High F3 Financial Strategy passing score, F3 exam review

Chartered Institute of Management Accountants — Strategic Level F3

Enhancing shareholder wealth: *while the overall aim of all listed firms is to maximise shareholder wealth, specific financial aims in a firm's annual report would not normally make reference to this*

- Decrease cash for bonuses
- Increase brand reputation and recognition
- Invest in projects with positive NPV
- Decrease average cost of capital
  - If entity is all-equity financed, raising debt finance will decrease its cost of capital
- Moving profitable operations to low tax regimes

NOT FOR-PROFIT (NFP) ENTITIES: primary objective is provision of an acceptable level of service to key stakeholders; since services provided are limited by available funds, secondary objective is to raise maximum funds and to use such funds efficiently to maximise benefited generated

- **Public sector entities**: *ie hospitals, nationalised industry, government*; generally run to the benefit of society overall and often regulated; but major problem is obtaining a measurable objective:
  - Budgetary compliance: usually set by government
  - Risk exposure: risk averse due to political repercussions of failure
  - Profitability: largely absent as a concept in its truest form, but may be used to relate inputs to outputs
  - Cash generation
  - Value added
  - Return on Assets (RoA): interpretation impacted in the public sector as concept of profit is largely absent
  - Market share: increasingly relevant
  - Competitive position: increasingly relevant

Value for money (VFM) / 3Es: useful means of appraising NFP performance under the umbrella term 'cost-effectiveness'; the optimal use of resources to achieve the intended outcome

1. **Economy** (input measure): minimise the cost of resources (inputs) used; spend less
2. **Efficiency** (links input to output): relationship between products (outputs) and resources (inputs) used to produce them; spend well
3. **Effectiveness** (output measure): relationship between inputs and actual results of public spending (outcomes); spend wisely

…a fourth E is suggested: 4. **Equity**: extent to which services reach all people intended; spend fairly

- **VFM audit**: investigating whether arrangements have been made for securing 3Es in use of resources; focuses on specific area of expenditure to conclude if VFM has been achieved
  - Purpose: independent analysis on the way money has been spent to achieve policy objectives

For profit entity	Not for profit entity
Aim to maximise shareholder wealth	Aim to provide an acceptable level of service to key stakeholders and are concerned with VFM
Aim to satisfy a wide range of stakeholders	Aim to satisfy a wide range of stakeholders
Have financial and profit objectives	Do not have profit orientated objectives, but may have financial objectives

INTERNATIONAL OPERATIONS: entities are increasingly expanding across national boundaries in the modern business environment, resulting in some additional considerations:

Strategic considerations of international expansion	Financial considerations of international expansion
Risk management: interest rates, foreign exchange rates, government policy Competition: foreign markets may have weaker/stronger competition	Maximisation of shareholder wealth: by undertaking positive NPV projects internationally
Customers: may enhance/worsen customer relationships by moving closer/further away; while also exposing the firm to pool of potential new customers Economies of scale Costs: higher distribution costs; possibly lower raw materials and labour costs	Impact on financial statements: assets/transactions denominated in a foreign currency must be converted to the domestic (functional) currency, thus exposing the entity to translation risk as exchange rates fluctuate
Ethical issues: taking advantage of less developed labour laws Cultural issues: differences in language, customs, and advertising	Impact on cost of capital: likely to change to reflect increased associated risk

FINANCIAL PERFORMANCE APPRAISAL: investors (shareholders and lenders) appraise entity performance to asses whether it represents a good investment, necessitating ratio analysis:

- **Gross profit** = Revenue / sales - Cost of goods sold (COGS)
- **Operating profit** / Profit before interest and tax (PBIT) = Gross profit - Operating expenses
- **Profit before tax** = Operating profit - Finance costs (interest payable)
- **Earnings** / Net income / Profit after tax (PAT) = Profit before tax - Tax

PROFITABILITY RATIOS: ideal value varies; important to compare over time and between entities

- **Gross profit margin**: % of revenue retained after cost of goods sold (COGS) are deducted

$$Gross\ profit = Revenue - Cost\ of\ goods\ sold\ (COGS)$$

$$Gross\ profit\ margin = \frac{Gross\ profit}{Revenue} \times 100\%$$

- **Operating profit margin**: profit after operating expenses (indirect costs such as administration and distribution costs) but before interest (finance costs) and tax are deducted

$$Operating\ profit = Gross\ profit - Operating\ expenses = Profit\ before\ interest\ and\ tax\ (PBIT)$$

$$Operating\ profit\ margin = \frac{Operating\ profit}{Revenue} \times 100\%$$

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CIMA F3 Financial Strategy Sample Questions (Q204-Q209):

NEW QUESTION # 204
Company AAB is located in country A whose currency is the AS It has a subsidiary, BBA, located m country B that has the BS as its currency AAB has asked BBA to pay BS40 million surplus funds to AAB to assist with a planned new capital investment in country A The exchange rate today is AS1 = BS3
Tax regimes
* Company BBA pays withholding tax of 25% on all cash remitted to the parent company
* Company AAB pays tax of 10% on at cash received from its subsidiary
How much will company AAB have available for investment after receiving the surplus funds from BBA?

