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CFA® Program Level I

Financial Statement Analysis: 54 Free Practice Questions

2027 curriculum · 12 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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CFA® PROGRAM LEVEL I · FREE PRACTICE QUESTIONS

Financial Statement Analysis

Questions 1–54 · 12 readings

27 Introduction to Financial Statement Analysis

Question 1

An analyst converts a competitor's inventory figures to the same cost basis as her subject company, then calculates liquidity and profitability ratios and prepares common-size statements. In the financial statement analysis framework, this work is *best* described as:

A processing the data.

B analyzing and interpreting the data.

C gathering the data.

Question 2

An analyst is reading the notes that accompany a retailer's audited annual financial statements. Which of the following statements about those notes is *least* accurate? The notes:

A disclose contingencies, such as losses that could arise from pending claims.

B are covered by the independent auditor's examination.

C present management's own assessment of the year's operating performance and financial results.

Question 3

Ilse Brandt covers Corrigan Freight, a US public company. She wants management's own account of known trends and of the significant events and uncertainties that could affect Corrigan's liquidity, capital resources and results of operations. She is *most likely* to find this in:

A management's discussion and analysis (MD&A).

B the proxy statement.

C the notes to the financial statements.

Question 4

Priya Nandakumar is researching Corvell Biotech and wants information she can treat as objective. Which of the following sources should she be *least likely* to rely on for that purpose?

A Industry output statistics published by a government agency.

B A proxy statement that Corvell filed with the SEC.

C A press release issued by Corvell's investor relations team.

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28 Analyzing Income Statements

Question 5

On November 15, Halden Yacht Services receives $24,000 in cash from a customer for a winter storage and maintenance package that Halden will provide from January through March. Halden has not yet performed any of the service. At November 30, the effect of this transaction on Halden's balance sheet is *best* described as:

A cash and retained earnings each increase by $24,000.

B cash and unearned revenue each increase by $24,000.

C accounts receivable and revenue each increase by $24,000.

Question 6

Three U.S. hardware retailers are identical except for their inventory cost-flow assumption: one uses FIFO, one uses LIFO and one uses weighted average cost. Over the past several years, both the unit costs they pay suppliers and the number of units they sell have climbed steadily. An analyst who ranks the three on reported gross profit margin, without adjusting for inventory accounting, would *most likely* find the lowest margin at the retailer using:

A LIFO.

B Weighted average cost.

C FIFO.

Question 7

During the current year, Brantley Industrial recorded a $14 million restructuring charge to close two of its warehouses. Its board also approved a formal plan to sell Brantley's marine-engine business, a separate major line of business with its own plants, management and financing that can be clearly separated from the rest of the company. The business meets the criteria to be classified as held for sale, and the sale is expected to close next year at a gain. Which statement about Brantley's income statement for the current year is *most accurate*?

A The marine-engine business's results are reported net of tax after income from continuing operations, and the prior-year income statement presented is restated to show them separately.

B The restructuring charge is reported net of tax below income from continuing operations.

C The expected gain on the sale of the marine-engine business is recognized in the current year, when the disposal plan is approved.

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Question 8

Ravensworth Holdings entered 2025 with 3,000,000 common shares. Its capital transactions during the year, listed from latest to earliest, were: a sale of 240,000 new common shares on 31 October; an issue of €15 million of 6% convertible bonds on 31 May, convertible into common shares at a conversion price of €10; and a 20% stock dividend distributed on 28 February. The number of shares Ravensworth should use for its 2025 *basic* EPS is:

A 3,540,000.

B 3,640,000.

C 5,140,000.

Question 9

An analyst reviews the following margins for Halvorsen Marine:

Halvorsen Marine — selected margins from common-size income statements

Margin (% of revenue)	Year 1	Year 2	Year 3
Gross profit margin	30%	32%	34%
Operating profit margin	21%	23%	25%
Pretax margin	19%	19%	19%
Net profit margin	14%	14%	14%

Halvorsen's net profit margin has stayed flat even though its gross profit margin has widened. Based only on these data, the *most likely* explanation is an increase, relative to revenue, in:

A selling, general and administrative expenses.

B income tax expense.

C nonoperating expenses such as interest.

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29 Analyzing Balance Sheets

Question 10

Norvale Biotech, which reports under IFRS, is developing a rapid diagnostic kit. Early in the year it spent €640,000 on laboratory research, and that work showed the kit to be technically feasible. Norvale intends to finish the kit, has the resources to do so, and has signed a supply agreement with a hospital network. For the next phase it expects the following costs:

- staff training: €72,000
- materials and direct labor: €415,000
- production overhead: €185,000
- general administrative overhead: €38,000

The total amount Norvale should expense under IFRS is *closest* to:

A €640,000.

B €712,000.

C €750,000.

Question 11

Which statement *best* describes how available-for-sale securities are accounted for under US GAAP after purchase?

A They are carried at amortized cost, and changes in market value are ignored.

B They are carried at fair value, and unrealized gains and losses are recognized in other comprehensive income.

C They are carried at fair value, and unrealized gains and losses are recognized in the income statement.

Question 12

In Veloria, companies record revenue in their financial statements when a sale is made. Montclair Tiles sells mainly on 60-day credit terms. Which Velorian tax rule would *most likely* cause Montclair to report a deferred tax liability?

A Revenue is taxed when the sale is made.

B Revenue is taxed when cash is collected from the customer.

C Revenue is exempt from tax.

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Question 13

Part of the most recent common-size balance sheet of Harrowgate Mills is shown below.

Harrowgate Mills — excerpt from common-size balance sheet (most recent year)

Item	% of total assets
Preferred stock	10%
Common stock	2%
Additional paid-in capital	23%

Which interpretation of these data is *most appropriate*?

A Preferred stock accounts for 10% of shareholders' equity.

B Shareholders' equity equals 35% of total assets.

C The amount received from issuing common stock equals 25% of total assets.

Question 14

The liabilities and equity section of Galloway Instruments' balance sheet is shown below.

Galloway Instruments — liabilities and equity

Item	Amount
Accounts payable	400
Accrued expenses	150
Short-term notes payable	300
Long-term debt	1,500
Total equity	2,650
Total liabilities and equity	5,000

Treating only interest-bearing obligations as debt, as is usual for solvency ratios, Galloway's debt ratio is *closest* to:

A 36%.

B 47%.

C 68%.

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30 Analyzing Statements of Cash Flows I

Question 15

Alvern Truck Works builds delivery trucks for sale. It sells 25 new trucks for cash to Ardwell Couriers, which will use them in its delivery business for about eight years. Both companies report under US GAAP. How will the cash that changes hands be classified in each company's statement of cash flows? Answer in the form: Alvern; Ardwell.

A Operating inflow; investing outflow.

B Operating inflow; operating outflow.

C Investing inflow; investing outflow.

Question 16

An analyst is rebuilding the operating section of Castellan Paper's statement of cash flows, which is prepared using the indirect method. Which of the following items recorded by Castellan during the year requires an addition to net income in arriving at cash flow from operating activities?

A A loss on the early retirement of its bonds.

B A gain on the sale of a delivery truck.

C A decrease in its deferred tax liability.

Question 17

Dmitri Volkov is deciding whether to present the operating section of a projected statement of cash flows using the direct or the indirect format. Which of the following statements is *most accurate*?

A Under the direct method, depreciation is added to cash collected from customers because it is a noncash expense.

B Under the indirect method, depreciation is added back to net income because it is a noncash expense.

C Under the indirect method, changes in accounts receivable need no adjustment because net income already reflects them.

Question 18

On December 31, Tarn Retail, which reports under IFRS, borrowed €45,000 on a 90-day bank note and used the cash to buy merchandise inventory. On the same day it issued €200,000 of seven-year bonds and used the proceeds to buy delivery vans. No interest was paid during the year. The combined effect of these transactions on Tarn's statement of cash flows for the year is that:

A cash flow from financing activities increases by €200,000.

B cash flow from operating activities decreases by €45,000.

C cash flow from operating activities is unchanged.

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Question 19

Under US GAAP and under IFRS, how may **interest paid** be classified in the statement of cash flows?

A US GAAP: CFO or CFF; IFRS: CFO.

B US GAAP: CFO; IFRS: CFO or CFF.

C US GAAP: CFF; IFRS: CFO or CFF.

31 Free Cash Flow

Question 20

An analyst reviews three years of results for Pinecrest Media:

Pinecrest Media — net income and cash flow from operations ($ millions)

Year	Net income	Cash flow from operations	Accounts receivable (year-end)
Year 1	42	45	60
Year 2	51	38	84
Year 3	63	31	117

Which conclusion is *most appropriate* based on these data?

A Earnings quality appears high, because net income has grown steadily in every year.

B The widening gap is expected and harmless, because growing firms always report operating cash flow above net income.

C Earnings quality may be deteriorating; the firm could be recognizing revenue too early or delaying expense recognition.

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Question 21

Amara Osei is valuing Kestrel Logistics, which reports under US GAAP (interest paid is included in operating activities). She collects the following data:

Kestrel Logistics — selected data for the year

Item	Amount ($)
Net cash provided by operating activities	4,600
Fixed capital investment (net)	950
Cash interest paid	300
Income before tax	5,000
Income tax expense	1,250
Net income	3,750

Kestrel's free cash flow to the firm (FCFF) is *closest* to:

A $3,875.

B $3,425.

C $3,025.

