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CFA® Program Level I

Corporate Finance: 25 Free Practice Questions

2027 curriculum · 7 readings · answers and full explanations

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Version v2027.3 · October 2026

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2027 curriculum · Version v2027.3 · Generated October 6, 2026

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Contents

How to use these questions **1**

Corporate Finance (questions 1–25) **2**

Answers and explanations: Corporate Finance 8

Keep going at credguild.com **18**

How to use these questions

The 25 free questions on credguild.com for Corporate Finance, 2027 CFA® Program Level I curriculum, each with its answer and full explanation.

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If these questions help you, pass the file on to someone else who is studying.

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CFA® PROGRAM LEVEL I · FREE PRACTICE QUESTIONS

Corporate Finance

Questions 1–25 · 7 readings

20 Organizational Forms, Corporate Issuer Features, and Ownership

Question 1

Two siblings plan to buy and operate a vineyard. They will manage it themselves and accept unlimited liability for its debts. Four cousins will contribute capital but will take no part in running the business and want their liability capped at the amount they invest. The *most appropriate* organizational form is a:

A limited partnership.

B general partnership.

C limited liability partnership.

Question 2

An analyst drafts a list of features of Kittredge Marine, a corporation. Which item on her list is *incorrect*?

A Kittredge's shareholders do not have to take part in managing the company.

B Kittredge has no legal identity apart from that of its shareholders.

C Kittredge's profits may be taxed at the corporate level and again when paid out as dividends.

Question 3

Brenmoor Robotics is privately held. Its board wants to bring in new equity capital and, at the same time, allow its shares to be bought and sold by the public on a stock exchange. The board is *most likely* to pursue:

A a direct listing of its existing shares.

B a management buyout.

C an initial public offering.

21 Shareholder vs Stakeholder

Question 4

Orrin Freight has bank loans, preferred stock and common stock outstanding. Which of the following payments are contractual obligations of Orrin?

A Interest and principal on its bank loans.

B Interest on its loans and dividends on its common stock.

C Interest and principal on its loans, and dividends on its preferred stock.

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Question 5

Which of the following *best* describes the primary focus of the stakeholder theory of corporate governance?

A Serving the interests of groups other than shareholders in place of the interests of shareholders.

B Maximizing the market value of the company's common equity.

C Resolving the conflicting interests of the company's managers and the various groups affected by what the company does.

Question 6

Ardent Power generates most of its electricity from coal. New national emissions limits and a steady shift in customer demand toward low-carbon energy threaten to make several of its plants uneconomic before the end of their useful lives. The climate-related risk Ardent faces is *best* described as:

A physical risk.

B transition risk.

C governance risk.

22 Principal Agent Problem

Question 7

Between which two parties associated with a company does a principal-agent relationship *most likely* exist?

A Its customers and its suppliers.

B Its directors and its regulators.

C Its shareholders and its managers.

Question 8

Ridgeway Partners, a hedge fund, has built a 7% stake in Almont Paper and has started a proxy contest to replace three directors. Ridgeway's main aim is *most likely* to:

A keep the current board and management in place.

B reduce Almont's debt to protect its bondholders.

C increase the value of Almont's shares.

Question 9

The board of Castleford Water is drafting the charter of its new audit committee. Which of the following duties should be assigned to a different board committee instead?

A Overseeing the financial reporting process and the application of accounting policies.

B Reviewing the effectiveness of internal controls and of the internal audit function.

C Overseeing the company's corporate governance code, including board elections.

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23 Cash Conversion Cycle

Question 10

The CFO of Brightwater Distributors wants to shorten the company's cash conversion cycle (CCC). Which of the following changes would achieve this goal?

A Days sales outstanding increases.

B Days payable outstanding decreases.

C Days of inventory on hand decreases.

Question 11

Kellan Foods buys ingredients from a supplier that offers terms of 3/15, net 75. Kellan can also borrow from its bank at an annual rate of 9%. Which source of financing is cheaper for Kellan?

A Borrowing from the bank.

B Forgoing the discount and using the supplier's credit.

C The two sources cost the same.

Question 12

Talbridge Electronics' main component suppliers have cut the trade credit line they extend to it and now require payment within 15 days instead of 45 days. For Talbridge, this development is *best* described as a:

A drag on liquidity.