- A. A$ 12 million
- B. A$ 81 million
- C. A$ 27 million
- D. A$ 9 million

Answer: D

NEW QUESTION # 205
The long-term prospects for inflation in the UK and the USA are 1% and 4% per annum respectively.
The GBP/USD spot rate is currently GBP/USD1.40
Using purchasing power parity theory, what GBP/USD spot rate would you expect to see in six months' time?

- A. GBP/USD1.44
- B. GBP/USD1.38
- C. GBP/USD1.36
- D. GBP/USD1.42

Answer: D

NEW QUESTION # 206
A UK company enters into a 5 year borrowing with bank P at a floating rate of GBP Libor plus 3% It simultaneously enters into an interest rate swap with bank Q at 4.5% fixed against GBP Libor plus 1.5% What is the hedged borrowing rate, taking the borrowing and swap into account?
Give your answer to 1 decimal place.

- A. 6.0% p.a.The company:Borrows from bank P at Libor + 3%Enters a swap with bank Q: pay fixed 4.5%, receive Libor + 1.5%Combine the cash flows:Pay Libor + 3% (loan)Pay 4.5% (swap fixed leg)Receive Libor + 1.5% (swap floating leg)Net cost:(Libor+3%)+4.5%#(Libor+1.5%)=3%+4.5%#1.5%=6.0% (\text{Libor} + 3\%) + 4.5\% - (\text{Libor} + 1.5\%) = 3\% + 4.5\% - 1.5\% = 6.0\%(Libor+3%)+4.5% #(Libor+1.5%)=3%+4.5%#1.5%=6.0% So the hedged borrowing rate is:
- B. 6.0% p.a.

Answer: A,B

NEW QUESTION # 207
Company BBB has prepared a valuation of a competitor company, Company BBD. Company BBB is intending to acquire a controlling interest in the equity of Company BBD and therefore wants to value only the equity of Company BBD.
The directors of Company BBB have prepared the following valuation of Company BBD:
Value of Equity = 4.63 + 5.14 + 5.56 = S15.33 million

Additional information on Company BBD:
Which THREE of the following are weaknesses of the above valuation?

- A. The valuation is understated as forecast future growth has been ignored beyond year 3.
- B. Free cash flows to all investors should be discounted at the cost of equity of 10% rather than WACC of 8%.
- C. The valuation is understated as the directors have failed to include a perpetuity factor in the calculations.
- D. The approach used calculates the value of the total entity not the value of equity.
- E. The valuation is overstated as the directors have failed to deduct tax from the free cash flows.

Answer: C,D,E

NEW QUESTION # 208
A listed company is planning to raise $21.6 million to finance a new project with a positive net present value of $5 million. The finance is to be raised via a rights issue at a 10% discount to the current share price. There are currently 100 million shares in issue, trading at $2.00 each.
Taking the new project into account, what would the theoretical ex-rights price be?
Give your answer to two decimal places.

Answer:

Explanation:
$?
2.02, 2.03
Explanation:
In CIMA F3, rights issues and post-issue valuation are taught under the learning outcomes relating to financing decisions, equity issuance, and shareholder value analysis. The Theoretical Ex-Rights Price (TERP) represents the price a share should trade at immediately after the rights issue when the "value dilution" and
"value added" of the project are taken into account.
According to the financial strategy principles taught in F3, the TERP is calculated by adding:
The current market value of equity,
The cash raised from the rights issue, and
The net present value (NPV) of the investment project,
then dividing by the total number of shares after the issue. This reflects the CIMA F3 view that share prices should adjust to reflect both new financing inflows and future economic benefits associated with positive- NPV projects.
Step-by-step application of the F3 method
(1) Current shareholders' equity value:
(2) Rights issue price:
Rights issued at a 10% discount:
(3) Number of new shares issued:
(4) Total shares after issue:
(5) Total value after issue and project:
Add value of cash raised and NPV:
(6) TERP formula:
Rounded to two decimal places:
This calculation follows the CIMA F3 principle that positive-NPV projects increase shareholder wealth, and therefore must be added to the total post-issue company valuation before dividing by the enlarged share capital.

NEW QUESTION # 209
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