Question 22

Vasquez Dental Supply reports under US GAAP, so interest paid and income taxes paid are both included in its cash flow from operating activities. For the latest year, CFO was $7,800, cash interest paid was $600, and cash income taxes paid were $1,500. Vasquez's (cash flow) interest coverage ratio is *closest* to:

A 16.5.

B 14.0.

C 13.0.

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32 LIFO vs FIFO

Question 23

Brenvale Creamery makes aged cheese. Its costs for the year are shown below.

Brenvale Creamery: costs incurred during the year ($)

Cost	Amount
Milk and other direct materials	410,000
Direct labor	185,000
Fixed production overhead	260,000
Storage of cheese wheels during the aging stage of production	38,000
Normal spoilage during production	6,200
Spoilage caused by a refrigeration breakdown (abnormal)	29,000
Storage of packaged cheese awaiting delivery to customers	17,500

The cost that Brenvale should include in inventory is *closest* to:

A $928,200.

B $916,700.

C $899,200.

Question 24

Three companies each report that the net realizable value of their inventory is now above its original cost. Which company is *most likely* permitted to carry that inventory on its balance sheet at an amount above historical cost?

A Ridgeback Electronics, a US GAAP retailer of smartphones.

B Coldwater Timber, an IFRS producer of forest products that trade in an active market.

C Marigold Apparel, an IFRS reporter that wrote its clothing down to net realizable value last year.

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Question 25

Tolworth Hardware Supply reports under US GAAP and uses the LIFO method. For the year just ended it reported cost of goods sold of $4,815,000. Its inventory footnote shows a LIFO reserve of $612,000 at the beginning of the year and $538,000 at the end. Purchase costs fell during the year, and inventory quantities were unchanged. An analyst restates Tolworth's results to a FIFO basis to compare it with a peer that reports under IFRS. Tolworth's cost of goods sold on a FIFO basis is *closest* to:

A $4,889,000.

B $4,741,000.

C $4,277,000.

Question 26

An analyst suspects that Cordell Hardware, a LIFO user facing rising purchase costs, drew down old inventory layers this year to lift its reported profit. The *most* reliable evidence of such a LIFO liquidation is a:

A decrease in the LIFO reserve reported in the inventory footnote.

B rise in the gross profit margin.

C fall in inventory that is out of line with the change in sales.

Question 27

An analyst reviews the following data for Merrow Cycle Parts, whose industry peers have maintained steady inventory levels:

Merrow Cycle Parts — inventory data ($ thousands)

Item	Year 1	Year 2
Cost of goods sold	7,300	7,665
Average inventory	1,000	1,680
Finished goods (year-end)	610	975
Sales growth	4%	3%

Merrow's days of inventory on hand in Year 2, and the *most likely* interpretation, are:

A About 50 days; inventory is being managed more efficiently.

B About 80 days; inventory is being managed more efficiently.

C About 80 days; inventory may be slow-moving or obsolete.

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33 Straight Line Depreciation

Question 28

Holloway Brands owns three trademarks, each with a finite useful life. One was bought from a competitor, one was recognized when Holloway acquired Pinecrest Foods, and one was created by Holloway's own marketing department. Which trademark is *least likely* to be carried on Holloway's balance sheet at cost less accumulated amortization?

A The trademark bought from a competitor.

B The trademark recognized in the acquisition of Pinecrest Foods.

C The trademark created by Holloway's own marketing department.

Question 29

Two otherwise identical companies each spend the same amount on a long-lived asset in Year 1. Brackley Tools capitalizes the outlay and depreciates it; Ostrander Tools expenses it immediately. For the years that follow Year 1, Brackley, compared with Ostrander, will *most likely* report:

A Lower net income and higher return on assets.

B Lower net income and lower return on assets.

C Higher net income and lower return on assets.

Question 30

Tamarind Beverages reports under US GAAP. It owns a beverage brand that it acquired several years ago, and management has concluded that the brand has an indefinite useful life. The annual impairment review of the brand produces the following estimates.

Tamarind Beverages: impairment review of an indefinite-lived brand

Item	$ millions
Carrying amount	64
Undiscounted expected future cash flows	90
Present value of expected future cash flows (value in use)	58
Fair value	52
Costs to sell	3

The impairment loss that Tamarind recognizes on the brand is *closest* to:

A $12 million.

B $6 million.

C $0.

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Question 31

Harrowgate Freight uses straight-line depreciation with negligible salvage values. Selected data from its PP&E note are shown below.

Harrowgate Freight — PP&E note, latest fiscal year (USD millions)

Item	Amount
Gross PP&E, end of year	840
Accumulated depreciation, end of year	336
Depreciation expense for the year	48

The estimated remaining useful life of Harrowgate's PP&E is *closest* to:

A 7.0 years.

B 10.5 years.

C 17.5 years.

34 Finance Lease vs Operating Lease

Question 32

Which of the following is the *least likely* reason for Northgate Printing to lease a new press rather than purchase it?

A To lower its financing cost.

B To reduce the cash it pays out at the start.

C To share in any increase in the press's value.

Question 33

Aerolinea Sur leases a regional jet from Skyward Capital under an arrangement classified as an operating lease. The jet itself is reported as a physical asset on the balance sheet of:

A neither the lessor nor the lessee.

B the lessee.

C the lessor.

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Question 34

Marrick Semiconductor grants employee stock options on the terms below and expects all of them to vest.

Marrick Semiconductor — employee stock option grant (1 January)

Item	Value
Options granted	60,000
Share price on grant date	$38.00
Exercise price	$40.00
Fair value per option on grant date (option-pricing model)	$7.50
Vesting period	4 years (all options vest together)

The compensation expense Marrick recognizes in the first year is *closest* to:

A $450,000.

B $112,500.

C $0.

Question 35

Which of the following items is *least likely* to be a required disclosure about Tavener Systems' share-based compensation plans?

A How the fair value of the awards at the grant date was determined.

B The effect of share-based payment transactions on the company's balance sheet.

C Tavener's share price at the reporting date.

35 Deferred Tax Liability

Question 36

When pretax income reported in the financial statements differs from taxable income because of a temporary difference, the *most likely* consequence is:

A the recognition of a deferred tax asset or deferred tax liability.

B a gain or loss recognized in other comprehensive income.

C a permanent gap between the firm's effective and statutory tax rates.

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Question 37

Which of the following is *most likely* to cause a deferred tax asset to be created?

A Accelerated tax depreciation.

B Unearned revenue.

C A decrease in the enacted tax rate.

Question 38

Lochmere Outfitters has built up large tax loss carryforwards. Its deferred tax balances at the start of the year, measured at the 24% income tax rate then enacted, are shown below.

Lochmere Outfitters: deferred tax balances at the start of the year (measured at 24%)

Deferred tax item	Balance ($ thousands)
Deferred tax asset (tax loss carryforwards and warranty provisions)	360
Deferred tax liability (accelerated tax depreciation)	150

During the year the legislature enacts an increase in the income tax rate to 28%, applying from next year onward, when all of these differences are expected to reverse. No temporary differences arise or reverse during the year. As a result of the rate change, Lochmere's income tax expense for the year will:

A increase by $25,000.

B remain unchanged.

C decrease by $35,000.

Question 39

An analyst reclassifies a company's deferred tax liability from liabilities to equity. Which of the following ratios is *least likely* to be affected by this reclassification?

A Return on assets.

B Debt-to-equity ratio.

C Return on equity.

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Question 40

An analyst reviewing Kittredge Pharma notes that its effective tax rate is 6 percentage points below its statutory rate. Almost all of the gap comes from a tax holiday granted for a new plant in Malaysia. This reconciliation item is *most likely*:

A continuous in nature, so the date on which the holiday ends does not matter.

B sporadic in nature, but its effect is normally cancelled out by higher home-country tax when the profits are repatriated.

C sporadic in nature, and the analyst should find out when the holiday ends and whether taxes will become payable at that point.

36 Financial Reporting Quality

Question 41

An analyst concludes that Fenwick Brewing's financial reports are of high quality. Fenwick's reported earnings *could* still be:

A of low quality, because they are not sustainable.

B smoothed through management's choice of estimates.

C overstated because asset impairments were recognized late.

Question 42

A review of an accounting scandal concludes that the company's managers had both the motivation and the opportunity to misreport. Which third factor typically completes the set of conditions behind low-quality financial reporting?

A Weak internal controls.

B Rationalization of the actions.

C Pressure to beat earnings expectations.

Question 43

The management of Orsini Fabrication wants to use its accounting discretion to raise operating income in the coming period. Which of the following actions is it *most likely* to take?

A Raise the estimated residual values of its plant and equipment.

B Shorten the estimated useful lives of its plant and equipment.

C Revalue its plant and equipment upward from depreciated cost to fair value.

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Question 44

The management of Pellworth Chemicals is worried that the company will breach a bank-loan covenant that sets a minimum interest coverage ratio. If management manipulates its financial reporting to avoid the breach, it is *most likely* to:

A overstate earnings.

B understate assets.

C capitalize leases.

Question 45

Which of the following observations about Sandhurst Industrial, a diversified manufacturer, is *most likely* to signal that management is manipulating how its results are perceived?

A Sandhurst adopted a new lease accounting standard in the year it became mandatory for all companies.

B Sandhurst's ratio of operating cash flow to net income has stayed between 1.1 and 1.3 for five years.

C Sandhurst has reported large restructuring charges labeled nonrecurring in five of the last six years.

