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Topic Break Down

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Topic 1, Financial analysis and planning	32
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QUESTION NO: 1

Rehan Gates has in issue 10% debentures of a nominal value of $100. The market price is $90 ex interest.

Ignoring taxation, calculate the cost of this capital if the debenture is redeemable at par after 10 years.

A. 10.20%

B. 14.00%

C. 11.10%

D. 11.76%

ANSWER: D

Explanation:

11.76% is the appropriate answer. The pre-tax cost of redeemable debt is the investor's yield to redemption: the discount rate that equates the current ex-interest market price with the present value of the remaining annual interest receipts and the redemption amount. The annual coupon is $10 (10% × $100 nominal value), the current price is $90, the redemption value is $100, and redemption occurs in 10 years. Thus, the required rate solves: $90 = $10 × annuity factor for 10 years + $100 × discount factor in year 10. Discounting those cash flows at approximately 11.76% produces a value very close to the observed $90 market price, so this is the company's annual pre-tax cost of this debt capital. The yield exceeds the 10% coupon because an investor buys the debenture for $90 but receives $100 on redemption, creating an additional capital gain over its remaining life. "Ex interest" confirms that $90 is the clean price and should not be adjusted for accrued coupon interest in this calculation. Bond valuation discounts coupon payments and principal repayment at the required yield, as described by OpenStax's bond valuation guidance and the yield-to-maturity definition.

QUESTION NO: 2

Aralia Co and Corylus Co both pay a constant dividend of $0.30 per share. Aralia Co has a beta of 1.2 and Corylus Co has a beta of 0.9. The market share price of Aralia Co is $3.70 and the market share price of Corylus Co is $3.80.

The market rate of return is 8% and the risk free rate is 5%.

Based on the Capital Asset Pricing Model (CAPM) analysis, which ONE of the following combinations (underpriced/overpriced) concerning the market price of the shares of Aralia Co and Corylus Co is correct?

A. Aralia Co = Overpriced, Corylus Co = Overpriced

B. Aralia Co = Overpriced, Corylus Co = Underpriced

C. Aralia Co = Underpriced, Corylus Co = Overpriced

D. Aralia Co = Underpriced, Corylus Co = Underpriced

ANSWER: B

Explanation:

Aralia Co = Overpriced, Corylus Co = Underpriced is correct. CAPM gives the return required by shareholders as the risk-free rate plus beta multiplied by the market risk premium. The market risk premium is 3% (8% less 5%). Aralia Co's required return is therefore 8.6%: 5% + (1.2 × 3%). With a constant annual dividend of $0.30 and no dividend growth, its CAPM-based intrinsic value is $3.49 approximately ($0.30 / 0.086). Since its actual market price of $3.70 exceeds this value, it is overpriced relative to the return required for its systematic risk. Corylus Co's required return is 7.7%: 5% + (0.9 × 3%). Its intrinsic value is approximately $3.90 ($0.30 / 0.077). Its market price of $3.80 is below that value, so it is underpriced. This applies the constant-growth dividend valuation model with a zero growth rate, alongside CAPM's beta-based required return. Further background on CAPM is available from the CFA Institute's Capital Asset Pricing Model refresher.

QUESTION NO: 3

Companies often invest temporary surplus cash to earn income. Consider the following statements:

1) The main advantage of short-term deposits with finance houses is that they are easily transferable to another investor should the company require cash sooner than previously thought.

2) Treasury bills are short-term instruments issued by government when they need money. They pay a small amount of cash interest on the sum invested.

Which ONE of the following combinations (true/false) is correct?

A. Statement 1 = True, Statement 2 = True

B. Statement 1 = True, Statement 2 = False

C. Statement 1 = False, Statement 2 = True

D. Statement 1 = False, Statement 2 = False

ANSWER: D

Explanation:

Statement 1 = False, Statement 2 = False is correct. A short-term deposit with a finance house is ordinarily a deposit made for an agreed term, rather than a negotiable security designed to be sold or transferred to a replacement investor. Its attraction to a company with temporary surplus funds is normally a known return over a selected short period, subject to the deposit terms and the institution's creditworthiness. If cash is needed early, access depends on the contractual early-withdrawal provisions and may involve notice, loss of interest, or a penalty; easy transferability is not its defining benefit.

