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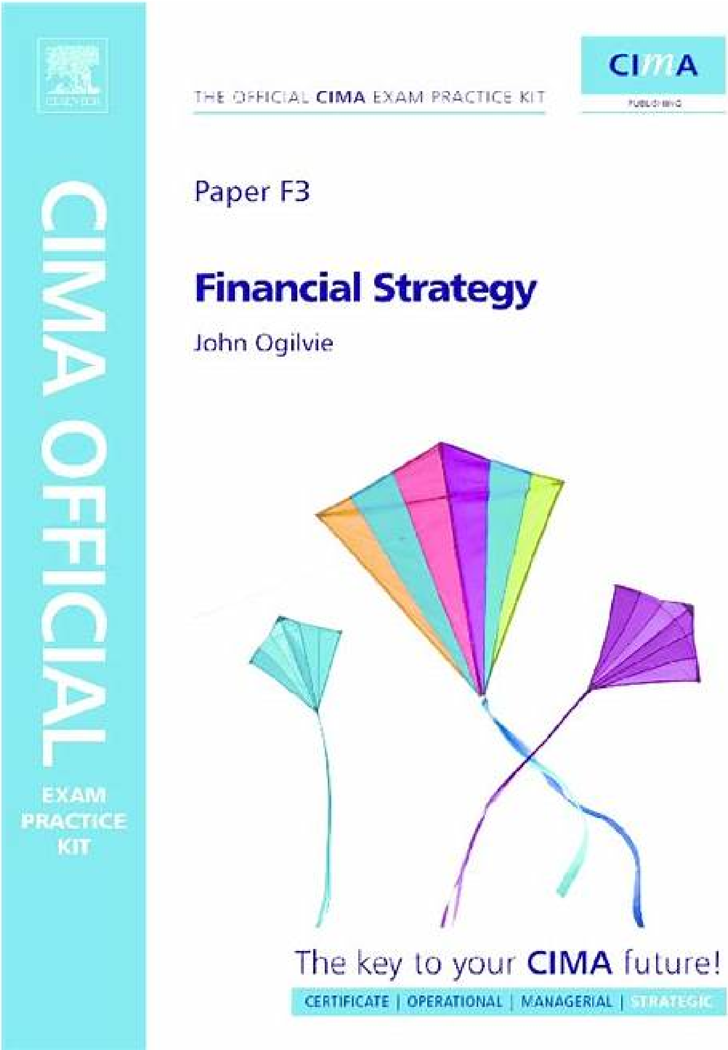

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CIMA F3 Financial Strategy Sample Questions (Q163-Q168):

NEW QUESTION # 163
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 market value of the company's equity.
- B. increase shareholder wealth.
- C. increase the company's asset beta.
- D. decrease the company's equity beta.

Answer: B

Explanation:
According to Modigliani and Miller with tax, the value of a levered firm is:
VL=VU+Tc×DV_L = V_U + T_c \times DVL=VU+Tc×D
where TcT_cTc is the corporate tax rate and DDD is the market value of debt. With corporate income tax, interest is tax-deductible, so increasing debt creates a tax shield and increases total firm value.
Initially:
Debt = 40
Equity = 60
Total value = 100
Tax rate = 20%.
If the company increases debt and uses the proceeds to buy back shares until debt equals equity, then:
New structure: D=ED = ED=E
Total firm value rises because Tc×DT_c \times DTc×D increases.
The extra value (PV of the additional tax shield) accrues to shareholders, even though the accounting market value of equity after the buyback may fall in absolute terms; shareholders have also received cash from the buyback, so their total wealth increases.
Business risk (and therefore asset beta) is unchanged; however equity beta would rise, not fall, because of higher financial leverage.
Therefore the only correct statement is that the plan would increase shareholder wealth - answer C.

NEW QUESTION # 164
Company E is a listed company. Its directors are valuing a smaller listed company, Company F, as a possible acquisition.
The two companies operate in the same markets and have the same business risk.
Relevant data on the two companies is as follows:
Both companies are wholly equity financed and both pay corporate tax at 30%.
The directors of Company E believe they can "bootstrap" Company F's earnings to improve performance.
Calculate the maximum price that Company E should offer to Company F's shareholders to acquire the company.
Give your answer to the nearest $million.

- A. 2,700
- B. 1,890
- C. 4,500
- D. 3,150

Answer: D

NEW QUESTION # 165
The value of a call option will increase because of:

- A. An increase in the time to expiry.
- B. A decrease in the market value of the share
- C. An increase in the strike price.
- D. A decrease in the volatility of the share.

Answer: A

Explanation:
The value of a call option increases when:
The underlying share price increases
The strike price decreases
The time to expiry increases
Volatility increases
Risk-free rate increases
Looking at the options:
A). Increase in strike price # reduces call value
B). Decrease in volatility # reduces call value
C). Increase in time to expiry # increases call value #
D). Decrease in share price # reduces call value

NEW QUESTION # 166
A company plans to acquire new machinery.
It has two financing options; buy outright using a bank loan, or a finance lease.
Which of the following is an advantage of a finance lease compared with a bank loan?

- A. Tax depreciation allowances may be passed on to the company by the lessor.
- B. The interest rate offered might be more favourable because the lessor has the security of the asset.
- C. The lessor provides maintenance of the asset.
- D. It is "off-balance sheet" and will not affect the company's gearing.

Answer: B

Explanation:
In CIMA F3, finance leases are analysed as a form of debt financing and are compared directly with bank loans when evaluating long-term funding options. The syllabus (under Financing Decisions and Leasing vs Buying) explains that a finance lease is economically similar to borrowing to purchase an asset, because the lessee assumes substantially all the risks and rewards of ownership.
Option B is correct because one key advantage of a finance lease over a bank loan is that the lessor retains legal ownership of the asset, which provides strong security for the lender. As a result, the lessor's risk is lower than that of a bank providing an unsecured or partially secured loan. CIMA F3 study guidance highlights that this reduced risk can allow the lessor to offer more favourable interest rates or financing terms than a conventional bank loan.
The other options are incorrect under current accounting and financial strategy principles:
A is incorrect because finance leases are not off-balance sheet. Under IFRS 16 (examined in F3), finance leases must be recognised on the statement of financial position, increasing both assets and liabilities and therefore affecting gearing.
C is incorrect because tax depreciation (capital allowances) normally remain with the legal owner, the lessor.
These benefits are not "passed on" directly, although they may be reflected indirectly in lease pricing.
D is incorrect because maintenance is a feature of operating leases, not finance leases. In a finance lease, the lessee is responsible for maintenance and insurance.

NEW QUESTION # 167
Company T has 1,000 million shares in issue with a current share price of $10 each.
Company V has 300 million shares in issue with a current share price of $5 each.

Company T is considering acquiring Company V.
Total synergy gains of $100 million have been estimated.
The purchase of Company V's shares would be by cash at a 10% premium above the current share price.
In seeking approval for the acquisition, the likely reaction from T's shareholders will be:

- A. rejected as T's shareholders will see a decrease in their wealth overall of $50 million.
- B. accepted as there is $100 million of synergy which will all go to T's shareholders.
- C. accepted as there will be an increase in the value of the business of $1,500 million.
- D. rejected as T's shareholders will not be willing to pay more than $1,500 million for V.

Answer: A

NEW QUESTION # 168
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