Question #1 of 26

Question ID: 1577955

Items in an initial research report on a company that are *most likely* to also appear in subsequent reports include a(n):

A) industry overview and analysis of the company's competitive position.

B) description of the company's business model and strategy.

C) rationale for the investment recommendation.

Explanation

Both initial and subsequent research reports typically include a buy/hold/sell recommendation and an explanation of the rationale for the recommendation. A company description and industry overview are included in an initial research report but are typically not repeated in subsequent reports unless new information has emerged.

(Module 45.1, LOS 45.a)

Question #2 of 26

Question ID: 1577962

Which of the following ratios should an analyst use who wishes to evaluate the returns a company generates based on the amount of financial leverage?

A) Return on equity (ROE).

B) Return on invested capital (ROIC).

C) Return on assets (ROA).

Explanation

ROE will incorporate the use of financial leverage. In fact, ROE is equal to ROA multiplied by the financial leverage ratio (assets/equity). Both ROA and ROIC are used to express unlevered returns.

(Module 45.2, LOS 45.e)

Question #3 of 26

Question ID: 1577963

Joel Lettner, CFA, is an analyst studying the balance sheets of several companies within the same industry. His boss has asked him to do comparisons of capital structures between the companies. Which elements of the balance sheet will Lettner *most likely* focus on?

A) Noncurrent assets and liabilities.

B) Liabilities and stockholders' equity.

C) Noncurrent assets and stockholders' equity.

Explanation

A company's capital structure is the combination of its liabilities (current and noncurrent) and stockholders' equity. Assets comprise the company's asset structure.

(Module 45.2, LOS 45.e)

Question #4 of 26

Question ID: 1577960

Which of the following statements is *most accurate* regarding a company who is experiencing economies of scale as production output is increasing?

A) Total fixed costs are decreasing, with no change to variable costs.

B) Both fixed costs per unit and variable costs per unit may be decreasing.

C) Fixed costs are decreasing, but variable costs are increasing.

Explanation

Economies of scale result in decreasing unit costs as output increases. Fixed costs are presumably constant overall, but as production increases, the per-unit fixed cost will decrease. Also, variable costs per unit may decreases as well due to gains in production efficiencies and increased bargaining power over suppliers.

(Module 45.2, LOS 45.d)

Question #5 of 26

Question ID: 1577338

Which of the following elements can be found in the "front matter" section of a company research report?

A) A description of the company's business model.

B) A target buy price of $12 per share.

C) A competitive analysis of the industry in which the company operates.

Explanation

In a company research report, the front matter section will include things like issuer name, legal disclosures, a recommendation (buy, sell, hold), and target purchase/sale prices. The other items listed will be in the research report, but they will not be considered front matter.

(Module 45.1, LOS 45.a)

Question #6 of 26

Question ID: 1577336

Jason Schmidt, CFA, is preparing his very first company research report. It will be distributed internally within his company, as well as to external advisors and investors. He can expect that, relative to his initial report, his subsequent reports will be:

A) less thorough. ✓

B) more thorough. ✗

C) equivalent in depth. ✗

Explanation

While the initial company research report prepared for both internal and external parties will be very thorough, subsequent reports will be less so under the premise that the initial report contains the bulk of the foundational information needed in a report.

(Module 45.1, LOS 45.a)

Question #7 of 26

Question ID: 1577344

An analyst assesses that the gross domestic product for a country is growing (on average) by 3% per year. He also determines that the market share for a company is approximately 6% of its overall industry. By using these statistics to forecast revenue growth, the analyst is taking a(n):

A) top-down approach. ✓

B) economic approach. ✗

C) bottom-up approach. ✗

Explanation

A top-down approach to forecasting revenue growth will start with economic measures (such as gross domestic product) and industry market share. A bottom-up approach looks very specifically at price, volume, and business segments. The "economic" approach is not a valid approach to forecasting revenue.

(Module 45.2, LOS 45.c)

Question #8 of 26

Question ID: 1577961

If a company's operating income increases from $3 million to $3.3 million and its net income increases from $1.5 million to $1.8 million, its degree of financial leverage is *closest* to:

A) 1.0.

B) 2.0.

C) 0.5.

Explanation

The degree of financial leverage (DFL) is a measure used to evaluate the extent to which a company uses debt relative to equity in its capital structure. The DFL is calculated by taking the change in net income and dividing it by the change in operating income. Here, net income increased by 20% ($1.5 million to $1.8 million) and operating income increased by 10% ($3 million to $3.3 million); 20% / 10% = 2.0. With the other answer options, 0.5 switches the numerator and denominator, and 1.0 just takes the $0.3 million change in both rather than the percentage changes.

(Module 45.2, LOS 45.e)

Question #9 of 26

Question ID: 1577966

In a given period, which of the following metrics is *most likely* to be the largest for a company?

A) Pretax earnings.

B) EBIT.

C) EBITDA.

Explanation

EBITDA represents earnings before subtracting the expenses for interest, tax, depreciation, and amortization. EBIT is EBITDA minus depreciation and amortization expenses. Pretax earnings are EBIT minus interest expense.