Treasury bills are indeed short-term government borrowing instruments, but their return is generally generated through discounting rather than periodic cash interest payments. An investor purchases a bill below its face (redemption) value and receives the full face value at maturity. The difference between the purchase price and redemption value represents the investment return. This discount basis is a key feature of Treasury bills and is particularly relevant when comparing cash-management instruments. The UK Debt Management Office describes Treasury bills as being issued at a discount and redeemed at par: UK Debt Management Office—Treasury bills. The Bank of England also explains Treasury bill issuance and settlement through its money-market operations: Bank of England—Treasury bills.

QUESTION NO: 4

Dorsal Co intends to make a bonus issue of ordinary shares during the forthcoming year.

Which one of the following will be affected as a result of the issue?

A. Financial gearing

B. Total equity

C. Earnings per share

D. Liquidity

ANSWER: C

Explanation:

Earnings per share will be affected because a bonus issue increases the number of ordinary shares in issue without bringing additional resources into the business. The same pool of earnings is therefore represented by a larger number of shares, changing the earnings attributable to each individual share. This is particularly important for reported EPS because it is intended to allow meaningful comparison between periods and between entities.

IAS 33 requires the weighted-average number of ordinary shares used in basic EPS to be adjusted retrospectively for a bonus issue, share split, or similar event in which the number of shares changes without a corresponding change in resources. Accordingly, the bonus element is treated as if the additional shares had always existed for EPS-comparison purposes. Comparative EPS figures are restated on the same basis, and the adjusted share number is used in calculating

the current period's EPS. The adjustment ensures that an apparent reduction in EPS caused solely by the increased share count is presented consistently and is not confused with a change in the company's operating performance or profitability.

See IAS 33 Earnings per Share, especially the requirements for bonus issues and retrospective adjustment, and the IFRS IAS 33 overview.

QUESTION NO: 5

Consider the following statements:

1. A beta factor measures the relationship between market returns and the returns of an individual security.

2. A share that has a beta of 1·0 will have an expected return equal to the risk-free rate.

Which ONE of the following combinations (true/false) is correct?

A. Statement 1 = True, Statement 2 = True

B. Statement 1 = True, Statement 2 = False

C. Statement 1 = False, Statement 2 = True

D. Statement 1 = False, Statement 2 = False

ANSWER: B

Explanation:

Statement 1 = True, Statement 2 = False is correct. Beta is a measure of systematic risk: it expresses the sensitivity of an individual security's returns to movements in the return on the market portfolio. More specifically, beta is derived from the covariance between the security's return and market return, relative to the variance of market returns. It therefore captures the relationship between the two return series and indicates how strongly the security tends to move when the market changes.

Under the Capital Asset Pricing Model (CAPM), expected return is calculated as the risk-free rate plus beta multiplied by the market risk premium: expected return = risk-free rate + beta × (market return − risk-free rate). Consequently, where beta is 1.0, the security has the same systematic risk as the market and its expected return equals the expected market return, not the risk-free rate. The risk-free rate is the expected return associated with a beta of zero. This distinction is central to applying CAPM when estimating a cost of equity or evaluating the return required for a given level of systematic risk. See the SEC Investor.gov explanation of beta and OpenStax's CAPM overview.

QUESTION NO: 6

Gobi Co has irredeemable 4% loan notes in issue with a nominal value of $20m. The current market value of the loan notes is $10 million and the tax rate is 25%. The equity shares of Gobi Co have a total market capitalization of $30 million. The company's weighted average cost of capital is 10%.

What is the cost of equity for Gobi Co?

A. 10.7%

B. 11.3%

C. 12.3%

D. 12.5%

ANSWER: B

Explanation:

11.3% is the cost of equity. For irredeemable debt, the pre-tax cost of debt is the annual interest payment divided by the debt's current market value. The annual coupon is 4% of the $20 million nominal value, or $0.8 million. Dividing $0.8 million by the $10 million market value gives an 8% pre-tax debt cost. Interest is tax deductible, so the after-tax debt cost used in the weighted average cost of capital calculation is 8% × (1 − 0.25) = 6%.

WACC weights must be based on market values. Equity is worth $30 million and debt is worth $10 million, producing equity and debt weights of 75% and 25%, respectively. Therefore: 10% = (0.75 × cost of equity) + (0.25 × 6%). Solving gives a cost of equity of 11.33%, which rounds to 11.3%. This applies the standard market-value WACC framework and the tax adjustment for debt financing. See the ACCA guidance on WACC and Corporate Finance Institute's WACC formula overview.

QUESTION NO: 7

Which ONE of the following statements concerning the issue of shares is correct?