B pull on liquidity.

C secondary source of liquidity.

Question 13

Three companies describe how they handle their working capital. Whose practice fits a conservative approach *best*?

A A distributor pays its warehouse rent and staff wages with rolling 90-day bank loans.

B A manufacturer keeps far more long-term assets than short-term assets relative to its sales.

C A retailer finances its inventory with a ten-year term loan.

24 NPV vs IRR

Question 14

Tamsin Foods is reviewing three capital projects. Which one would typically need the *most* detailed analysis?

A Replacing a packaging machine that still works with a newer model that costs less to run.

B Launching a new product line in a region where the company does not yet sell.

C Installing fire-suppression equipment that the company's insurer now requires.

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Question 15

Harwick Instruments has estimated that a proposed sensor line has an internal rate of return of 11.5% and a net present value of +$1.9 million. The company's 9.0% cost of capital is appropriate for the risk of the line. Harwick should *most likely*:

A reject the line, based on both its NPV and its IRR.

B accept the line, but only on the basis of its NPV.

C accept the line, based on both its NPV and its IRR.

Question 16

Fenmoor Packaging earns an operating margin after tax of 8.0%, and its sales are 1.5 times its invested capital. The blended rate of return that its debt and equity investors require is 10.0%. Which statement about Fenmoor is *most accurate*?

A Its ROIC is 5.3%, so it is losing value over time.

B Its ROIC is 8.0%, so it is losing value over time.

C Its ROIC is 12.0%, so it is adding value over time.

Question 17

For the past eight years, Farrow Plastics' capital budget has been set at roughly the prior year's amount plus 3%, even though the returns on its recent projects have been falling. This practice is best described as which capital allocation pitfall?

A Failure to generate alternative investment ideas.

B Pet projects of senior management.

C Inertia in setting the entire capital budget.

Question 18

Kinloss Cold Storage is evaluating a refrigerated warehouse that would cost $8.20 million today. Discounted at Kinloss's required rate of return, the warehouse's expected after-tax cash flows have a present value of $7.65 million. For an additional $0.45 million paid now, Kinloss can buy the adjoining parcel of land, which would allow it to double the warehouse's capacity later if demand justifies it. Using a decision tree, Kinloss's analysts value this expansion option at $1.30 million. The NPV of the warehouse project including the expansion option is *closest* to:

A +$0.30 million.

B −$0.55 million.

C −$1.00 million.

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25 Modigliani Miller

Question 19

Harlan Steelworks has no preferred stock. An equity analyst wants a WACC figure that measures Harlan's current opportunity cost of capital, and she has collected these data:

Harlan Steelworks: capital and cost data

Item	Value
Debt, market value	$175 million
Debt, book value	$200 million
Common equity, market value	$525 million
Common equity, book value	$900 million
Yield to maturity on Harlan's bonds (pretax cost of debt)	5.6%
Cost of common equity	13.2%
Marginal tax rate	25%

Interest expense is tax-deductible. Harlan's WACC is *closest* to:

A 10.95%.

B 11.30%.

C 11.56%.

Question 20

Treloar Bakeries' revenue growth has slowed to a few percent a year, its operating cash flow is large and stable, and its business risk is low. Given its life cycle stage, Treloar is *most likely* to be financed with:

A equity almost exclusively, possibly with some convertible debt.

B a significant amount of debt, including unsecured debt at relatively low cost.

C limited debt, used conservatively and secured by receivables or fixed assets.

Question 21

Sorrel Systems would have a cost of equity of 10.5% if it had no debt. The company borrows at 6.0%, has a debt-to-equity ratio of 0.6, and faces a 25% corporate tax rate. Under Modigliani and Miller's Proposition II with taxes, Sorrel's cost of equity is *closest* to:

A 13.20%.

B 12.53%.

C 11.77%.

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Question 22

Halvard Retail generates far more cash than it can invest profitably. One of its directors argues that the company should take on more debt, because the required interest and principal payments would leave management with less spare cash to spend on lavish perks and low-return acquisitions. The director's argument is *most* consistent with:

A pecking order theory.

B the use of debt to signal management's confidence.

C the free cash flow hypothesis.

