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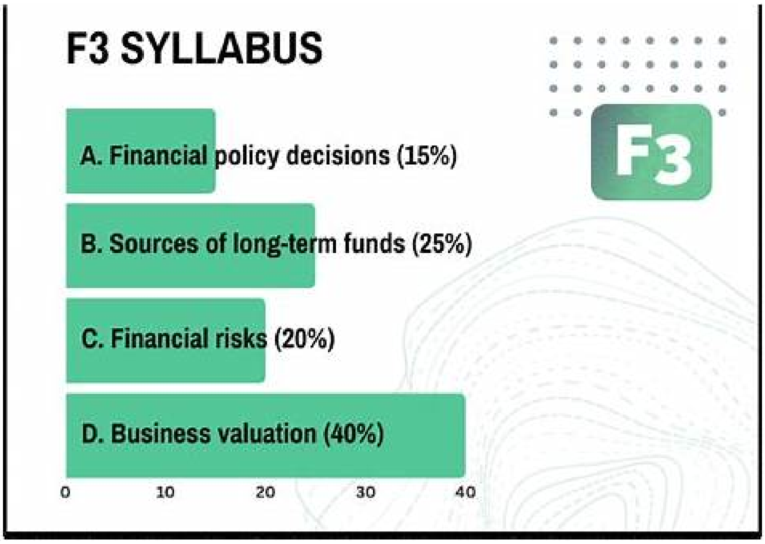

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CIMA F3 Financial Strategy Sample Questions (Q129-Q134):

NEW QUESTION # 129
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.

Answer: D

NEW QUESTION # 130
A company's dividend policy is to pay out 50% of its earnings.
Its most recent earnings per share was $0.50, and it has just paid a dividend per share of $0.25.
Currently, dividends are forecast to grow at 2% each year in perpetuity and the cost of equity is 10.5%.
In order to grow its earnings and dividends, the company is considering undertaking a new investment funded entirely by debt finance. If the investment is undertaken:
* Its cost of equity will immediately increase to 12% due to the increased finance risk.
* Its earnings and dividends will immediately commence growing at 4% each year in perpetuity.
Which of the following is the expected percentage change in the share price if the new investment is undertaken?

- A. Increase = 2%
- B. Decrease = 7.7%
- C. Increase = 10.5%
- D. Increase = 8.3%

Answer: D

Explanation:
Current:
DPS just paid D0=0.25D_0 = 0.25D0=0.25, growth g = 2%, ke=10.5%k_e = 10.5\%ke=10.5%
D1=0.25×1.02=0.255,P0=0.2550.105#0.02=0.2550.085=3.00D_1 = 0.25 × 1.02 = 0.255,\quad P_0 = \frac {0.255} {0.105 - 0.02} = \frac{0.255} {0.085} = 3.00D1=0.25×1.02=0.255,P0=0.105#0.020.255=0.0850.255=3.00
After investment: growth g = 4%, ke=12%k_e = 12\%ke=12%
D1#=0.25×1.04=0.26,P1=0.260.12#0.04=0.260.08=3.25D_1' = 0.25 × 1.04 = 0.26,\quad P_1 = \frac{0.26} {0.12 - 0.04} = \frac{0.26} {0.08} = 3.25D1#=0.25×1.04=0.26,P1=0.12#0.040.26=0.080.26=3.25 Percentage change: 3.25#3.003.00=0.253=8.33%\frac{3.25 - 3.00} {3.00} = \frac{0.25} {3} = 8.33\%3.003.25#3.00=30.25=8.33%

NEW QUESTION # 131
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. 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
- B. The shareholder was confusing the cost of capital with shareholder wealth
- C. WW was approaching a debt covenant limit and it was therefore important to reduce gearing.
- D. A lower gearing ratio creates greater flexibility for WW in the future
- E. Reducing the gearing ratio has reduced the financial risk of WW which will benefit shareholders
- F. A lower gearing ratio will result in an increase in the value of the company

Answer: C,E,F

NEW QUESTION # 132
Company AEE has a 10 year 6% corporate bond in issue which has a nominal value of $400 million, which is currently trading at 95%. The bond is secured on the company's property
The Board of Directors has calculated the equity value of Company AEE as follows;
Which THREE of the following are errors in the valuation?

- A. Using the company's weighted average cost of capital to discount cash flows attributable to shareholders.
- B. Including retained earnings from the Statement of Financial Position.
- C. Using cash flows to equity rather than expected dividends as the initial cash flows.
- D. Deducting $400 million for the value of the company's corporate bond.
- E. Deducting replacement capital expenditure

Answer: A,B,E

NEW QUESTION # 133
Which of the following statements about the tax impact on debt finance is correct?

- A. Preference share dividends attract tax relief in the same way as debenture interest.
- B. Interest on debt is deducted from post-tax profits.
- C. Debt instruments issued with fixed and floating charges do not attract tax relief on interest paid.
- D. Interest on debt is deducted from pre-tax profits.

Answer: D

NEW QUESTION # 134
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