A. A placing of shares involves an offer of shares to selected investors rather than to the general public

B. An offer for sale is an invitation to the general public to subscribe for shares not yet in issue

C. An offer for subscription is an invitation to the general public to subscribe for shares already in issue

D. A bonus issue raises finance through an offer of shares to existing shareholders

ANSWER: A

Explanation:

A placing of shares involves an offer of shares to selected investors rather than to the general public. In a placing, the company normally appoints one or more financial intermediaries, such as investment banks or brokers, to identify and approach suitable institutional or other professional investors. The shares are allocated directly to that restricted group, rather than being offered through a public invitation open to all investors. This can provide an efficient means of raising equity because the issuer can access investors with the resources and expertise to assess the investment, often with a shorter timetable and lower marketing requirements than a retail public offer.

The precise regulatory treatment depends on the jurisdiction, the type of investor approached, the size of the offer, and whether the shares are admitted to trading. In the UK, the Financial Conduct Authority's prospectus regime includes exemptions that can be relevant where offers are made solely to qualified investors or to fewer than 150 persons per EEA/UK state, subject to the applicable rules. The FCA also describes placing as a recognised method by which listed companies may issue securities. These features support the defining distinction in the statement: a placing is targeted at selected investors, not the general public. See the FCA's Prospectus regime guidance and the UK government's guidance on prospectuses.

QUESTION NO: 8

Vela Co is considering a project requiring an immediate investment of $400,000. The project is expected to generate annual cash inflows of $150,000 for four years. The company uses a cost of capital of 10%, and the four-year annuity factor at 10% is 3.170.

By what percentage can the annual cash inflows decrease before the project has a net present value of zero?

A. 12.6%

B. 15.9%

C. 18.9%

D. 50.3%

ANSWER: B

Explanation:

15.9% is correct. The present value of the forecast annual cash inflows is $150,000 multiplied by 3.170, or $475,500. The project's current net present value is therefore $475,500 - $400,000 = $75,500.

For the NPV to fall to zero, the present value of annual inflows must decrease by $75,500. The equivalent annual reduction is $75,500 divided by 3.170 = $23,817. Expressed as a percentage of the original annual inflow of $150,000, this is approximately 15.9%.

Sensitivity analysis measures the extent to which a variable can change before an investment decision is reversed. See ACCA's investment appraisal guidance.

QUESTION NO: 9

Kubilai Co, a listed company, is considering issuing additional equity capital. To ensure that all the new equity shares are sold, Kubilai Co wants to gain assurance that any shares not bought by the general public will be subscribed.

What term correctly describes a firm which agrees to subscribe for the equity shares which are not taken up?

A. A sponsoring member firm

B. An issuing house

C. An underwriter

D. An intermediary

ANSWER: C

Explanation:

An underwriter is correct because an underwriting arrangement gives the issuing company assurance that the full planned amount of equity finance will be raised. The underwriter commits, in return for an underwriting fee, to subscribe for any shares that remain unsubscribed after the offer has been made to the public. These unpurchased shares are commonly called the “underwriting commitment” or the “shortfall.” Consequently, Kubilai Co can proceed with its equity issue knowing that it will receive the intended capital even if investor demand is insufficient to take up every new share directly. Underwriting is particularly valuable where the company needs certainty over the funds available for investment, acquisition, or refinancing purposes. The underwriter will normally assess the issuer’s financial position, the issue price, market conditions, and likely investor demand before agreeing to the commitment, as it assumes the risk of having to hold or later sell any shares not taken up. The UK Financial Conduct Authority’s prospectus framework recognises underwriting arrangements as a material element of an offer, including disclosure concerning underwriting commitments where applicable. See the FCA Prospectus Regulation Rules on underwriting and the U.S. SEC investor overview of going public.

QUESTION NO: 10

Lyra Co has issued $100 7% irredeemable preference shares which are currently quoted at $92 per share.

What is the cost of preference shares for Lyra Co?

A. 7.00%

B. 7.61%

C. 7.92%

D. 8.24%

ANSWER: B

Explanation:

7.61% is correct. The cost of irredeemable preference shares is calculated as the annual preference dividend divided by the current market value of the preference share. The annual dividend is 7% of the $100 nominal value, or $7.

The cost of preference shares is therefore $7 divided by $92 = 0.0761, or 7.61%. Preference dividends are paid from post-tax profits and are not normally tax deductible, so no tax adjustment is made. This differs from the after-tax treatment generally applied to interest on debt. See ACCA: Cost of capital.