26 Business Models

Question 23

An analyst is writing up the business model of Seabrook Outfitters. Which of the following items is *least likely* to belong in the description of the business model?

A Detailed forecasts of revenue and expenses for the next five years.

B The customer groups the company targets and how it reaches them.

C The key assets and critical suppliers the company relies on.

Question 24

A laptop maker has sold a premium keyboard, a high-resolution display and three years of on-site support as separate options. For its next model it decides to stop selling them separately and to include all three with the laptop for one combined base price. Which pricing model *best* reflects this decision?

A Value-based pricing.

B Bundling.

C Dynamic pricing.

Question 25

Fairfield Mills produces breakfast cereals that are sold only under the store brands of several large supermarket chains. Fairfield's name does not appear on any package. Which business model *best* describes Fairfield Mills?

A Value-added reseller.

B Licensing agreement.

C Private label manufacturer.

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CORPORATE FINANCE

Answers and explanations

Answer key: 1. A · 2. B · 3. C · 4. A · 5. C · 6. B · 7. C · 8. C · 9. C · 10. C · 11. A · 12. B · 13. C · 14. B · 15. C · 16. C · 17. C · 18. A · 19. A · 20. B · 21. B · 22. C · 23. A · 24. B · 25. C

Question 1 **Answer: A**

A limited partnership combines general partners, who manage the business and have unlimited liability (the siblings), with limited partners, whose liability is limited to their investment (the cousins). That is the mix described.

Why the other options are wrong

- **B.** In a general partnership every partner is a general partner with unlimited liability, so the cousins could not cap their liability.
- **C.** A limited liability partnership has no general partner: every partner has a liability shield. It does not fit owners who choose to accept unlimited liability, and some US states restrict LLPs to designated professions such as law and accounting.

Key takeaway Mixed roles (managers with unlimited liability + passive investors with limited liability) point to a limited partnership.

Reading 20: Organizational Forms, Corporate Issuer Features, and Ownership. Notes: credguild.com/cfa/level-1/notes/corporate-finance/organizational-forms-corporate-issuer-features-and-ownership/

Question 2 **Answer: B**

The defining feature of a corporation is its legal identity, separate from that of its owners and its managers. It is formed by filing articles of incorporation with a regulator and, as a legal person, it can hire employees, enter into contracts, and borrow and lend in its own name. Having no legal identity apart from the owner describes a sole proprietorship, whose business is legally an extension of its owner. For a corporation this item is the error on the list.

Why the other options are wrong

- **A.** This item is accurate. Ownership and management are separated in a corporation: shareholders elect the board, which hires the managers. A large shareholder may sit on the board or serve as an executive, but most shareholders take no management role.
- **C.** This item is accurate for a country that taxes corporate earnings and also taxes dividends as personal income, which is why it says profits *may* be taxed twice. The second layer of tax falls on distributed profit, so the burden is smaller when the company retains more of its earnings.

Key takeaway Key features of a corporation: separate legal identity, owners separated from managers, limited liability for shareholders, and possible double taxation of distributed profits.

Reading 20: Organizational Forms, Corporate Issuer Features, and Ownership. Notes: credguild.com/cfa/level-1/notes/corporate-finance/organizational-forms-corporate-issuer-features-and-ownership/

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Question 3 **Answer: C**

An initial public offering (IPO) typically includes new shares sold by the company to the public (existing holders may sell some shares as well), so the proceeds add to its equity capital, and the shares then trade on an exchange. It is the only choice that achieves both of the board's goals.

Why the other options are wrong

- **A.** A direct listing of existing shares makes them tradable on an exchange, but no new shares are sold, so the company raises no new capital. Some exchanges also allow a primary direct listing that sells new shares, but this option lists existing shares only.
- **B.** A management buyout is a way of taking a public company private; it raises no equity for the company and moves in the opposite direction.

Key takeaway IPO = go public, typically raising new capital; direct listing of existing shares = go public without raising capital; buyout = go private.

Reading 20: Organizational Forms, Corporate Issuer Features, and Ownership. Notes: credguild.com/cfa/level-1/notes/corporate-finance/organizational-forms-corporate-issuer-features-and-ownership/

Question 4 **Answer: A**

Lenders have a legal, contractual claim to the interest and principal payments the company has promised. Owners have only a residual claim: the company may pay dividends, but it is not required to.

