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CIMA F3 Financial Strategy Sample Questions (Q401-Q406):

NEW QUESTION # 401
The directors of the following four entities have been discussing dividend policy:
Which of these four entities is most likely to have a residual dividend policy?

- A. A
- B. B
- C. C
- D. D

Answer: B

NEW QUESTION # 402

Company M is a geared company whose equity has a market value of $1,500 million and debt has a market value of S300 million. The company plans to issue $200 million of new shares and use the funds raised to pay off some of the debt Company M currently has a cost of equity of 13% and a WACC of 10% It pays corporate tax at the rate of 30% Company B, an ungeared company operating in the same business sector as Company M, has a cost of equity of 12% Assume Modigliani and Miller's theory of capital structure with tax applies Which calculation below shows the correct approach to calculating the new WACC following the planned changes in capital structure?

- A.
- B.
- C.
- D.

Answer: D

NEW QUESTION # 403
An all equity financed company reported earnings for the year ending 31 December 20X1 of $5 million.
One of its financial objectives is to increase earnings by 5% each year.
In the year ending 31 December 20X2 it financed a project by issuing a bond with a $1 million nominal value and a coupon rate of 7%.
The company pays corporate income tax at 30%.
If the company is to achieve its earnings target for the year ending 31 December 20X2, what is the minimum operating profit (profit before interest and tax) that it must achieve?

- A. $7.57 million
- B. $7.50 million
- C. $8.40 million
- D. $5.25 million

Answer: A

NEW QUESTION # 404
WW is a quoted manufacturing company. The Finance Director has addressed the shareholders during WW's annual general meeting-She has told the shareholders that WW raised equity during the year and used the funds to repay a large loan that was maturing, thereby reducing WW's gearing ratio At the conclusion of the Finance Director's speech one of the shareholders complained that it had been foolish for WW to have used equity to repay debt The shareholder argued that the Modigliani and Miller model (with tax) offers proof that debt is cheaper than equity when companies pay tax on their profits.
Which THREE arguments could the Finance Director have used in response to the shareholder?

- A. A lower gearing ratio will result in an increase in the value of the company
- B. Reducing the gearing ratio has reduced the financial risk of WW which will benefit shareholders
- C. A lower gearing ratio creates greater flexibility for WW in the future
- D. The Modigliani and Miller model would only be valid in practice if WW's shareholders were aware of the model and believed in its validity
- E. The shareholder was confusing the cost of capital with shareholder wealth
- F. WW was approaching a debt covenant limit and it was therefore important to reduce gearing.

Answer: B,C,F

Explanation:
B). WW was approaching a debt covenant limit...
If gearing was close to a covenant ceiling, repaying debt with equity avoids breaching the covenant and the costly consequences (default, renegotiation, higher rates).
C). A lower gearing ratio creates greater flexibility...
With less debt, WW has more headroom to borrow in the future if good projects arise, and is less constrained by lenders.
E). Reducing the gearing ratio has reduced the financial risk...
Less debt means lower risk of financial distress and lower volatility of equity returns, which is beneficial for shareholders even if debt is "cheaper" before adjusting for risk.
Why not the others?
A is not generally true; under MM with tax, more debt can increase firm value up to a point.

D is a bit off-target: the issue is not confusing cost of capital with wealth, but ignoring financial risk and constraints.
F is just wrong - a theory's validity doesn't depend on whether shareholders know it exists.

NEW QUESTION # 405
Company P is a pharmaceutical company listed on an alternative investment market.
The company is developing a new drug which it hopes to market in approximately six years' time.
Company P is owned and managed by a group of doctors who wish to retain control of the company. The company operates from leased laboratories with minimal fixed assets.
Its value comes from the quality of its research staff and their research.
The company currently has one approved drug which generates sufficient cashflow to cover day to day operations but not sufficient for major new research and development.
Company P wish to raise debt finance to develop the new drug.
Recommend which of the following types of debt finance would be most appropriate for Company P to help finance the development of this new drug.

- A. 6% Eurobond repayable at par in 5 years' time.
- B. 3% Commercial Paper.
- C. 5% Bond repayable at par in 7 years' time.
- D. 4% Convertible bond with a conversion ratio of 350 ordinary shares per bond.

Answer: D

NEW QUESTION # 406
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