(Module 45.2, LOS 45.d)

Question #10 of 26

Question ID: 1577956

Publicly available third-party information that can be used to determine a company's business model *most likely* includes:

A) filings with regulatory agencies.

B) reports produced by well-known analysts.

C) social media commentary.

Explanation

Social media commentary on a company by third parties is publicly available information. Filings with regulatory agencies come directly from a company. Some analyst reports are publicly available while others are proprietary.

(Module 45.1, LOS 45.b)

Question #11 of 26

Question ID: 1577342

An analyst assesses a company's business model primarily by using press releases and information from the company's investor relations department. These sources of information are *best* categorized as:

A) proprietary third-party information.

B) proprietary primary research.

C) direct information from the company.

Explanation

Information directly obtained from the company includes regulatory filings, press releases, investor presentations, investor relations department communications, and the company website. The analyst performs proprietary primary research themselves rather than from the company. Also, proprietary third-party information comes from certain analyst reports and other companies that perform the research.

(Module 45.1, LOS 45.b)

Question #12 of 26

Question ID: 1577957

A company's main product sells for $20 per unit and has variable costs of $15 per unit. If fixed costs are $25,000 and the company is able to sell 8,000 units, the total contribution margin is equal to:

A) $40,000.

B) $15,000.

C) $25,000.

Explanation

The contribution margin per unit is equal to the sale price per unit less variable costs per unit ($20 – $15 = $5 per unit). The total contribution margin is equal to 8,000 units × $5 per unit = $40,000—$15,000 represents the operating profit, and $25,000 is the fixed cost total.

(Module 45.2, LOS 45.d)

Question #13 of 26

Question ID: 1577345

Which of the following companies is *most likely* to benefit by raising their sale prices and exercising significant pricing power?

A) A company whose products have few substitutes.

B) A company in a price-taker market structure.

C) A company whose products are highly elastic.

Explanation

If a company provides a product with few substitutes, it will have greater pricing power and can raise its prices without significantly impacting quantity demanded in a negative way. The company may lose some demand, but the price increase will more than offset the demand loss and will still allow the company to increase sales. In a price-taker market structure, companies have low pricing power. Elasticity is a measure of sensitivity, and a highly elastic product will not provide a company with much pricing power.

(Module 45.2, LOS 45.c)

Question #14 of 26

Question ID: 1577959

An analyst is reviewing an income statement that reflects two years of information. Over those two years, sales have risen from $10 million to $12 million. At the same time, operating profit has risen from $1.2 million to $1.5 million. The company's degree of operating leverage is *closest* to:

A) 0.15.

B) 1.25.

C) 0.80.

Explanation

Operating leverage represents the fixed-cost component of a company's operating cost structure. The degree of operating leverage is a measure used to express the extent to which a company uses fixed costs relative to variable costs. It is calculated by dividing the change in operating profit by the change in sales.

Here, operating profit has increased 25% ($1.2 million to $1.5 million). Sales have increased 20% ($10 million to $12 million). The degree of operating leverage (DOL) = 25% / 20% = 1.25. With the other answer options, 0.15 is equal to the change in operating profit ($0.3 million) by the change in sales ($2.0 million), and 0.80 puts the sales change of 20% over the operating profit change of 25%.

(Module 45.2, LOS 45.d)

Question #15 of 26

Question ID: 1577347

A market has 10 companies and total revenue of $88 million in the last fiscal year. Company XYZ had revenue last year of $17.6 million. Which of the following statements is *most accurate* about this market and Company XYZ?

A) Company XYZ's market share is larger than the average company in this market.

B) The market size is $105.6 million.

C) Company XYZ's market share is $17.6 million.

Explanation

The market size, which is the total revenue of all companies in the market, is $88 million. A company's market share is a ratio (not a dollar amount) of the company's revenue to the market size. With 10 companies, the average market share will be 10%. Company XYZ's market share is 20% ($17.6 million / $88 million).

(Module 45.2, LOS 45.c)

Question #16 of 26

Question ID: 1577339

Which of the following items will *most likely* be found in both the initial company research report and any subsequent reports that are issued?

A) Recommendations and associated rationales.

B) An overview of the company's industry.

C) Environmental, social, and governance factors.

Explanation

An initial company research report will include a recommendation (buy, sell, hold) and rationales for the recommendation. Any subsequent reports will also include a recommendation and rationales. Industry overviews and environmental, social, and governance factors are most likely found in just the initial research report.

(Module 45.1, LOS 45.a)

Question #17 of 26

Question ID: 1577965

During a period of increasing sales, compared to firms with lower operating leverage, earnings growth for firms with high operating leverage will be:

A) higher.

B) unaffected.

C) lower.

Explanation

High operating leverage, other things held constant, means that a relatively small change in sales will result in a large change in operating income. Therefore, during a period of increasing sales, a highly leveraged firm will have higher earnings growth than a lesser leveraged firm.

(Module 45.2, LOS 45.d)

Question #18 of 26

Question ID: 1577346

A highly competitive market structure will reflect which of the following characteristics?