Why the other options are wrong

- **B.** Common stock dividends are paid at the board's discretion. They are not a contractual obligation.
- **C.** Preferred stock dividends are also not a contractual obligation of the company. Only interest and principal owed to lenders are.

Key takeaway Contractual = interest + principal to lenders. Dividends (common or preferred) = discretionary distributions to owners.

Reading 21: Investors and Other Stakeholders. Notes: credguild.com/cfa/level-1/notes/corporate-finance/shareholder-vs-stakeholder/

Question 5 **Answer: C**

Under stakeholder theory, corporate governance deals with the competing interests of the people who run the company and all the groups its actions affect. Shareholders are one of those groups, alongside creditors, employees, suppliers, customers, communities and governments.

Why the other options are wrong

- **A.** Stakeholder theory does not replace shareholders' interests with those of other groups. Shareholders are among the stakeholders whose interests are balanced.
- **B.** Maximizing the value of common equity is the focus of shareholder theory.

Key takeaway Stakeholder theory = balance everyone, shareholders included. Shareholder theory = maximize equity value.

Reading 21: Investors and Other Stakeholders. Notes: credguild.com/cfa/level-1/notes/corporate-finance/shareholder-vs-stakeholder/

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Question 6 **Answer: B**

Transition risk arises when government regulation or consumer choices force a shift from high-carbon to low-carbon activities. Assets made unviable by that shift, like Ardent's coal plants, become stranded assets.

Why the other options are wrong

- **A.** Physical risk is the risk of damage to assets or operations from climate events such as more frequent severe weather. Nothing in the scenario involves physical damage.
- **C.** Governance factors concern board composition, executive pay, bribery, lobbying and similar matters. The threat here comes from environmental regulation and market shifts. How the company is governed is not the issue.

Key takeaway Climate risk splits into physical risk (weather damage) and transition risk (rules and preferences moving to low carbon); assets killed by transition become stranded assets.

Reading 21: Investors and Other Stakeholders. Notes: credguild.com/cfa/level-1/notes/corporate-finance/shareholder-vs-stakeholder/

Question 7 **Answer: C**

In a principal-agent relationship one party hires another to act on its behalf. Shareholders (the principals), acting through the board of directors, hire managers (the agents) to run the company in the shareholders' best interests.

Why the other options are wrong

- **A.** Customers and suppliers deal with the company under contracts; neither hires the other to act on its behalf.
- **B.** Regulators oversee companies to enforce laws. Directors are not agents hired by regulators; they are agents of the shareholders.

Key takeaway Shareholders = principals; managers and directors = agents. Their differing interests create agency costs.

Reading 22: Corporate Governance: Conflicts, Mechanisms, Risks, and Benefits. Notes: credguild.com/cfa/level-1/notes/corporate-finance/principal-agent-problem/

Question 8 **Answer: C**

Activist shareholders hold significant stakes and push for changes they believe will increase shareholder value. Their tactics include shareholder lawsuits, seeking board seats, shareholder resolutions, proxy contests and tender offers. Hedge funds increasingly act as activists at companies where they hold large stakes.

Why the other options are wrong

- **A.** A proxy contest seeks shareholders' proxies to vote for the activist's alternative proposals, such as new directors. Its purpose is to change the board, not to keep it.
- **B.** The fund is a shareholder. Its interest is the value of its shares; protecting bondholders is not what activists pursue.

Key takeaway Activists buy a sizable stake and use lawsuits, board seats, resolutions, proxy contests or tender offers to raise shareholder value.

Reading 22: Corporate Governance: Conflicts, Mechanisms, Risks, and Benefits. Notes: credguild.com/cfa/level-1/notes/corporate-finance/principal-agent-problem/

Question 9 Answer: C

Oversight of the corporate governance code and of board elections belongs to the nominating/governance committee. That committee also sets nomination policy for board candidates, implements the code of ethics and conflict-of-interest policies, and monitors compliance with laws, regulations and the company's governance policies. The audit committee's work centers on financial reporting and control.

