CIMA

F3

Financial Strategy

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Question: 1

A new company was set up two years ago using the personal financial resources of the founders.
These funds were used to acquire suitable premises.
The company has entered into a long-term lease on the premises which are not yet fully fitted out.
The founders are considering requesting loan finance from the company's bank to fund the purchase of custom-made advanced technology equipment.
No other companies are using this type of equipment.
The company expects to continue to be profitable for the forseeable future.
It re-invests some of its surplus cash in on-going essential research and development.
Which THREE of the following features are likely to be considered negatives by the bank when assessing the company's credit-worthiness?

A. The equipment is advanced technology custom-made equipment.
B. The company will continue to remain profitable and to generate net cash.
C. The company premises are on a long-term lease but are not yet fully fitted out.
D. The founders invested their personal financial resources in the company.
E. Essential on-going research and development expenditure is required.

Answer: A, C, E

Question: 2

Company Y plans to diversify into an activity where Company X has an equity beta of 1.6, a debt beta of zero and gearing of 50% (debt/debt plus equity).
The risk-free rate of return is 5% and the market portfolio is expected to return 10%.
The rate of corporate income tax is 30%.
What would be the risk-adjusted cost of equity if Company Y has 60% equity and 40% debt?

A. 11.6%
B. 11.9%
C. 9.1%
D. 13%

Answer: B

Question: 3

If a company's bonds are currently yielding 8% in the marketplace, why would the entity's cost of debt be lower than this?

A. There should be no difference; the cost of debt is the same as the bond's market yield.
B. Interest is deductible for tax purposes.
C. The company's credit rating has changed.
D. Market interest rates have decreased.

Answer: B

Question: 4

A company plans to cut its dividend but is concerned that the share price will fall. This demonstrates the ______________ effect

A. A
B. B

Answer: A

Question: 5

A company aims to increase profit before interest and tax (PBIT) each year.
The company reports in A$ but has significant export sales priced in B$.
All other transactions are priced in A$.
In 20X1, the company reported:

	Total	
Revenue	A$ 500 million	Including export sales of B$ 800 million (equivalent to A$ 400 million)
Costs	A$ 200 million	
PBIT	A$ 300 million	

In 20X2, the only changes expected are:

- An increase in export prices of 10%, but no change to units sold.
- A rise in the value of the B$ to A$/B$ 2.500 (that is, A$ 1 = B$ 2.5)

Is it likely that the company would still meet its objective to grow PBIT between 20X1 and 20X2?

A. Yes, PBIT would increase by A$ 48 million.
B. No, PBIT would fall by A$ 48 million.
C. Yes, PBIT would increase by A$ 150 million.
D. No, PBIT would fall by A$ 150 million.

Answer: B

Question: 6

Holding cash in excess of business requirements rather than returning the cash to shareholders is most likely to result in lower:

A. liquidity.
B. vulnerability to a takeover bid.
C. net profit.
D. return on equity.

Answer: D

Question: 7

A company has a financial objective of maintaining a gearing ratio of between 30% and 40%, where gearing is defined as debt/equity at market values.
The company has been affected by a recent economic downturn leading to a shortage of liquidity and a fall in the share price during 20X1.
On 31 December 20X1 the company was funded by:

- Share capital of 4 million $1 shares trading at $4.0 per share.
- Debt of $7 million floating rate borrowings.

The directors plan to raise $2 million additional borrowings in order to improve liquidity.
They expect this to reassure investors about the company's liquidity position and result in a rise in the share price to $4.2 per share.
Is the planned increase in borrowings expected to help the company meet its gearing objective?

A. No, gearing would increase but the gearing objective would be met both before and after the announcement.
B. No, gearing would increase and the gearing objective would be exceeded both before and after the announcement.
C. No, gearing would increase and the gearing objective would be met before the announcement but exceeded after the announcement.
D. Yes, gearing would fall and the gearing objective would be exceeded before the announcement but met after the announcement.

Answer: B

Question: 8

A company is considering the issue of a convertible bond compared to a straight bond issue (non-convertible bond).
Director A is concerned that issuing a convertible bond will upset the shareholders for the following reasons:
• it will dilute their control
• the interest payments will be higher therefore reducing liquidity

• it will increase the gearing ratio therefore increasing financial risk
Director B disagrees, and is preparing a board paper to promote the issue of the convertible bond rather than a non-convertible.
Advise the Director B which THREE of the following statements should be included in his board paper to promote the issue of the convertible bond?

A. The convertible bond may not dilute control as the bond holder has an option to choose conversion.
B. The coupon rate on the convertible bond will be lower than that on a non-convertible bond.
C. When converted into shares, the company will receive a cash inflow which can be used for future investments.
D. Issuing a convertible bond will have a more favourable impact on the gearing ratio than a non-convertible bond.
E. Over the life of the bond, a convertible will be more expensive than a non-convertible.

Answer: A, B, D

Question: 9

A private company manufactures goods for export, the goods are priced in foreign currency B$.
The company is partly owned by members of the founding family and partly by a venture capitalist who is helping to grow the business rapidly in preparation for a planned listing in three years' time.
The company therefore has significant long term exposure to the B$.
This exposure is hedged up to 24 months into the future based on highly probable forecast future revenue streams.
The company does not apply hedge accounting and this has led to high volatility in reported earnings.
Which of the following best explains why external consultants have recently advised the company to apply hedge accounting?

A. To provide a more appropriate earnings figure for use in calculating the annual dividend.
B. To make it easier for the market to value the business when it is listed on the Stock Exchange.
C. To ensure that the venture capitalist receives regular annual returns on its investment.
D. To fully adopt IFRS in preparation for listing the company.

Answer: B

Question: 10

A company generates and distributes electricity and gas to households and businesses.
Forecast results for the next financial year are as follows:

	$ million
Revenue from electricity sales at $2.00 per Kilowatt	300
Costs	200
Net profit	100

The Industry Regulator has announced a new price cap of $1.50 per Kilowatt.
The company expects this to cause consumption to rise by 10% but costs would remained unaltered.
The price cap is expected to cause the company's net profit to fall to:

A. $47.5 million profit
B. $27.5 million profit
C. $20.0 million profit
D. $35.0 million loss

Answer: A