Financial Strategy

Cima F3

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QUESTION NO: 1

Company B is an all equity financed company with a cost of equity of 10%.

It is considering issuing bonds in order to achieve a gearing level of 20% debt and 80% equity.

These bonds will pay a coupon rate of 5% and have an interest yield of 6%.

Company B pays corporate tax at the rate of 25%.

According to Modigliani and Miller's theory of capital structure with tax what will be Company B's new cost of equity?

A)

B)

C)

D)

A. Option A

B. Option B

C. Option C

D. Option D

ANSWER: B

QUESTION NO: 2

A company's current earnings before interest and taxation are $5 million.

These are expected to remain constant for the forseeable future.

The company has 10 million shares in issue which currently trade at $3.60.

It also has a $10 million long term floating rate loan.

The current interest rate on this loan is 5%.

The company pays tax at 20%.

The company expects interest rates to increase next year to 6% and it's Price/Earnings (P/E) ratio to move to 9.5 times by the end of next year.

What percentage reduction in the share price will occur by the end of next year if the interest rate increase and the P/E movement both occur?

A. Reduction of 7%

B. Reduction of 5%

C. Reduction of 1%

D. Reduction of 0%

ANSWER: A

QUESTION NO: 3

Which THREE of the following long term changes are most likely to increase the credit rating of a company?

A. An increase in the interest cover ratio.

B. A decrease in the (Net debt) / (Earnings before interest tax depreciation and amortisation) ratio.

C. An increase in the free cashflow generated from operations.

D. A decrease in the (Book value of debt) / (Book value of equity) ratio.

E. A decrease in the dividend cover ratio.

ANSWER: A B C

QUESTION NO: 4

A listed publishing company owns a subsidiary company whose business activity is training.

It wishes to dispose of the subsidiary company.

The following information is available:

The board of the publishing company believe that the value of the subsidiary company and hence the value of the equity invested in it can be determined by calculating the present value of the subsidiary's free cashflows.

Which of the following is the most appropriate discount rate to use when determining the enterprise value of the company?

A. A WACC that reflects the gearing of the publishing company and the asset beta of a listed company that provides training activities.

B. A cost of equity that reflects the asset beta of a listed company that provides training activities.

C. A WACC that reflects the gearing of the subsidiary company and the asset beta of a listed company that provides training activities.

D. A WACC that the reflects the gearing of the publishing company and the equity beta factor of the publishing company.

ANSWER: A

QUESTION NO: 5

A consultancy company is dependent for profits and growth on the high value individuals it employs.

The company has relatively few tangible assets.

Select the most appropriate reason for the net asset valuation method being considered unsuitable for such a company.

A. It does not account for the intangible assets.

B. It accounts for the intangible assets at historical value.

C. It accounts for intangible assets at net realisable value.

D. It does not account for tangible assets.

ANSWER: A

QUESTION NO: 6

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A. Reduction of 7%

B. Reduction of 5%

C. Reduction of 1%

D. Reduction of 0%

ANSWER: A

QUESTION NO: 7

A company's Board of Directors is assessing the likely impact of financing new projects by using either debt or equity finance.

The impact of using debt or equity finance on some key variables is uncertain.

Which THREE of the following statements are true?

A. The use of equity finance reduces the company's overall financial risk.

B. The use of equity finance will create pressure for increases in dividend per share in the future.

C. The use of debt finance will always result in an increase in earnings per share.

D. Retained earnings is the cheapest form of equity finance.

E. The use of debt finance increases the cost of equity.

F. The use of debt finance is always preferable to equity finance.

ANSWER: A B E

QUESTION NO: 8

Company A is a listed company that produces pottery goods which it sells throughout Europe. The pottery is then delivered to a network of self employed artists who are contracted to paint the pottery in their own homes. Finished goods are distributed by network of sales agents.The directors of Company A are now considering acquiring one or more smaller companies by means of vertical integration to improve profit margins.

Advise the Board of Company A which of the following acquisitions is most likely to achieve the stated aim of vertical integration?

A. A company in a similar market to Company A.

B. A pottery factory in the Middle East.

C. A company that produces accessories.

D. A listed international logistics firm.

ANSWER: D

QUESTION NO: 9

The Board of Directors of a listed company have decided that it needs to increase its equity capital to ensure it is in a more stable financial position.

The shareholder profile is a mix of institutional and individual small shareholders.

