio
- D. Market price adjustments

The dividends in the growth phases of a multi-stage Dividend Discount Model (DDM) are primarily determined by proportional change based on retained earnings. In this model, companies typically reinvest a portion of their earnings back into the business, which can lead to increased dividends over time as the company grows. The retained earnings contribute to the overall growth of the company, allowing it to fund future projects, expand operations, or increase its dividend payout. By utilizing retained earnings effectively, companies can generate higher future profits, which can then be distributed to shareholders as dividends. This approach considers the relationship between earnings and dividends, highlighting how reinvested profits can influence dividend growth during different phases of the company's lifecycle. While elements like the historical dividend payout ratio and constant growth rates may provide some context or context in specific scenarios, they do not directly dictate the growth of dividends in the same way that the adjustments based on retained earnings do. Market price adjustments, on the other hand, are more concerned with how investors perceive the stock's value rather than the underlying mechanics of dividend growth.

10. Which method requires creating the Income Statement first?

- A. Temporal Method
- B. All Current Method**
- C. Direct Quote Method
- D. Indirect Quote Method

The All Current Method is the correct choice because it involves translating all assets and liabilities at the current exchange rate while translating income statement items at the average exchange rate for the period. In this method, the income statement is constructed first before the balance sheet because it is essential to capture the financial performance for the period based on the average exchange rates. Once the income statement is translated, the balance sheet figures are then translated, allowing for a clear distinction between the transactional effects captured in the income statement and those reflected in the balance sheet using spot rates. This approach emphasizes reflecting the economic environment during which income and expenses were incurred, rather than the time when the transactions occurred. In contrast, the Temporal Method requires a different sequence and methodology for translation, focusing on maintaining the historical exchange rates for certain assets and liabilities. The Direct Quote Method and the Indirect Quote Method pertain more to how exchange rates are expressed rather than how financial statements are translated or organized.

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!

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