37 Dupont Analysis

Question 46

Leon Varga places this year's gross profit margin, inventory turnover, and debt-to-equity ratio for Pallister Grocers next to the same ratios, for the same year, of four rival supermarket chains. Varga's approach is best described as:

A cross-sectional analysis.

B time-series analysis.

C common-size analysis.

Question 47

An analyst notes that the inventory turnover of Fenmore Outdoor dropped sharply this year, although its sales and cost of goods sold were roughly unchanged. Which explanation is *most* consistent with the decline?

A At the start of the year, Fenmore wrote a large amount of obsolete stock down to net realizable value.

B A fault in a new ordering system placed duplicate orders with suppliers and built up surplus stock.

C Fenmore switched to a just-in-time system in which suppliers deliver goods only as they are needed.

Question 48

An analyst wants to assess how well a manufacturer converts its sales into operating profits. Which of the following ratios is *least likely* to be one of the operating profitability ratios she would use?

A Gross profit / net sales.

B Net sales / total assets.

C Net income / net sales.

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Question 49

A company has positive net income and positive shareholders' equity. Holding its net profit margin and its equity multiplier constant, if the company improves its total asset turnover, its return on equity will:

A decrease.

B increase.

C increase, decrease, or stay the same.

Question 50

Carraway Outfitters reported sales of $200 million for 20X5 and expects sales to grow by 9.5% in 20X6. Cost of goods sold is expected to stay at 50% of sales, and management targets an average of 50 days of inventory on hand in 20X6. Using a 365-day year, Carraway's forecast average inventory for 20X6 is *closest* to:

A $13.70 million.

B $15.00 million.

C $30.00 million.

38 Pro Forma Financial Statements

Question 51

An analyst building sales-based pro forma financial statements will *most likely* carry out which of these tasks first?

A Building the pro forma cash flow statement.

B Estimating SG&A expenses.

C Forecasting capital expenditures and net PP&E.

Question 52

Since finishing her earnings forecast for Brenton Mining, Clara Voss has seen the company announce a new product line and a reorganization of its divisions. She had anticipated some of these developments in her forecast but not others. Nonetheless, she is unwilling to revise her forecast. Voss is *most likely* displaying:

A confirmation bias.

B conservatism bias.

C representativeness bias.

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Question 53

Sorrel Audio sells 2,000 speakers a year at $80 each; unit COGS is $50 and SG&A is a fixed $30,000. Next year the input cost per speaker will rise by $4. Sorrel plans to raise its selling price by exactly $4 and expects unit sales to be unaffected. Sorrel's gross margin next year is *closest* to:

A 35.7%.

B 37.5%.

C 40.5%.

Question 54

When choosing an explicit forecast horizon for a company whose earnings swing sharply with the economy, an analyst should *most appropriately* extend the forecast:

A over one year only.

B far enough to include the middle of the business cycle.

C far enough to include two complete business cycles.

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FINANCIAL STATEMENT ANALYSIS

Answers and explanations

Answer key: 1. A · 2. C · 3. A · 4. C · 5. B · 6. A · 7. A · 8. B · 9. C · 10. C · 11. B · 12. B · 13. C · 14. A · 15. A · 16. A · 17. B · 18. B · 19. B · 20. C · 21. A · 22. A · 23. C · 24. B · 25. A · 26. A · 27. C · 28. C · 29. B · 30. A · 31. B · 32. C · 33. C · 34. B · 35. C · 36. A · 37. B · 38. C · 39. A · 40. C · 41. A · 42. B · 43. A · 44. A · 45. C · 46. A · 47. B · 48. B · 49. B · 50. B · 51. B · 52. B · 53. A · 54. B

Question 1 **Answer: A**

Adjusting the reported statements where appropriate, calculating ratios, and preparing exhibits such as graphs and common-size statements are the activities of step 3, process the data. No conclusion has yet been drawn from the ratios, so the analyst has not reached the analysis-and-interpretation step.

The six steps:

1. State the objective and context: questions to answer, output format, time and resources.
2. Gather data: statements, industry and economic data, discussions with management, suppliers and customers, site visits.
3. Process the data: adjustments, ratios, statistical work, exhibits such as graphs and common-size statements.
4. Analyze and interpret the data: answer the step-1 questions and decide what the evidence supports.
5. Report the conclusions or recommendations: communicate to the audience in line with the Code and Standards.
6. Update the analysis: repeat periodically and revise conclusions as needed.

The analyst's work (adjustment, ratios, common-size statements) fits step 3.

Why the other options are wrong

- **B.** Analyzing and interpreting (step 4) means using the processed figures to answer the questions posed in step 1 and deciding what conclusions or recommendations they support. The analyst is still preparing the figures.
- **C.** Gathering data (step 2) is acquiring the statements and other industry and economic information and asking questions of management, suppliers and customers. It comes before any adjustment or ratio work.

Key takeaway Adjusting, calculating and building exhibits is processing the data. Using the results to answer the questions is analyzing and interpreting the data.

Reading 27: Introduction to Financial Statement Analysis. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/introduction-to-financial-statement-analysis/

Question 2 **Answer: C**

Management's own evaluation of results appears in management's commentary, also called management's discussion and analysis (MD&A), which is a separate section of the annual report. The notes (footnotes) explain the accounting methods, assumptions and estimates used and give detail on items such as contingencies, acquisitions and disposals.

Check each statement against what footnotes contain:

1. Contingent losses are disclosed in the notes (accurate).

2. The notes are audited with the statements (accurate).
3. Management's assessment of performance belongs in management's commentary, so this statement is the least accurate.

Why the other options are wrong

- **A.** This is accurate. Contingencies and commitments, such as possible losses from litigation, are standard footnote disclosures.
- **B.** This is accurate. Footnotes are an integral part of the financial statements and are audited along with the primary statements.

Key takeaway Footnotes cover accounting methods, estimates and supporting detail, and they are audited. Management's narrative on results and outlook appears in management commentary (MD&A), which may be unaudited.

Reading 27: Introduction to Financial Statement Analysis. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/introduction-to-financial-statement-analysis/

Question 3 **Answer: A**

For US public companies, the SEC requires management's discussion and analysis to discuss trends and to identify significant events and uncertainties that affect liquidity, capital resources and results of operations. It is management's own commentary on the business, which is what Brandt is looking for. Parts of it may be unaudited.

Why the other options are wrong

- **B.** The proxy statement is sent to shareholders when a vote is needed. It covers board elections and qualifications, compensation, management qualifications and stock option issuance, not the discussion of trends and uncertainties.
- **C.** The footnotes give the detail behind the statements: the basis of presentation, accounting methods, assumptions and estimates, contingencies, acquisitions and similar items. They do not carry management's narrative on trends and uncertainties.

Key takeaway Management's view of trends, significant events and uncertainties is in MD&A; accounting methods and estimates are in the notes; votes, board elections and compensation are in the proxy statement.

Reading 27: Introduction to Financial Statement Analysis. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/introduction-to-financial-statement-analysis/

Question 4 **Answer: C**

Press releases are written by the company and are unlikely to have been audited, so they are the least objective of the three. Government statistics are public third-party data, and a proxy statement is a regulated filing with the SEC. For objective context, an analyst compares the firm with its competitors and studies economy-wide and sector conditions, using government agencies, trade journals and statistical reporting services.

Why the other options are wrong

- **A.** Government agency statistics on the economy and industry are public third-party sources. Along with trade journals and statistical reporting services, analysts are expected to use them when comparing a company with its industry and competitors.

- **B.** Proxy statements are filed with the SEC and are a good source on board elections and qualifications, executive compensation, management qualifications and stock option issuance.

Key takeaway Issuer-provided material (press releases, earnings calls, presentations) is unlikely to have been audited, so cross-check it against filings and independent data. SEC filings such as proxy statements are regulated disclosures.

Reading 27: Introduction to Financial Statement Analysis. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/introduction-to-financial-statement-analysis/

Question 5 **Answer: B**

Revenue is recognized when it is earned, that is, as the promised service is provided. Cash received before any service is delivered creates a liability, unearned (deferred) revenue, because Halden still owes the customer the service. The asset cash rises by $24,000 and the liability rises by the same amount; no revenue, and therefore no retained earnings, is recognized yet.

Why the other options are wrong

- **A.** This treats the prepayment as revenue that raises net income and retained earnings. No service has been performed, so no revenue has been earned by November 30.
- **C.** The customer has already paid, so there is no receivable, and revenue is not recognized before the service is provided.

Key takeaway Cash received in advance is a liability, unearned revenue. It becomes revenue only as the goods or services are delivered.

Reading 28: Analyzing Income Statements. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-income-statements/

Question 6 **Answer: A**

With rising purchase prices, LIFO charges the most recent, and therefore highest, costs to cost of goods sold. Revenue is the same whatever cost-flow method is used, so the higher COGS under LIFO produces the lowest gross profit (and net profit) margins.

Why the other options are wrong

- **B.** Weighted average cost blends older, cheaper units with newer, dearer ones, so its COGS and margins fall between those under FIFO and LIFO.
- **C.** FIFO charges the oldest, cheapest costs to COGS when prices are rising, so FIFO firms report the lowest COGS and the highest margins.

Key takeaway With rising prices, FIFO gives the lowest COGS and the highest margins, LIFO the highest COGS and the lowest margins, and average cost falls in between. Sales are unaffected by the choice.