Why the other options are wrong

- **A.** Overseeing financial reporting and the implementation of accounting policies is a core audit committee duty.
- **B.** Reviewing internal controls and the internal audit function is also an audit committee responsibility, as are recommending the external auditor and its pay (which shareholders then approve as an ordinary resolution) and proposing remedies based on audit findings.

Key takeaway Audit committee: financial reporting, accounting policies, internal controls and internal audit, and the choice and pay of the external auditor. Nominating/governance committee: governance code, board nominations and elections, ethics and compliance.

Reading 22: Corporate Governance: Conflicts, Mechanisms, Risks, and Benefits. Notes: credguild.com/cfa/level-1/notes/corporate-finance/principal-agent-problem/

Question 10 Answer: C

The CCC equals DOH plus DSO minus DPO and measures how long cash is tied up in inventory and receivables before it returns from sales. Selling inventory faster lowers DOH and therefore shortens the CCC.

$$\text{CCC} = \text{DOH} + \text{DSO} - \text{DPO}$$

A lower DOH shortens the CCC; a higher DSO or a lower DPO lengthens it.

Why the other options are wrong

- **A.** Slower collection of receivables raises DSO and lengthens the CCC.
- **B.** Paying suppliers sooner lowers DPO; because DPO is subtracted, the CCC gets longer.

Key takeaway CCC falls when DOH or DSO falls, or when DPO rises.

Reading 23: Working Capital and Liquidity. Notes: credguild.com/cfa/level-1/notes/corporate-finance/cash-conversion-cycle/

Question 11 Answer: A

Forgoing a 3% discount to delay payment by 60 days is an implicit loan from the supplier. Its effective annual rate is about 20.4%, far above the 9% explicit cost of bank borrowing, so Kellan should borrow from the bank and pay within 15 days to take the discount.

Financing period $= 75 - 15 = 60$ days; forgoing the discount means paying \$3 extra for each \$97 of credit.

$$\text{EAR} = \left(1 + \frac{0.03}{1 - 0.03}\right)^{365/60} - 1 = (1.030928)^{6.0833} - 1 \approx 0.2036 = 20.4\%$$

Bank: 9%. Since 20.4% > 9%, the bank is cheaper.

Why the other options are wrong

- **B.** Comparing the 3% discount with the 9% bank rate ignores the time period: the 3% is earned for only 60 days, which annualizes to about 20.4%. Supplier credit is therefore the more expensive source.
- **C.** The costs are far apart (about 20.4% vs. 9%). Even a simple, uncompounded annualization ($3.093\% \times 365/60 \approx 18.8\%$) is well above the bank rate.

Key takeaway Terms a/b net c: $\text{EAR} = \left(1 + \frac{a}{1-a}\right)^{365/(c-b)} - 1$, with a as a decimal. Trade credit that forgoes a discount is usually far more expensive than a bank loan.

Reading 23: Working Capital and Liquidity. Notes: credguild.com/cfa/level-1/notes/corporate-finance/cash-conversion-cycle/

Question 12 **Answer: B**

A pull on liquidity occurs when cash outflows speed up, for example when suppliers reduce credit lines or demand faster payment. Days payable outstanding falls, the cash conversion cycle lengthens and liquidity is reduced.

Why the other options are wrong

- **A.** A drag on liquidity is a delay in cash inflows, such as slow-moving or obsolete inventory or slow collection of receivables. Here the problem is faster outflows.
- **C.** Secondary sources of liquidity are actions the firm can take to raise cash, such as suspending dividends, delaying capital spending, selling assets, issuing equity or restructuring debt. Losing supplier credit reduces liquidity rather than providing it.

Key takeaway Drag = inflows slow down (DOH or DSO up). Pull = outflows speed up (DPO down).

Reading 23: Working Capital and Liquidity. Notes: credguild.com/cfa/level-1/notes/corporate-finance/cash-conversion-cycle/

Question 13 **Answer: C**

A conservative approach finances working capital, including permanent needs such as inventory, salaries and rent, with long-term sources (long-term debt and equity). It also involves holding relatively high levels of short-term assets compared with long-term assets.

Why the other options are wrong

- **A.** Paying recurring costs such as rent and wages with short-term borrowing that must be rolled over is typical of an aggressive approach.
- **B.** Conservative firms hold relatively *more* short-term assets. A firm with low short-term assets relative to long-term assets is closer to the aggressive end.