The board is considering either:

• A scrip dividend

• A zero dividend

Which THREE of the following would be considered disadvantages of a scrip dividend compared to a zero dividend?

A. A scrip dividend results in distributable reserves being moved to non-distributable reserves.

B. A scrip dividend will dilute the control of current shareholders.

C. A scrip dividend results in more shares in issue which will create an expectation for future dividends.

D. There will be company secretarial and additional administration involved with a scrip dividend.

E. A scrip issue may give shareholders the impression that they are receiving something of value.

ANSWER: A C D

QUESTION NO: 10

Two listed companies in the same industry are joining together through a merger.

What are the likely outcomes that will occur after the merger has happened?

Select ALL that apply.

A. Increase in customer base.

B. Competition authorities step in to stop a potential price monopoly.

C. Decrease in employee motivation due to internal changes.

D. Changes to supplier relationships owing to internal changes.

E. Cost savings from synergistic benefits and economies of scale.

ANSWER: A C D E

QUESTION NO: 11

A listed company in a high growth industry where innovation is a key driver of success has always operated a residual dividend policy resulting in volatility in dividends due to periodic significant investments in research and development.

The company has recently come under pressure from some investors to change its dividend policy so that shareholders receive a consistent growing dividend. In addition they suggested that the company should use more debt finance.

If the suggested change is made to the financial policies which THREE of the following statements are true?

A. It may give a signal to the market that the company is entering a period of stable growth.

B. There may be a change to the shareholder profile due to 'the clientele effect'.

C. The directors will not have to take shareholder dividend preferences into consideration in future.

D. Retained earnings have a lower cost than debt finance.

E. The company's financial risk will increase due to its increased use of debt finance.

ANSWER: A B E

QUESTION NO: 12

A national airline has made an offer to acquire a smaller airline in the same country.

Which of the following would be of most concern to the competition authorities?

A. After the acquisition the board propose to reduce the number of flight destinations from the country.

B. The board informed a major institutional shareholder about the proposed acquisition before informing other shareholders.

C. After the acquisition the board propose to increase prices significantly on routes where no other airlines operate.

D. The acquisition is likely to result in significant redundancies of staff currently working for the smaller airline.

ANSWER: C

QUESTION NO: 13

A company plans a four-year project which will be financed by either an operating lease or a bank loan.

Lease details:

• Four year lease contract.

• Annual lease rentals of $45 000 paid in advance on the 1st day of the year.

Other information:

• The interest rate payable on the bank borrowing is 10%.

• The capital cost of the project is $200 000 which would have to be paid at the beginning of the first year.

• A salvage or residual value of $100 000 is estimated at the end of the project's life.

• Purchased assets attract straight line tax depreciation allowances.

• Corporate income tax is 20% and is payable at the end of the year following the year to which it relates.

A lease-or-buy appraisal is shown below:

Which THREE of the following items are errors within the appraisal?

A. Lease payments are timed incorrectly

B. Tax relief on lease payments have not been lagged correctly

C. Using the 10% discount rate is incorrect

D. The project's operating cashflows should be included

E. The bank loan repayments should be included

F. The salvage value has been included within the lease option

ANSWER: B C F

QUESTION NO: 14

Company F's current profit before interest and taxation is $5.0 million.

It has a 10% long-term corporate bond in issue with a nominal value of $10 million.

Corporate tax is paid at 25%.

The industry average P/E multiple is 10.

Company X has made an approach to acquire the entire share capital of Company F for $30 million.

Company X has announced that anticipated synergies (after interest and taxation) arising from its acquisition of Company F will be $1 million each year in perpetuity.

Advise the Board of Directors of Company F if the bid should be accepted based on the above information?

A. Accept the bid because Company F is potentially worth $30 million to Company X.

B. Reject the bid because Company F is potentially worth $40 million to Company X.

C. Reject the bid because Company F is potentially worth $50 million to Company X.

D. Reject the bid because Company F is potentially worth $60 million to Company X.

ANSWER: B

QUESTION NO: 15

Which THREE of the following would be most important if a hospital wishes to review the effectiveness of its services?

A. The proportion of surgical procedures that are deemed to be successful.

B. Average waiting times for treatment.

C. Patient satisfaction ratings.

D. Staff costs compared to previous years.

E. Revenue generated from car park charges.

ANSWER: A B C