Reading 28: Analyzing Income Statements. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-income-statements/

Question 7 **Answer: A**

The marine-engine business is a separate major line of business, physically and operationally distinct, and it is held for sale under a formal disposal plan. It therefore qualifies as a discontinued operation. Its income or loss is reported separately, net of tax, after income from continuing operations, and the prior-period income statements presented are restated so that the discontinued business is shown separately in every year.

Placement of the two items:

Item	Where it is reported	Tax presentation
Restructuring charge (an unusual or infrequent item)	Within income from continuing operations	Pre-tax
Marine-engine business (discontinued operation)	After income from continuing operations	Net of tax

The measurement date is the date the formal plan was approved; the period until the sale closes is the phaseout period. Had a loss on the sale been expected, the held-for-sale assets would be written down at once to fair value less costs to sell. Operating results of the phaseout period are recognized as they occur, and future operating losses are not accrued in advance. An expected gain is not recognized until the sale is completed.

Why the other options are wrong

- **B.** A restructuring charge is an unusual or infrequent item, so it is reported before tax, within income from continuing operations. Only discontinued operations are shown net of tax below that line.
- **C.** An expected gain on disposal cannot be recognized until the sale is actually completed. Only an expected loss on disposal is recognized early, as a write-down of the held-for-sale assets to fair value less costs to sell. Operating losses of the phaseout period are not accrued in advance either; they are recognized as incurred.

Key takeaway Unusual or infrequent items: pre-tax, inside continuing operations. Discontinued operations: net of tax, below continuing operations, with prior periods restated. Analysts usually exclude discontinued operations when forecasting earnings.

Reading 28: Analyzing Income Statements. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-income-statements/

Question 8 **Answer: B**

Basic EPS ignores potential shares from convertible securities, so the convertible bonds are not counted. The stock dividend is applied retroactively to the opening shares, and the new shares sold on 31 October are weighted for the remaining two months.

Opening shares restated: $3{,}000{,}000 \times 1.20 = 3{,}600{,}000$ (all year).

New shares: $240{,}000 \times \frac{2}{12} = 40{,}000$.

$$\text{WASO} = 3{,}600{,}000 + 40{,}000 = 3{,}640{,}000$$

(Monthly form: $[3{,}000{,}000(12) + 600{,}000(12) + 240{,}000(2)]/12 = 43{,}680{,}000/12 = 3{,}640{,}000$.) The €15 million of convertible bonds would convert into 1,500,000 shares, which matters only for diluted EPS.

Why the other options are wrong

- **A.** 3,540,000 treats the 600,000 dividend shares as outstanding only from 28 February (3,000,000 × 2/12 + 3,600,000 × 10/12 + 40,000). A stock dividend is applied retroactively to the start of the year.
- **C.** 5,140,000 adds the 1,500,000 shares issuable on conversion of the convertible bonds (€15,000,000/€10). Potential shares from convertibles are excluded from basic EPS.

Key takeaway Basic EPS denominator excludes convertibles; stock dividends are retroactive; new issues are time-weighted.

Reading 28: Analyzing Income Statements. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-income-statements/

Question 9 **Answer: C**

The gap between operating margin and pretax margin measures net nonoperating expense, chiefly interest, as a share of revenue. That gap widens from 2% to 6% of revenue and absorbs the whole 4-point gain in operating margin, so pretax and net margins stay flat.

Each cost layer as % of revenue:

Layer	Formula	Yr 1	Yr 2	Yr 3
COGS	100% − gross margin	70%	68%	66%
Operating expenses	gross − operating margin	9%	9%	9%
Nonoperating expense	operating − pretax margin	2%	4%	6%
Income tax	pretax − net margin	5%	5%	5%

Effective tax rate $= 5/19 \approx 26.3\%$ in every year.

Only the nonoperating layer grows (+4 points), offsetting the +4-point improvement in gross (and operating) margin.

Why the other options are wrong

- **A.** Operating expenses below gross profit (the gross-minus-operating-margin gap) are a constant 9% of revenue in all three years, so the operating margin rises one-for-one with the gross margin.
- **B.** The pretax-minus-net-margin gap is a constant 5% of revenue, and the effective tax rate is unchanged at about 26.3% of pretax income. Taxes do not explain the flat net margin.

Key takeaway Subtract adjacent margins to isolate each cost layer. Gross minus operating margin gives operating expenses; operating minus pretax margin gives nonoperating items; pretax minus net margin gives taxes.

Reading 28: Analyzing Income Statements. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-income-statements/

Question 10 **Answer: C**

Under IFRS, costs of the research phase are expensed, while development-phase costs are capitalized once the project is technically feasible, a market exists, and the firm has the intention and resources to complete and sell the product. All of these conditions are met here. Training costs and administrative overhead are expensed whenever they are incurred, even during development; materials, direct labor and production overhead of the development phase are capitalized.

Classify each cost:

Cost	Phase	Treatment
Laboratory research €640,000	Research	Expense
Staff training €72,000	Any	Expense
Administrative overhead €38,000	Any	Expense
Materials and direct labor €415,000	Development	Capitalize
Production overhead €185,000	Development	Capitalize

$$\text{Expensed} = 640{,}000 + 72{,}000 + 38{,}000 = €750{,}000$$

Capitalized development cost $= 415{,}000 + 185{,}000 = €600{,}000$. (Under US GAAP all €1,350,000 would be expensed.)

Why the other options are wrong

- **A.** €640,000 expenses only the research-phase costs and wrongly capitalizes the training and administrative overhead, which must be expensed as incurred.
- **B.** €712,000 correctly expenses research and training but forgets that general administrative overhead is also expensed as incurred.

Key takeaway Research costs are expensed. Once the development criteria are met, materials, direct labor and production overhead are capitalized. Training, administrative overhead, advertising, start-up, relocation and termination costs are always expensed.

Reading 29: Analyzing Balance Sheets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-balance-sheets/

Question 11 **Answer: B**

Available-for-sale securities are reported at fair value on the balance sheet, but their unrealized gains and losses bypass the income statement and are reported in other comprehensive income, within shareholders' equity. Interest, dividends and realized gains and losses still go to the income statement.

Why the other options are wrong

- **A.** Amortized cost with market value changes ignored describes held-to-maturity securities.
- **C.** Fair value with unrealized gains and losses in the income statement describes trading securities.

Key takeaway AFS: fair value on the balance sheet, unrealized gains/losses in OCI (the IFRS counterpart is FVOCI).

Reading 29: Analyzing Balance Sheets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-balance-sheets/

Question 12 **Answer: B**

If revenue is taxed only on collection, credit sales appear in the income statement before they are taxable. Income tax expense in the financial statements then exceeds taxes currently payable, and the tax due when the cash arrives is recorded as a deferred tax liability. This is a temporary timing difference that reverses on collection.

Why the other options are wrong

- **A.** Taxing revenue at the point of sale matches the accounting treatment, so no timing difference and no deferred tax arises.
- **C.** Revenue that is never taxable creates a permanent difference. Deferred taxes arise only from temporary timing differences.

Key takeaway DTL: revenue in the books before it is taxed (or expense deducted for tax before it is booked). Permanent differences never create deferred taxes.

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Reading 29: Analyzing Balance Sheets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-balance-sheets/

Question 13 **Answer: C**

A common-size balance sheet states each item as a percentage of total assets. Capital raised by issuing common shares is recorded partly as common stock (at par value) and partly as additional paid-in capital (the excess over par), so together they show that common share proceeds are $2\% + 23\% = 25\%$ of total assets.

Common-share proceeds $= \text{common stock} + \text{additional paid-in capital} = 2\% + 23\% = 25\%$ of total assets.

Why the other options are wrong

- **A.** The 10% is a percentage of total assets. As a share of shareholders' equity, preferred stock would be larger than 10%.
- **B.** Adding the three items (35%) leaves out other parts of equity, such as retained earnings and accumulated OCI, so total equity is very likely larger than 35% of assets.

Key takeaway Common stock (par) + additional paid-in capital = contributed capital from common shares. Every common-size balance sheet percentage is relative to total assets.

Reading 29: Analyzing Balance Sheets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-balance-sheets/

Question 14 **Answer: A**

The debt ratio divides total debt by total assets. For solvency ratios, debt means interest-bearing obligations (here the short-term notes payable and the long-term debt), so accounts payable and accrued expenses are excluded. Total assets equal total liabilities and equity of 5,000.

Total debt (interest-bearing) $= 300 + 1{,}500 = 1{,}800$

$$\text{debt ratio} = \frac{\text{total debt}}{\text{total assets}} = \frac{1{,}800}{5{,}000} = 36\%$$

Why the other options are wrong

- **B.** 47% treats every liability as debt, including non-interest-bearing accounts payable and accrued expenses: $2{,}350/5{,}000$. Some data services define the debt ratio as total liabilities to total assets, but the question measures debt as interest-bearing obligations only, so payables and accruals are left out.
- **C.** 68% is the total debt-to-equity ratio $(1{,}800/2{,}650)$, which uses equity rather than total assets as the denominator.

Key takeaway Solvency ratios use interest-bearing debt; the financial leverage ratio (assets/equity) is the one that captures all liabilities.

Reading 29: Analyzing Balance Sheets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-balance-sheets/

Question 15 **Answer: A**

Cash flows are classified by what the transaction means for the company that reports it. Selling trucks is Alvern's ordinary business: the trucks are its inventory, the sale produces revenue and cost of goods sold, and the cash is collected from a customer, so it is an operating inflow. For Ardwell the trucks are long-term assets

bought for use over several years, so the payment is an investing outflow. One transaction can therefore fall in different sections of the two companies' statements.