Key takeaway Conservative: lots of current assets, long-term financing. Aggressive: few current assets, short-term financing.

Reading 23: Working Capital and Liquidity. Notes: credguild.com/cfa/level-1/notes/corporate-finance/cash-conversion-cycle/

Question 14 **Answer: B**

An expansion project that brings a new product into a new market requires forecasts of demand, revenues and expenses that are all highly uncertain. It therefore needs the most detailed analysis of the three.

Why the other options are wrong

- **A.** Replacing a usable machine to lower costs is a going concern project. It needs a cost comparison, but its cash flows are much easier to estimate than those of a new product in a new market.
- **C.** Insurer-mandated safety equipment is a regulatory/compliance project. The firm must do it, so the analysis centers on comparing alternative ways of complying.

Key takeaway Depth of analysis rises with uncertainty. Projects that maintain the business need little analysis, regulatory/compliance projects call for comparing alternative ways to comply, and expansion and other projects need the most detailed analysis.

Reading 24: Capital Investments and Capital Allocation. Notes: credguild.com/cfa/level-1/notes/corporate-finance/npv-vs-irr/

Question 15 Answer: C

Both decision rules point the same way. The NPV is positive, so the line is expected to add value for shareholders. The IRR of 11.5% is above the 9.0% cost of capital (the hurdle rate), so the IRR rule also says accept. For a conventional, independent project the two rules always agree, because a discount rate below the IRR produces a positive NPV.

Why the other options are wrong

- **A.** Rejection would require a negative NPV and an IRR below the hurdle rate. Here the NPV is positive and 11.5% > 9.0%.
- **B.** The IRR rule also supports acceptance (11.5% exceeds 9.0%). Relying on the NPV alone would only be needed if the two rules conflicted, and they do not here.

Key takeaway Positive NPV and IRR above the cost of capital go together for a conventional independent project: accept on both criteria.

Reading 24: Capital Investments and Capital Allocation. Notes: credguild.com/cfa/level-1/notes/corporate-finance/npv-vs-irr/

Question 16 Answer: C

Return on invested capital (ROIC) is after-tax operating profit divided by invested capital, which equals the operating margin after tax times capital turnover. Analysts compare ROIC with the blended rate of return required by debt and equity investors. Fenmoor's ROIC of 12.0% is above the 10.0% required return, so it is adding value over time.

$$ROIC = \frac{\text{after-tax operating profit}}{\text{sales}} \times \frac{\text{sales}}{\text{invested capital}} = 8.0\% \times 1.5 = 12.0\%$$

Compare: $12.0\% > 10.0\%$, so the firm earns more than its investors require.

Why the other options are wrong

- **A.** 5.3% divides the margin by the turnover, $8.0\%/1.5$. ROIC is the product of the two ratios.
- **B.** 8.0% is the operating margin after tax alone. It measures profit per unit of sales and leaves out how hard the invested capital is worked.

Key takeaway ROIC = operating margin after tax × capital turnover. ROIC above the blended required return means the firm is adding value over time.

Reading 24: Capital Investments and Capital Allocation. Notes: credguild.com/cfa/level-1/notes/corporate-finance/npv-vs-irr/

Question 17 **Answer: C**

Anchoring each year's capital budget to the prior year's, rather than to the positive-NPV opportunities actually available, is the behavioral bias of inertia. A budget that stays the same or keeps rising while returns fall is the usual warning sign. A firm focused on shareholder value would return excess funds when good projects are scarce.

Why the other options are wrong

- **A.** This bias is stopping at the first acceptable idea without searching for better ones. It concerns which projects are proposed rather than how the size of the budget is set.
- **B.** Pet projects are individual projects backed by influential executives that get optimistic forecasts and little scrutiny. Nothing in the scenario points to a favored project.

Key takeaway A static or steadily rising capital budget combined with declining returns signals inertia (anchoring to last year's budget).

Reading 24: Capital Investments and Capital Allocation. Notes: credguild.com/cfa/level-1/notes/corporate-finance/npv-vs-irr/

Question 18 **Answer: A**

A real option is brought into the project analysis by adding its estimated value to the NPV without the option and deducting any extra cost of acquiring it. On its own the warehouse has an NPV of −$0.55 million. The expansion option is worth $0.85 million more than it costs, which more than covers that shortfall, so the project with the option has a positive NPV and is worth undertaking.

