CIMA

F3
Financial Strategy

Question: 1

On 31 October 20X3:
• A company expected to agree a foreign currency transaction in January 20X4 for settlement on 31 March 20X4.
• The company hedged the currency risk using a forward contract at nil cost for settlement on 31 March 20X4.
• The transaction was correctly treated as a cash flow hedge in accordance with IAS 39 Financial Instruments: Recognition and Measurement.
On 31 December 20X3, the financial year end, the fair value of the forward contract was $10,000 (asset).
How should the increase in the fair value of the forward contract be treated within the financial statements for the year ended 31 December 20X3?

A. Not recognised in 20X3 as the forward contract is not settled until after the year end.
B. Not recognised in 20X3 as the gain will be offset by a loss on the hedged transaction.
C. A $10,000 profit will be recognised within the Income Statement.
D. A $10,000 profit will be recognised within other comprehensive income.

Answer: D

Question: 2

A company is funded by:
• $40 million of debt (market value)
• $60 million of equity (market value)
The company plans to:
• Issue a bond and use the funds raised to buy back shares at their current market value.
• Structure the deal so that the market value of debt becomes equal to the market value of equity.
According to Modigliani and Miller's theory with tax and assuming a corporate income tax rate of 20%, this plan would:

A. increase the company's asset beta.
B. decrease the company's equity beta.
C. increase shareholder wealth.
D. increase the market value of the company's equity.

Answer: C

Question: 3

A company has 6 million shares in issue. Each share has a market value of $4.00.

$9 million is to be raised using a rights issue.
Two directors disagree on the discount to be offered when the new shares are issued.
• Director A proposes a discount of 25%
• Director B proposes a discount of 30%
Which THREE of the following statements are most likely to be correct?

A. The theoretical ex-rights price will be higher under Director B's proposal than under Director A's proposal.
B. More shares will be issued under Director B's proposal than under Director A's proposal.
C. The rights issue price will be $3.00 under Director A's proposal.
D. The terms of the rights issue will be one new share for every two existing shares under Director A's proposal.
E. Shareholder wealth will be higher under Director A's proposal than under Director B's proposal.

Answer: B, C, D

Question: 4

A wholly equity financed company has the following objectives:
1. Increase in profit before interest and tax by at least 10% per year.
2. Maintain a dividend payout ratio of 40% of earnings per year.
Relevant data:
• There are 2 million shares in issue.
• Profit before interest and tax in the last financial year was $5 million.
• The corporate income tax rate is 30%.
At the beginning of the current financial year, the company raised long term debt of $2 million at 10% interest each year.
Calculate the dividend per share that will be announced this year assuming the company achieves its objective of increasing profit before interest and tax by 10%.

A. $0.74
B. $0.67
C. $1.11
D. $1.01

Answer: A

Question: 5

When valuing an unlisted company, a P/E ratio for a similar listed company may be used but adjustments to the P/E ratio may be necessary.
Which THREE of the following factors would justify a reduction in the proxy p/e ratio before use?

A. The relative lack of marketability of unlisted company shares.

B. A lower level of scrutiny and regulation for unlisted companies.
C. Unlisted companies being generally smaller and less established.
D. Control premium not being included within the proxy p/e ratio used.
E. The forecast earnings growth being relatively higher in the unlisted company.
F. A profit item within the unlisted company's latest earnings which will not reoccur.

Answer: A, B, C

Question: 6

A company is financed as follows:
• 400 million $1 shares quoted at $3.00 each.
• $800 million 5% bonds quoted at par.
The company plans to raise $200 million long term debt to finance a project with a net present value of $100 million.
The bank that is providing the debt is insisting on a maximum gearing level covenant.
Gearing will be based on market values and calculated as debt/(debt + equity).
What is the lowest figure for the gearing covenant that the bank could impose without the company breaching the agreement?

A. 43%
B. 44%
C. 45%
D. 46%

Answer: B

Question: 7

Hospital X provides free healthcare to all members of the community, funded by the central Government.
Hospital Y provides healthcare which has to be paid for by the individual patients. It is a listed company, owned by a large number of shareholders.
In comparing the above two organisations and their objectives, which THREE of the following statements are correct?

A. X is a not-for-profit organisation while Y is a for-profit organisation.
B. X and Y have the same primary financial objective - to maximise shareholder wealth.
C. The performance of X will be appraised primarily on the basis of value for money.
D. Only Y is likely to have a mixture of financial and non-financial objectives.
E. X and Y will have the same primary non financial objective - provision of quality of health care.

Answer: A, C, E

Question: 8

Companies A, B, C and D:
• are based in a country that uses the K$ as its currency.
• have an objective to grow operating profit year on year.
• have the same total levels of revenue and cost.
• trade with companies or individuals in the eurozone. All import and export trade with companies or individuals in the eurozone is priced in EUR.
Typical import/export trade for each company in a year are as follows:
Which company's growth objective is most sensitive to a movement in the EUR/K$ exchange rate?

A. Company A
B. Company B
C. Company C
D. Company D

Answer: B

Question: 9

A company has a cash surplus which it wishes to distribute to shareholders by a share repurchase rather than paying a special dividend.
Which THREE of the following statements are correct?

A. The payment of a special dividend could raise shareholders' expectations of similar distributions in the future, unlike a share repurchase.
B. The share repurchase could send a negative signal to shareholders as it could be interpreted as a failure of management to find suitable investment opportunities.
C. Determination of the repurchase price will be easy as shareholders will insist on receiving the open market price.
D. Different tax regimes could result in shareholders having a preference for a share repurchase due to the often more preferential tax treatment of capital gains.
E. The share repurchase, if approved by the shareholders, will be binding on all of the company's shareholders.

Answer: A, B, D

Question: 10

A company's gearing (measured as debt/(debt + equity)) is currently 60% and it is investigating whether an optimal gearing structure exists within the industry.

It has analysed the capital structure of similar companies in the industry and it would appear that there is evidence supporting the traditional theory of capital structure.
Companies with the lowest WACC in the industry have gearing of around 45% to 50%.
Which of the following actions would result in the company achieving a more optimal capital structure?

A. Undertaking a rights issue of equity to repay some of its debt.
B. Refinancing to replace some of its short term debt with long term debt.
C. Increasing the level of dividend to return more cash to shareholders.
D. Using retained cash to undertake a buyback of some of its equity.

Answer: A

Question: 11

CORRECT TEXT
A company is planning to repurchase some of its shares. Relevant details are as follows:
• 100 million shares in issue
• Current share price $5
• 5 million shares to be repurchased
• 10% repurchase premium
• Repurchased shares to be cancelled
What would you expect the share price after the repurchase to be?
Give your answer to two decimal places.
$?

Answer: 4.97, 4.98