- Alvern: trucks held for sale are inventory. Cash received from customers is part of cash flow from operations (CFO).
- Ardwell: trucks bought for use are property, plant, and equipment, a noncurrent asset. Purchases of long-term assets belong in cash flow from investing activities (CFI). Ardwell will later depreciate the trucks, which reduces net income but is a noncash expense.

Why the other options are wrong

- **B.** This treats Ardwell's purchase as an operating payment. Buying a long-term asset for use over several years is an investing activity; only Alvern, for which the trucks are inventory, reports an operating cash flow.
- **C.** This treats Alvern's sale as the disposal of a long-term asset. Trucks that Alvern builds in order to sell them are inventory, not PP&E, so the proceeds are cash collected from customers, an operating inflow.

Key takeaway Classify a cash flow by its role for the reporting company. The sale of inventory is operating for the seller, while the same asset bought for long-term use is an investing outflow for the buyer.

Reading 30: Analyzing Statements of Cash Flows I. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-statements-of-cash-flows-i/

Question 16 **Answer: A**

The indirect method starts with net income and removes items that affected income without a matching operating cash flow. A loss on retiring debt early reduced net income, but the cash paid to retire the bonds is a financing outflow, so the loss is added back. Otherwise operating cash flow would be reduced by an amount that belongs in financing activities.

Why the other options are wrong

- **B.** A gain on the sale of a truck raised net income, but the full sale proceeds are an investing inflow. The gain is subtracted so that it is not counted in operating cash flow as well.
- **C.** A decrease in a deferred tax liability means income tax expense was lower than the tax payable for the period, so net income overstates the cash left after taxes. The decrease is subtracted from net income.

Key takeaway Indirect method: add back losses and subtract gains that arise from investing or financing transactions, such as asset sales and debt retirement. Add increases and subtract decreases in deferred tax liabilities.

Reading 30: Analyzing Statements of Cash Flows I. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-statements-of-cash-flows-i/

Question 17 **Answer: B**

The indirect method begins with net income, and net income has been reduced by both cash and noncash expenses. Depreciation reduced net income without any cash leaving the firm, so it is added back when reconciling net income to CFO.

Why the other options are wrong

- **A.** The direct method ignores depreciation entirely. It lists cash receipts and payments, and depreciation is neither.

- **C.** Net income includes sales rather than cash collections. The change in receivables is exactly the gap between the two, so it must be adjusted for.

Key takeaway Depreciation matters only under the indirect method, where it is added back to net income. It never appears as a cash item under the direct method.

Reading 30: Analyzing Statements of Cash Flows I. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-statements-of-cash-flows-i/

Question 18 **Answer: B**

Classification follows the nature of each cash flow, not the maturity of the borrowing. Buying inventory is part of day-to-day operations, so the €45,000 paid is an operating outflow. Borrowing, whether on a short-term note or long-term bonds, is a financing inflow, and buying vans is an investing outflow.

CFO: inventory purchase −€45,000.

CFI: vans −€200,000.

CFF: note +€45,000 and bonds +€200,000, a total of +€245,000.

The net change in cash is zero.

Why the other options are wrong

- **A.** Financing cash flow rises by €245,000, because the 90-day note is also borrowing and belongs in financing activities together with the bonds.
- **C.** The cash used to buy inventory is an operating outflow, so operating cash flow falls by €45,000 even though the purchase was funded by a bank note.

Key takeaway Borrowing of any maturity is financing; paying for inventory is operating; buying long-term assets is investing. Match each leg of a transaction to its own section.

Reading 30: Analyzing Statements of Cash Flows I. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-statements-of-cash-flows-i/

Question 19 **Answer: B**

US GAAP requires interest paid to be reported as an operating cash flow. IFRS allows interest paid to be classified as either an operating or a financing cash flow. These are the IAS 7 choices the exam applies; IFRS 18, effective for annual periods beginning on or after 1 January 2027, removes the choice for companies whose main business is not investing or financing and puts their interest paid in financing.

Why the other options are wrong

- **A.** This reverses the two frameworks. US GAAP has no choice for interest paid; IFRS has the choice.
- **C.** The IFRS part is right, but US GAAP classifies interest paid as an operating outflow.

Key takeaway Interest paid is CFO under US GAAP and CFO or CFF under IFRS. Interest received is CFO under US GAAP and CFO or CFI under IFRS.

Reading 30: Analyzing Statements of Cash Flows I. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/analyzing-statements-of-cash-flows-i/

credguild.com

Question 20 **Answer: C**

A stable relationship between net income and operating cash flow indicates good earnings quality. Here net income rises from 42 to 63 while CFO falls from 45 to 31, and receivables nearly double; earnings that increasingly exceed operating cash flow can signal aggressive or even improper accounting, such as recognizing revenue too early or delaying the recognition of expenses. The build-up in receivables points to revenue being booked well ahead of cash collection.

Net income minus CFO: Year 1 $= 42 - 45 = -3$; Year 2 $= 51 - 38 = 13$; Year 3 $= 63 - 31 = 32$.

Receivables grow from 60 to 117 (+95%) while net income grows 50%, so revenue is being booked faster than it is collected.

Why the other options are wrong

- **A.** Steady growth in reported income says little about quality when operating cash flow is moving the opposite way; the diverging trend is the warning sign.
- **B.** Growing firms often have operating cash flow below net income because working capital expands, so the direction of the statement is wrong. A persistent, widening gap also calls for investigation.

Key takeaway Compare net income with CFO over several years: a persistent, widening excess of earnings over CFO is a red flag for earnings quality.

Reading 31: Analyzing Statements of Cash Flows II. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/free-cash-flow/

Question 21 **Answer: A**

FCFF starting from CFO adds back after-tax interest (because interest is a payment to debtholders, who are capital providers) and deducts fixed capital investment. The tax rate is inferred from the income statement.

Tax rate $t = 1{,}250/5{,}000 = 25\%$

$$FCFF = CFO + Int(1 - t) - FC_{INV}$$

$$FCFF = 4{,}600 + 300(1 - 0.25) - 950 = 4{,}600 + 225 - 950 = 3{,}875$$

Why the other options are wrong

- **B.** \$3,425 subtracts the after-tax interest ($4{,}600 - 225 - 950$) instead of adding it back. Interest paid is available to debtholders and belongs in FCFF.
- **C.** \$3,025 starts from net income ($3{,}750 + 225 - 950$) and omits noncash charges and working capital investment; with net income as the base those adjustments are required, which is why the CFO-based formula is used when CFO is given.

Key takeaway $\text{FCFF} = \text{CFO} + \text{Int}(1 - t) - \text{FCInv}$. If t is not given, compute it as $\text{tax expense}/\text{pretax income}$.

Reading 31: Analyzing Statements of Cash Flows II. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/free-cash-flow/

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Question 22 **Answer: A**

The cash flow interest coverage ratio measures the firm's ability to meet its interest obligations. Because CFO has already been reduced by interest and taxes paid, both are added back to obtain the cash available before those payments, which is then divided by interest paid.

$$\text{Interest coverage} = \frac{CFO + \text{interest paid} + \text{taxes paid}}{\text{interest paid}} = \frac{7{,}800 + 600 + 1{,}500}{600} = \frac{9{,}900}{600} = 16.5$$

Why the other options are wrong

- **B.** 14.0 adds back interest paid but not taxes paid: $(7{,}800 + 600)/600$. Taxes paid must also be added back.
- **C.** 13.0 simply divides CFO by interest paid ($7{,}800/600$) without adding back the interest and taxes already deducted in CFO.

Key takeaway Interest coverage (cash basis) adds back both interest and taxes paid. If an IFRS firm reports interest paid in financing activities, no interest add-back is needed.

Reading 31: Analyzing Statements of Cash Flows II. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/free-cash-flow/

Question 23 **Answer: C**

Inventory cost includes the costs of purchase and conversion needed to bring the goods to their present location and condition: materials, direct labor, production overhead, normal spoilage and storage that is a necessary part of production, such as aging. Abnormal waste and storage of finished goods waiting for delivery are expensed as incurred.

$$410{,}000 + 185{,}000 + 260{,}000 + 38{,}000 + 6{,}200 = \$899{,}200$$

Expensed: abnormal spoilage $29,000 and storage of packaged cheese $17,500.

Why the other options are wrong

- **A.** $928,200 also capitalizes the $29,000 of abnormal spoilage from the refrigeration breakdown, $899{,}200 + 29{,}000$. Abnormal waste is expensed when it occurs.
- **B.** $916,700 also capitalizes the $17,500 of storage after production, $899{,}200 + 17{,}500$. Storage is part of inventory cost only when it is required in the production process.

Key takeaway Put purchase and conversion costs, normal waste and production-related storage into inventory; expense abnormal waste, post-production storage, administrative overhead and selling costs.

Reading 32: Analysis of Inventories. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/lifo-vs-fifo/

Question 24 **Answer: B**

Producers and dealers of commodities, such as agricultural and forest products, mineral ores and precious metals, may report inventory at net realizable value even when it exceeds historical cost. The exception applies under both IFRS and US GAAP. Gains and losses from changing market prices are recognized in the income statement, and the quoted price is used when an active market exists.