NPV without the option, in millions of dollars: $7.65 - 8.20 = -0.55$.

$$\text{NPV}_{\text{with option}} = \text{NPV}_{\text{without option}} - \text{cost of option} + \text{value of option}$$

$$\text{NPV}_{\text{with option}} = -0.55 - 0.45 + 1.30 = +0.30$$

The project with the expansion option has an NPV of about +$0.30 million.

Why the other options are wrong

- **B.** −$0.55 million is the warehouse's NPV without the option. It leaves out both the $1.30 million value of the expansion option and the $0.45 million paid for it. The NPV without real options serves only as the project's minimum value.
- **C.** −$1.00 million deducts the $0.45 million cost of the option but gives no credit for its $1.30 million value, as if the option were worth something only once exercised. A real option has value today, and that value can never fall below zero.

Key takeaway $\text{NPV}_{\text{with option}} = \text{NPV}_{\text{without option}} - \text{cost of option} + \text{value of option}$. A project with a negative stand-alone NPV becomes acceptable when the option's value, net of its cost, exceeds that shortfall.

Reading 24: Capital Investments and Capital Allocation. Notes: credguild.com/cfa/level-1/notes/corporate-finance/npv-vs-irr/

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Question 19 **Answer: A**

Market-value weights reflect current market conditions, so they are the right weights for measuring the current opportunity cost of capital. Total capital at market value is $175 + 525 = \$700$ million, so debt is 25% and equity 75%. Because interest is tax-deductible, the cost of debt enters the WACC after tax.

Market-value weights: $w_d = 175/700 = 0.25$; $w_e = 525/700 = 0.75$.

After-tax cost of debt: $5.6\% \times (1 - 0.25) = 4.2\%$.

$$WACC = w_d\, r_d(1 - t) + w_e\, r_e = 0.25(4.2\%) + 0.75(13.2\%) = 1.05\% + 9.90\% = 10.95\%$$

Why the other options are wrong

- **B.** 11.30% uses the correct market-value weights but the 5.6% pretax cost of debt: $0.25(5.6\%) + 0.75(13.2\%) = 1.40\% + 9.90\%$. It ignores the tax deductibility of interest.
- **C.** 11.56% weights debt and equity by book values, $200/1{,}100 = 18.18\%$ and $900/1{,}100 = 81.82\%$: $0.1818(4.2\%) + 0.8182(13.2\%) = 0.76\% + 10.80\%$. Book values do not reflect current market conditions; here the book value of equity is far above its market value, so book weights overstate the weight of equity, the more expensive source.

Key takeaway For the current cost of capital, weight each source by its market value (or by management's target weights) and use the after-tax cost of debt. Book values can differ sharply from market values, especially for equity.

Reading 25: Capital Structure. Notes: credguild.com/cfa/level-1/notes/corporate-finance/modigliani-miller/

Question 20 **Answer: B**

Treloar has the features of a mature company: slower growth, significant and stable cash flow and low business risk. Mature companies can support substantial debt, and lenders offer it widely, including unsecured debt, at a relatively low cost.

Why the other options are wrong

- **A.** Almost all-equity financing, sometimes with convertible debt or leasing, fits a start-up with low or negative cash flow, high business risk and little collateral.
- **C.** Conservative, secured debt fits a growth-stage company whose cash flow is rising but whose business risk is still higher than a mature company's.

Key takeaway Start-up: almost all equity; growth: some secured debt; mature: significant debt, including unsecured.

Reading 25: Capital Structure. Notes: credguild.com/cfa/level-1/notes/corporate-finance/modigliani-miller/

Question 21 **Answer: B**

MM Proposition II says the cost of equity rises linearly with the debt-to-equity ratio. With taxes, the leverage premium is scaled down by $(1 - t)$ because the debt tax shield absorbs part of the extra risk borne by shareholders.

$$r_e = r_0 + \frac{D}{E}(r_0 - r_d)(1 - t) = 10.5\% + 0.6(10.5\% - 6.0\%)(1 - 0.25)$$

$$= 10.5\% + 0.6(4.5\%)(0.75) = 10.5\% + 2.025\% = 12.525\% \approx 12.53\%$$

Why the other options are wrong

- **A.** 13.20% is the no-tax version of Proposition II; it omits the $(1 - t)$ factor.
- **C.** 11.77% uses the debt-to-total-capital ratio ($0.6/1.6 = 0.375$) instead of the debt-to-equity ratio of 0.6.