A) High levels of commoditization.

B) Relatively high switching costs.

C) Significant barriers to entry.

Explanation

Commoditization is found in highly competitive markets where there is less differentiation, lots of substitute products, minimal barriers to entry, minimal brand loyalty, and insignificant switching costs (the costs for customers to change from one product to another).

(Module 45.2, LOS 45.c)

Question #19 of 26

Question ID: 1577337

An analyst will often include pro forma financial statements in a company research report because they are useful in helping investors understand:

A) the growth in sales numbers over the last several years.

B) how the company has changed its mix of debt and equity in its capital structure.

C) forecasted bottom-line profits over the next several years.

Explanation

Pro forma financial statements are projected financial statements based on historical numbers and expectations for the future. Forecasted bottom-line profits will appear in a pro forma presentation. The growth in sales numbers over the last several years and the change of debt and equity in the capital structure are all historical data found in the actual financial statements themselves.

(Module 45.1, LOS 45.a)

Question #20 of 26

Question ID: 1577340

In setting her expectations for a company she is analyzing, Lisa Kale, CFA, will use which company model as the foundation?

A) Risk based.

B) Business.

C) Financial.

Explanation

The business model is the foundation for helping an analyst set expectations, as it considers elements such as customers; products and services; sales channels; suppliers; and pricing or payment.

(Module 45.1, LOS 45.b)

Question #21 of 26

Question ID: 1577964

In assessing a company's uses of capital, an analyst may look at:

A) marketable security sales and dividend payments. ✗

B) treasury stock purchases and principal payments on debt. ✓

C) new stock issuances and intangible asset purchases. ✗

Explanation

Uses of capital represents outflows, which will include share repurchases (treasury stock) and principal payments on debt. Dividend payments and intangible asset purchases are also uses of capital. Marketable security sales and new stock issuances are sources (rather than uses) of capital.

(Module 45.2, LOS 45.e)

Question #22 of 26

Question ID: 1577343

Laurie Palmer, CFA, is analyzing the business model for ABC Corp. Given that this is a new company for Palmer, what is one of the first questions she will need to answer?

A) “What is the company’s customer retention ratio?” ✗

B) “Has the company been able to meet its debt covenants related to its outstanding bond issuances?” ✗

C) “What products and services does the company offer?” ✓

Explanation

While all three questions are legitimate questions, for understanding a company's business model for the first time, asking about the products and services the company offers is an appropriate first (or early) question to ask. How the company obtains customers is important as well, although the retention ratio is very specific. Debt covenants associated with bond issuances must be met, but that is not one of the first questions to ask in understanding a company's business model.

(Module 45.1, LOS 45.b)

Question #23 of 26

Question ID: 1577967

The percent change in a company's net income that results from a given percent change in its operating income is the company's degree of:

A) operating leverage.

B) total leverage.

C) financial leverage.

Explanation

The degree of financial leverage is the ratio of the percent change in net income to the percent change in operating income. The degree of financial leverage increases with greater use of debt financing.

(Module 45.2, LOS 45.e)

Question #24 of 26

Question ID: 1577958

A company's income statement for the previous year reflects the following amounts:

- Revenue: $1,500,000
- Cost of sales: $900,000
- Operating expenses: $250,000
- Depreciation and amortization: $50,000

The company's EBITDA is *closest* to:

A) $350,000.

B) $600,000.

C) $300,000.

Explanation

EBITDA is equal to earnings before interest, taxes, depreciation, and amortization. It is calculated by subtracting the cost of sales and operating expenses from revenue. EBITDA for this company = $1,500,000 – $900,000 – $250,000 = $350,000—$300,000 subtracts depreciation and amortization of $50,000, which produces EBIT (earnings before interest and taxes), and $600,000 is just revenue less cost of sales.

(Module 45.2, LOS 45.d)

Question #25 of 26

Question ID: 1577341

In reviewing whether a company requires fairly common materials and inputs in its production process or ones that are more specialized, an analyst is evaluating the bargaining power of which party?

A) Frontline workers.

B) Suppliers.

C) Customers.

Explanation

The bargaining power of suppliers relates to the types of inputs a company uses in its production process. If the inputs are fairly common, the suppliers have less bargaining power—but if they are more specialized, suppliers will have more bargaining power. Bargaining power of customers and frontline workers is important, but it is not what is described in this situation.

(Module 45.1, LOS 45.b)

Question #26 of 26

Question ID: 1576022

A firm is *most likely* to have pricing power if:

A) costs to exit the industry are high.

B) its market share is high.

C) its product is differentiated.

Explanation

Firms offering products that are differentiated in terms of quality and features are more likely to have pricing power than firms that produce undifferentiated (commodity-like) products. High market share does not necessarily imply pricing power; for example, if four firms each have 25% market share, none of them are likely to have significant pricing power. High exit costs can create overcapacity in an industry and result in a high degree of price competition as firms try to maintain production volume during a period of reduced demand.

(Module 45.2, LOS 45.c)