Why the other options are wrong

- **A.** Under US GAAP, inventory is carried at the lower of cost and net realizable value (lower of cost or market for LIFO and the retail method), so a rise in value above cost is not recognized. The commodity exception does not extend to an electronics retailer.
- **C.** Under IFRS, a write-down is reversed when net realizable value recovers, but the reversal is limited to the amount of the original write-down. The carrying amount can return to cost but cannot exceed it.

Key takeaway Inventory above historical cost is allowed for commodity producers and dealers (agricultural and forest products, minerals, precious metals) under both IFRS and US GAAP, with value changes in the income statement. A write-down reversal restores cost at most.

Reading 32: Analysis of Inventories. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/lifo-vs-fifo/

Question 25 **Answer: A**

FIFO cost of goods sold equals LIFO cost of goods sold minus the change in the LIFO reserve over the year. The reserve fell by $74,000, so the change is negative and FIFO COGS is higher than LIFO COGS. That fits falling purchase costs: FIFO charges the older, higher costs to COGS, while LIFO charges the newest, lower costs. Inventory quantities did not change, so no old LIFO layers were drawn down: the fall in the reserve reflects lower purchase costs, not a LIFO liquidation. The restatement formula would be the same in either case.

Change in the LIFO reserve $= 538{,}000 - 612{,}000 = -74{,}000$.

$$\text{FIFO COGS} = \text{LIFO COGS} - (\text{ending LIFO reserve} - \text{beginning LIFO reserve})$$

$$\text{FIFO COGS} = 4{,}815{,}000 - (-74{,}000) = 4{,}889{,}000$$

Check with the inventory equation, COGS = beginning inventory + purchases − ending inventory. Purchases are the same under both methods. FIFO inventory exceeds LIFO inventory by $612,000 at the start of the year and by $538,000 at the end, so FIFO COGS exceeds LIFO COGS by $612{,}000 - 538{,}000 = 74{,}000$.

Why the other options are wrong

- **B.** $4,741,000 subtracts $74,000 from LIFO COGS, as if the reserve had risen. The reserve fell, so the change is negative and subtracting it raises COGS.
- **C.** $4,277,000 subtracts the whole ending LIFO reserve of $538,000. The ending reserve is the cumulative difference between FIFO and LIFO inventory and is the balance sheet adjustment. Only the change in the reserve during the year passes through COGS.

Key takeaway $\text{FIFO COGS} = \text{LIFO COGS} - \Delta\text{LIFO reserve}$ and $\text{FIFO inventory} = \text{LIFO inventory} + \text{LIFO reserve}$. A falling reserve makes FIFO COGS higher than LIFO COGS.

Reading 32: Analysis of Inventories. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/lifo-vs-fifo/

Question 26 **Answer: A**

In a LIFO liquidation, units from older, cheaper layers pass into cost of goods sold. The gap between FIFO and LIFO inventory, the LIFO reserve, then shrinks. A decrease in the reserve disclosed in the footnotes is therefore the direct signal, and the analyst should adjust margins if its effect is material.

Why the other options are wrong

- **B.** A liquidation does raise the gross margin, but margins also rise for many other reasons, such as higher selling prices or lower input costs, so a higher margin alone does not identify a liquidation.

- **C.** Inventory can fall relative to sales for other reasons, such as better inventory management, and under FIFO or weighted average cost no LIFO layers exist to liquidate. The footnote reserve is the specific test.

Key takeaway Look for a fall in the LIFO reserve in the footnotes to spot a LIFO liquidation; the profit boost it gives is not sustainable.

Reading 32: Analysis of Inventories. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/lifo-vs-fifo/

Question 27 **Answer: C**

Days of inventory on hand equals 365 divided by inventory turnover (COGS / average inventory). DOH has risen from 50 to 80 days while sales growth has slowed and finished goods have grown far faster than sales. These are signs of slow-moving or obsolete inventory that could require write-downs and depress future earnings.

Year 1: turnover $= 7{,}300/1{,}000 = 7.30$; DOH $= 365/7.30 = 50$ days.

Year 2: turnover $= 7{,}665/1{,}680 = 4.5625$; DOH $= 365/4.5625 = 80$ days.

Finished goods grow $975/610 - 1 \approx 59.8\%$ versus sales growth of 3%.

Why the other options are wrong

- **A.** About 50 days is the Year 1 figure; in Year 2 turnover fell to about 4.56, so DOH rose to about 80 days. A rise in DOH is not a sign of greater efficiency.
- **B.** The DOH figure is right, but a higher DOH (lower turnover) means inventory is sitting longer. Together with finished goods outpacing sales, this points to weaker inventory management.

Key takeaway Low turnover or rising DOH, together with finished goods outpacing sales, points to obsolescence and future write-downs.

Reading 32: Analysis of Inventories. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/lifo-vs-fifo/

Question 28 **Answer: C**

The costs of creating an intangible asset such as a trademark internally are generally expensed as incurred, so no asset is recognized and there is nothing to amortize. A trademark bought from another party is recorded at cost, and one obtained in a business combination is recorded at its fair value under the acquisition method; both are then amortized because they have finite lives.

Why the other options are wrong

- **A.** A purchased intangible asset is recognized at cost (its fair value when bought). Because this trademark has a finite life, that cost is amortized, so it does appear at cost less accumulated amortization.
- **B.** Under the acquisition method, identifiable intangibles of the target are recognized at fair value on the acquisition date, even if the target built them itself. A finite-lived trademark recognized this way is then amortized.

Key takeaway Intangibles that are purchased or acquired in a business combination are on the balance sheet; those created internally are expensed, apart from the R&D and software exceptions.

Reading 33: Analysis of Long-Term Assets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/straight-line-depreciation/

Question 29 **Answer: B**

After the year of the outlay, the capitalizing firm still deducts depreciation, while the expensing firm has already charged the full amount, so the capitalizer's net income is lower. Its total assets are also higher because the capitalized cost is still on the balance sheet. A lower numerator over a higher denominator gives a lower return on assets (net income / total assets).

Why the other options are wrong

- **A.** Net income is lower, but ROA cannot be higher: the capitalizer has both a smaller numerator and a larger asset base.
- **C.** Net income is higher only in the year the cost is incurred (when capitalizing avoids the full expense). In later years depreciation makes it lower.

Key takeaway Compared with expensing, capitalizing gives higher net income and higher CFO in the first year, because the outlay is an investing flow. In later years it gives lower net income and lower ROA and ROE, while CFO is unchanged for a single outlay because amortization and depreciation are noncash.

Reading 33: Analysis of Long-Term Assets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/straight-line-depreciation/

Question 30 **Answer: A**

An intangible asset with an indefinite useful life is not amortized. It is tested for impairment at least annually, and an impairment loss is recognized when its carrying amount exceeds its fair value. Under US GAAP there is no recoverability screen based on undiscounted cash flows for such an asset, so the $64 million carrying amount is compared directly with the $52 million fair value. The loss of $12 million is measured against fair value itself, with no deduction for costs to sell.

$$\text{Impairment loss} = \text{carrying amount} - \text{fair value} = 64 - 52 = \$12 \text{ million}$$

The brand is written down to $52 million and the $12 million loss is reported in the income statement.

For comparison, the two tests that do not apply here:

Test	Calculation	Result
US GAAP recoverability test for PP&E held for use	undiscounted cash flows 90 > carrying amount 64	no impairment
IFRS recoverable amount	$\max(52 - 3,\ 58) = 58$; loss $= 64 - 58$	loss of 6

Why the other options are wrong

- **B.** $6 million uses the IFRS recoverable amount, the higher of fair value less costs to sell ($49 million) and value in use ($58 million). Tamarind reports under US GAAP, which measures the loss against fair value.
- **C.** $0 applies the US GAAP recoverability test used for PP&E and finite-lived assets held for use: undiscounted cash flows of $90 million exceed the carrying amount, so that test would stop there. An indefinite-lived intangible asset is compared directly with its fair value, so the undiscounted cash flows do not matter.

Key takeaway Under US GAAP, PP&E held for use passes an undiscounted cash flow test before any loss is measured. An indefinite-lived intangible asset skips that screen: whenever its carrying amount exceeds fair value, the excess is an impairment loss, even if undiscounted cash flows are well above the carrying amount.

Reading 33: Analysis of Long-Term Assets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/straight-line-depreciation/

Question 31 **Answer: B**

Remaining useful life is net PP&E (gross PP&E minus accumulated depreciation) divided by annual depreciation expense.

$$\text{Net PP\&E} = 840 - 336 = 504$$

$$\text{Remaining useful life} = \frac{504}{48} = 10.5 \text{ years}$$

Check: total useful life $= 840/48 = 17.5$; average age $= 336/48 = 7.0$; $17.5 - 7.0 = 10.5$.

Why the other options are wrong

- **A.** 7.0 years is the average age (accumulated depreciation / depreciation expense = 336 / 48).
- **C.** 17.5 years is the total useful life (gross PP&E / depreciation expense = 840 / 48).

Key takeaway Remaining life = total life − average age; computing all three is a quick consistency check.

Reading 33: Analysis of Long-Term Assets. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/straight-line-depreciation/

Question 32 **Answer: C**

A lessee usually returns the asset at the end of the lease, so it does not benefit from any appreciation (unless the lease includes a purchase option). Capturing gains in the asset's value is a reason to own the asset rather than lease it.

Why the other options are wrong

- **A.** Since the leased asset effectively serves as collateral, the implicit lease rate may be below what a lender would charge to finance a purchase. This is a genuine reason to lease.
- **B.** Leases typically require a small initial payment, if any, so leasing conserves cash at inception compared with a purchase. This is also a genuine reason to lease.

