#1-179A

EASY INTERMEDIATE HARD

CFA® SAMPLE QUESTION – LEVEL I

Corporate Finance

Q: Firm ABC has the below financial ratios for the past two financial years:

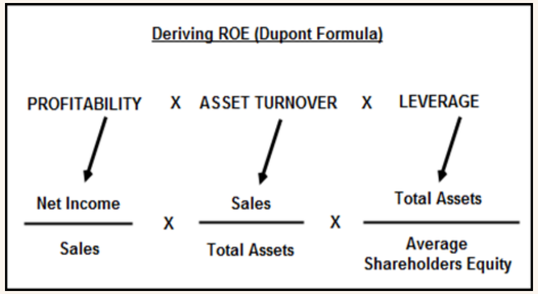
Year	Net Profit Margin	Total Asset Turnover	Financial Leverage
20X5	17%	1.3	1.6
20X6	15%	0.8	3

Based on the above figures, you can conclude that the ROE of firm ABC in year 20x6 compared to year 20x5 has:

CORRECT ANSWER:

ⓑ **increased, because the company ABC has used more debt financing**

We need to find out the ROE for the year 20x5 and 20x6 first.
Remember ROE is the Return of Equity = Net income/ Total Shareholder's equity. By Du Point Formula, we can further decompose the ROE into three different components:



So ROE, Year 20x5 = 17% x 1.3 x 1.6 = 35.4%
ROE, Year 20x6 = 15% x 0.8 x 3 = 36.0%

ROE in year 20x6 has increased, it is because of the increased financial leverage (1.6=> 3). In fact, both the profit margin and asset utilization have been decreased.

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