Key takeaway MM II with taxes: $r_e = r_0 + (D/E)(r_0 - r_d)(1 - t)$. The leverage term uses D/E; using D/V is a common error.

Reading 25: Capital Structure. Notes: credguild.com/cfa/level-1/notes/corporate-finance/modigliani-miller/

Question 22 **Answer: C**

Under the free cash flow hypothesis, debt disciplines managers. Committing cash to interest and principal payments reduces the free cash flow that managers could use for their own benefit, and it forces them to run the company efficiently so that those payments can be met. Greater financial leverage therefore tends to reduce the agency costs of equity.

Why the other options are wrong

- **A.** Pecking order theory ranks financing sources by how negative a signal they send under asymmetric information: internal funds first, then debt, then new external equity. It does not argue for borrowing to take cash away from managers.
- **B.** Debt signaling holds that taking on fixed payment obligations tells outside investors that management is confident about future cash flows. The director's concern is curbing managers' use of spare cash; she says nothing about what the borrowing would tell investors.

Key takeaway Free cash flow hypothesis: more debt leaves managers less free cash flow to misuse, which lowers the agency costs of equity. Pecking order: internal funds, then debt, then external equity. Signaling: new debt signals confidence, while new equity is often read as a sign of overvaluation.

Reading 25: Capital Structure. Notes: credguild.com/cfa/level-1/notes/corporate-finance/modigliani-miller/

Question 23 **Answer: A**

A business model explains how a firm provides its product, finds and serves customers, and makes a profit: who the customers are, what is offered, how and where it is delivered, and how it is priced. Detailed forecasts of revenue and expenses belong in a financial plan, not in the business model.

Why the other options are wrong

- **B.** Target customers and how they are acquired and kept are core parts of a business model.
- **C.** The assets and suppliers that matter to the firm are part of how the business model works.

Key takeaway Business model = who, what, how, where and how much; detailed financial forecasts belong to the financial plan.

Reading 26: Business Models. Notes: credguild.com/cfa/level-1/notes/corporate-finance/business-models/

Question 24 **Answer: B**

Bundling prices several complementary products together as one package, usually to make the overall offer more profitable. Here the laptop, the premium keyboard, the high-resolution display and the three-year support contract are all sold for one combined base price. This is different from add-on pricing, where the base laptop would be sold at a normal margin and the upgrades and support offered separately, after the purchase decision, at high margins.

Why the other options are wrong

- **A.** Value-based pricing sets the price according to the value customers perceive in the product. The decision described here is about how the items are sold: complementary items that were sold separately are combined into a single package price, which is bundling.
- **C.** Dynamic pricing charges different prices depending on the time of day or day of the week (peak and off-peak pricing). Nothing in the decision depends on timing.

Key takeaway Complementary extras included in one package price are bundling. Extras sold separately after the purchase decision are add-on pricing.

Reading 26: Business Models. Notes: credguild.com/cfa/level-1/notes/corporate-finance/business-models/

Question 25 **Answer: C**

Private label (contract) manufacturers make products that other companies sell under their own brand names, as store brands are. Fairfield makes the cereal and the supermarkets sell it under their brands, so Fairfield is a private label manufacturer.

Why the other options are wrong

- **A.** A value-added reseller resells complex equipment and adds installation, service, support or customization. Fairfield manufactures goods; it does not resell them with added services.
- **B.** In a licensing agreement, a company lets another company use its brand on that company's products for a fee. Here no brand is rented out: the supermarkets put their own brands on products Fairfield makes.

Key takeaway A firm that makes products for others to sell under their brands is a private label (contract) manufacturer. A firm that rents out its brand uses a licensing agreement.

Reading 26: Business Models. Notes: credguild.com/cfa/level-1/notes/corporate-finance/business-models/

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