Key takeaway Advantages of leasing: smaller initial outflow, cheaper financing, less obsolescence risk. Appreciation belongs to the owner (the lessor).

Reading 34: Topics in Long-Term Liabilities and Equity. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/finance-lease-vs-operating-lease/

Question 33 **Answer: C**

In an operating lease the underlying asset stays on the lessor's balance sheet (usually in PP&E), and the lessor depreciates it. The lessee instead recognizes a right-of-use asset and a lease liability, both initially equal to the present value of the lease payments; the ROU asset represents Aerolinea's right to use the jet, not the jet itself.

Why the other options are wrong

- **A.** The lessor still owns and reports the jet in an operating lease, so it does appear on a balance sheet.
- **B.** The lessee reports a right-of-use asset (its right to use the jet over the lease term) and a lease liability. The physical jet is owned and reported by the lessor.

Key takeaway Operating lease: physical asset on lessor's books; ROU asset and lease liability on lessee's books.

Reading 34: Topics in Long-Term Liabilities and Equity. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/finance-lease-vs-operating-lease/

Question 34 **Answer: B**

Both IFRS and US GAAP measure an employee stock option at its fair value on the grant date, estimated with an option-pricing model, and recognize that amount straight-line over the vesting period as compensation expense (with a matching credit to equity).

$$\text{Total fair value} = 60{,}000 \times 7.50 = \$450{,}000$$

$$\text{Annual expense} = \frac{450{,}000}{4} = \$112{,}500$$

Each year: compensation expense $112,500; equity (APIC or a share-based compensation reserve) +$112,500, so total equity is unchanged.

Why the other options are wrong

- **A.** $450,000 is the total grant-date fair value ($60{,}000 \times 7.50$), which would be expensed at once only if the options vested immediately. Here it is spread over four years.
- **C.** $0 uses the intrinsic value at grant (the share price of $38 is below the $40 exercise price). The expense is based on the options' grant-date fair value, which is positive even though they are out of the money.

Key takeaway Option expense equals grant-date fair value divided by the vesting years. It is not based on intrinsic value and is not remeasured for later share price changes.

Reading 34: Topics in Long-Term Liabilities and Equity. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/finance-lease-vs-operating-lease/

Question 35 **Answer: C**

Required share-based compensation disclosures are the nature and key terms of the plans (grant date, vesting date, service period, settlement features), how grant-date fair value was determined, and the effect of the arrangements on earnings and financial position. The share price at the reporting date may help users but is not a required disclosure.

Why the other options are wrong

- **A.** The method used to determine grant-date fair value is a required disclosure, because the expense rests on it.
- **B.** Companies must disclose the effect of share-based transactions on both the income statement and the balance sheet.

Key takeaway Share-based pay disclosures: plan nature and terms, how grant-date fair value was set, effects on the income statement and balance sheet.

Reading 34: Topics in Long-Term Liabilities and Equity. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/finance-lease-vs-operating-lease/

Question 36 **Answer: A**

A temporary difference creates a deferred tax item: a DTL if income tax expense (financial reporting) exceeds taxes payable (tax reporting), or a DTA if taxes payable exceed income tax expense. Permanent differences, rather than temporary ones, are what make the effective tax rate differ from the statutory rate.

Why the other options are wrong

- **B.** Neither temporary nor permanent differences generate a gain or loss; they affect tax balances and tax expense.
- **C.** Temporary differences typically do not make the effective and statutory rates differ, because the deferred tax expense adjusts income tax expense to the statutory rate on pretax income. Permanent differences cause that gap.

Key takeaway A temporary difference creates a deferred tax item. A permanent difference makes the effective rate differ from the statutory rate.

Reading 35: Analysis of Income Taxes. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/deferred-tax-liability/

Question 37 **Answer: B**

Unearned revenue (cash received in advance) is usually taxed when received but recognized in the income statement only later, when earned. Taxes payable therefore exceed income tax expense now, and a deferred tax asset is created that reverses when the revenue is recognized.

Why the other options are wrong

- **A.** Accelerated depreciation on the tax return (with straight-line depreciation in the financial statements) makes the tax deduction come before the book expense, so taxable income is initially lower than pretax income and a deferred tax liability is created. Other combinations of book and tax depreciation methods can produce either type of deferred tax item, but this pairing is the classic DTL case.
- **C.** A change in the enacted rate only remeasures existing deferred balances; a decrease *reduces* existing DTAs and DTLs rather than creating a DTA.

Key takeaway Typical DTA sources: unearned revenue, warranty provisions, post-employment benefits, tax loss carryforwards.

Reading 35: Analysis of Income Taxes. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/deferred-tax-liability/

Question 38 **Answer: C**

Deferred tax assets and liabilities are measured at the tax rate expected to apply when the differences reverse, so an enacted rate change remeasures both balances and the adjustment flows through income tax expense in the period of enactment. A higher rate raises both the DTA and the DTL. Lochmere's DTA is larger than its DTL, so the DTA rises by more, and income tax expense falls.

Underlying temporary differences: DTA $360/0.24 = 1{,}500$; DTL $150/0.24 = 625$ (thousands of dollars).

Remeasured at 28%: DTA $= 1{,}500 \times 0.28 = 420$, so $\Delta DTA = +60$; DTL $= 625 \times 0.28 = 175$, so $\Delta DTL = +25$.

$$\Delta\text{income tax expense} = \Delta DTL - \Delta DTA = 25 - 60 = -35$$

Income tax expense falls by $35,000 and net income rises by the same amount.

Why the other options are wrong

- **A.** An increase of $25,000 remeasures only the deferred tax liability. The deferred tax asset is remeasured too, and its $60,000 increase reduces tax expense by more than the liability adds.
- **B.** The balances must reflect the rate expected when they reverse. Once the higher rate is enacted they are remeasured at once, and the change is recognized in this year's income tax expense even though the new rate applies to later tax returns.

Key takeaway A higher enacted tax rate increases both DTAs and DTLs. Income tax expense rises for a company with a net DTL and falls for a company with a net DTA, so a rate increase does not always raise tax expense.

Reading 35: Analysis of Income Taxes. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/deferred-tax-liability/

Question 39 **Answer: A**

Reclassifying a DTL moves an amount from liabilities to equity; total assets and net income are unchanged, so return on assets is unaffected. Equity rises, which changes every ratio that uses equity in the numerator or denominator.

Why the other options are wrong

- **B.** The debt-to-equity ratio falls because liabilities decrease and equity increases.
- **C.** Return on equity falls because the equity denominator becomes larger while net income is unchanged.

Key takeaway Reclassifying a DTL as equity lowers leverage ratios and ROE but leaves ROA unchanged.

Reading 35: Analysis of Income Taxes. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/deferred-tax-liability/

Question 40 **Answer: C**

A tax holiday is a temporary exemption from tax in a particular jurisdiction, so it is a sporadic reconciliation item. The key analytical task is to establish when the holiday will expire and how its expiry (including any requirement to pay accumulated taxes) will affect future taxes payable and the effective rate.

Why the other options are wrong

- **A.** A tax holiday is temporary, so it is a sporadic item. Its termination date is the main thing the analyst needs to find out.
- **B.** Nothing suggests the holiday's benefit is routinely offset by home-country taxes. The analyst's focus is the end date and any taxes that become payable then.

Key takeaway A tax holiday is a sporadic item. Find its end date and any catch-up tax.

Reading 35: Analysis of Income Taxes. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/deferred-tax-liability/

Question 41 **Answer: A**

Reporting quality is about whether the reports give decision-useful information that faithfully represents what happened. Earnings quality is about the underlying results: whether earnings are sustainable and adequate. A company can report a weak or one-off year accurately, so high-quality reporting can sit alongside low-quality

earnings.

Why the other options are wrong

- **B.** Earnings smoothed through chosen estimates do not faithfully represent performance, so the reports would not be high quality.
- **C.** Delaying impairments overstates assets and earnings; that is a bias in the reporting, which rules out high reporting quality.

Key takeaway High reporting quality says the reports are faithful and useful; it does not guarantee that the earnings they show are sustainable or adequate.

Reading 36: Financial Reporting Quality. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/financial-reporting-quality/

Question 42 **Answer: B**

Low-quality (or fraudulent) reporting typically involves three conditions: motivation, opportunity, and a mindset that allows rationalization. Rationalization is the story managers tell themselves to justify the behavior ("we will fix it next quarter").

Why the other options are wrong

- **A.** Weak internal controls are an example of opportunity, which is already one of the two conditions named in the stem.
- **C.** Pressure to beat earnings expectations is an example of motivation, the other condition already given.

Key takeaway Motivation (why), opportunity (how), rationalization (the excuse).

Reading 36: Financial Reporting Quality. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/financial-reporting-quality/

Question 43 **Answer: A**

A higher residual (salvage) value reduces the depreciable base, so annual depreciation expense falls and operating income rises.

$$\text{Depreciation} = \frac{\text{cost} - \text{residual value}}{\text{useful life}}$$

A higher residual value shrinks the numerator, which lowers expense. A shorter life shrinks the denominator, which raises expense.

Why the other options are wrong

- **B.** Shorter useful lives spread the cost over fewer periods, which increases depreciation expense and lowers operating income.
- **C.** Under IFRS, a revaluation above depreciated cost is not recognized in profit (it goes to a revaluation surplus) unless it reverses a loss previously recognized. The higher carrying amount also increases depreciation in later periods, which lowers operating income.

Key takeaway Aggressive depreciation choices: longer lives and higher salvage values. Both lower depreciation and raise income.

Reading 36: Financial Reporting Quality. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/financial-reporting-quality/

Question 44 Answer: A

An interest coverage covenant is based on EBIT divided by interest expense. The most direct way to raise the ratio is to overstate earnings (the numerator), or possibly to understate interest expense (the denominator). Under US GAAP, for example, leases can be structured to qualify as operating leases, whose single lease cost is reported in operating expenses rather than as interest expense.

$$\text{Interest coverage} = \frac{\text{EBIT}}{\text{interest expense}}$$

Why the other options are wrong

- **B.** Asset values do not enter the interest coverage ratio, so understating (or overstating) assets does not help meet the covenant.
- **C.** Capitalizing leases works against the covenant. Treating a lease as a finance (capital) lease replaces the lease payment with depreciation plus interest expense: EBIT rises by roughly the interest component, but interest expense rises by the same amount, and for any firm whose coverage exceeds 1.0 that lowers the ratio (e.g., $(500 + 20)/(100 + 20) = 4.3\times$ versus $500/100 = 5.0\times$). A firm manipulating to meet the covenant would do the opposite and keep lease costs out of interest expense.

Key takeaway Match the manipulation to the covenant's formula. Coverage is EBIT / interest, so the levers are inflating EBIT or shrinking interest expense.

Reading 36: Financial Reporting Quality. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/financial-reporting-quality/

Question 45 Answer: C

Expenses that are classified as nonrecurring but appear year after year are a warning sign. Labeling ordinary costs as one-time charges again and again lowers the credibility of the category and invites investors to exclude real, recurring costs when they judge sustainable profitability.

Why the other options are wrong

- **A.** Adopting a new standard when it becomes mandatory is required of every company. It reflects no management choice, so it does not by itself signal manipulation.
- **B.** The warning sign is a ratio of operating cash flow to net income that is persistently below one or falling. A stable ratio above one suggests that earnings are well backed by cash.

Key takeaway Watch for nonrecurring charges that recur, heavy emphasis on non-GAAP earnings and aggressive use of special-charge labels. They can distort the picture of sustainable earnings.

Reading 36: Financial Reporting Quality. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/financial-reporting-quality/

Question 46 Answer: A

Setting a firm's ratios beside the same ratios of rival firms (or an industry average) for the same period is cross-sectional analysis. It shows how the firm performs relative to peers.

Why the other options are wrong

- **B.** Time-series analysis compares the same company's ratios across several periods, not across different firms in one period.
- **C.** Common-size analysis restates line items as percentages of a base (sales, total assets, or a base year). Varga is comparing ratios across firms, which is a different exercise.

Key takeaway Comparing several firms at one date is cross-sectional analysis. Following one firm across dates is time-series analysis.

Reading 37: Financial Analysis Techniques. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/dupont-analysis/

Question 47 **Answer: B**

Inventory turnover is cost of goods sold divided by average inventory. With cost of goods sold roughly unchanged, a sharp fall in turnover means that average inventory rose. Duplicate orders add surplus stock, which increases average inventory and lowers turnover.

Why the other options are wrong

- **A.** A write-down at the start of the year reduces the carrying amount of inventory for the whole year. Average inventory is lower, so turnover rises.
- **C.** A just-in-time system is designed to keep inventory low. Lower average inventory raises turnover.

Key takeaway $\text{Inventory turnover} = \text{COGS}/\text{average inventory}$. Low turnover relative to peers can signal slow-moving or obsolete stock; high turnover can mean efficient management or inventory kept too low to meet demand, so compare revenue growth with peers before concluding.

Reading 37: Financial Analysis Techniques. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/dupont-analysis/

Question 48 **Answer: B**

Sales divided by total assets is total asset turnover, an activity (operating efficiency) ratio that shows how effectively assets generate revenue. Operating profitability ratios compare a measure of profit with sales.

Why the other options are wrong

- **A.** Gross profit / net sales is the gross profit margin, a standard profitability ratio.
- **C.** Net income / net sales is the net profit margin, which is also a profitability ratio based on sales.

Key takeaway Profit ÷ sales is a profitability ratio (a margin). Sales ÷ assets is an activity ratio (a turnover).

Reading 37: Financial Analysis Techniques. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/dupont-analysis/

Question 49 **Answer: B**

In the original DuPont equation, ROE is the product of net profit margin, total asset turnover and financial leverage. Because net income and equity are positive, the net profit margin and the equity multiplier are both positive, so with those two components fixed ROE moves in the same direction as asset turnover.

Why the other options are wrong

- **A.** Asset turnover enters ROE as a multiplier. With a positive margin and a positive equity multiplier held constant, a higher turnover cannot lower ROE. It would lower ROE only for a loss-making firm, which the stem rules out.

- **C.** The outcome is not ambiguous here: the other two components are held constant and are positive. The result would be indeterminate only without the positive-income premise (a zero margin leaves ROE unchanged; a negative margin makes ROE fall).

Key takeaway ROE = net profit margin × total asset turnover × financial leverage; for a profitable firm, raising any one component with the others fixed raises ROE.

Reading 37: Financial Analysis Techniques. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/dupont-analysis/

Question 50 **Answer: B**

Forecast next year's sales, apply the common-size COGS percentage, and convert the target days of inventory on hand into an inventory balance: average inventory = COGS/365 × days of inventory on hand.

$$\text{Sales}_{20X6} = 200 \times 1.095 = 219 \qquad COGS = 0.50 \times 219 = 109.5$$

$$\text{Average inventory} = \frac{109.5}{365} \times 50 = 15.00 \quad (\$ \text{ millions})$$

Why the other options are wrong

- **A.** $13.70 million ignores the expected 9.5% sales growth and uses 20X5 COGS of $100 million.
- **C.** $30.00 million applies the inventory days to sales instead of cost of goods sold.

Key takeaway Days of inventory on hand is based on COGS: inventory = (COGS ÷ 365) × DOH.

Reading 37: Financial Analysis Techniques. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/dupont-analysis/

Question 51 **Answer: B**

The income statement is modeled first: revenue, then COGS, then SG&A, financing costs and taxes. Capital expenditures and net PP&E for the balance sheet come after, and the cash flow statement is built last because it is derived from the pro forma income statement and balance sheet.

Why the other options are wrong

- **A.** The pro forma cash flow statement is the final step; it cannot be constructed until the income statement and balance sheet are complete.
- **C.** Capital expenditures and net PP&E for the balance sheet are estimated after the income statement has been modeled.

Key takeaway The order is revenue, COGS, SG&A, financing costs and taxes, then the balance sheet (working capital, capex and PP&E), and finally the cash flow statement.

Reading 38: Introduction to Financial Statement Modeling. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/pro-forma-financial-statements/

Question 52 **Answer: B**

Conservatism bias (also called anchoring) is the tendency to make only small adjustments, or none, to a prior forecast when new information becomes available. Voss's reluctance to update despite new announcements fits this bias.

Why the other options are wrong

- **A.** Confirmation bias means seeking out evidence that supports an existing view and discounting contrary evidence. The scenario does not say whether the news supports or contradicts her view, only that she will not update.
- **C.** Representativeness bias is the tendency to rely on known classifications of past information; nothing in the scenario involves classifying the company based on superficial similarity.

Key takeaway Reluctance to update a forecast after new information is conservatism bias (anchoring).

Reading 38: Introduction to Financial Statement Modeling. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/pro-forma-financial-statements/

Question 53 **Answer: A**

Adding the money amount of the cost increase to the price keeps gross profit per unit (and operating profit) unchanged, but because sales revenue is higher, gross, operating and net margins all fall.

This year: gross margin $= (80 - 50)/80 = 37.5\%$.

Next year: price $= \$84$, unit COGS $= \$54$, gross profit per unit $= \$30$.

$$\text{gross margin} = \frac{30}{84} = 35.7\%$$

Operating profit is unchanged: $2{,}000 \times 30 - 30{,}000 = \$30{,}000$ in both years; operating margin falls from $30{,}000/160{,}000 = 18.75\%$ to $30{,}000/168{,}000 = 17.9\%$.

Why the other options are wrong

- **B.** 37.5% is this year's gross margin (30/80); it assumes margins are unaffected by a full pass-through, but the same gross profit is now spread over higher revenue.
- **C.** 40.5% raises the price to $84 but forgets the $4 increase in unit COGS ((84 − 50)/84).

Key takeaway Full money pass-through of a cost increase with stable volume: profit unchanged, margins lower.

Reading 38: Introduction to Financial Statement Modeling. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/pro-forma-financial-statements/

Question 54 **Answer: B**

The horizon for a cyclical company should be long enough that the current phase of the cycle does not drive above- or below-trend results. Extending the forecast to midcycle captures a midcycle (normalized) level of sales and profits.

Why the other options are wrong

- **A.** A one-year forecast may be more precise, but it reflects wherever the company currently is in the cycle, so earnings will be above or below trend.
- **C.** Two full cycles would be informative in principle, but forecasts that far out are unlikely to be accurate enough to be useful.

Key takeaway For a cyclical firm, forecast through midcycle to capture normalized earnings.

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Reading 38: Introduction to Financial Statement Modeling. Notes: credguild.com/cfa/level-1/notes/financial-statement-analysis/pro-forma-financial-statements/

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