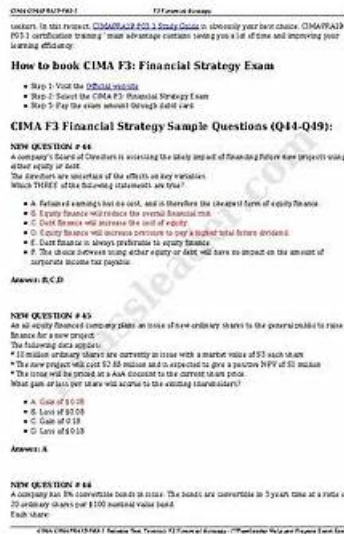


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CIMA F3 Financial Strategy Sample Questions (Q83-Q88):

NEW QUESTION # 83

A company is considering the issue of a convertible bond compared to a straight bond issue (non-convertible bond).

Director A is concerned that issuing a convertible bond will upset the shareholders for the following reasons:

- * it will dilute their control
 - * the interest payments will be higher therefore reducing liquidity
 - * it will increase the gearing ratio therefore increasing financial risk
- Director B disagrees, and is preparing a board paper to promote the issue of the convertible bond rather than a non-convertible.

Advise the Director B which THREE of the following statements should be included in his board paper to promote the issue of the convertible bond?

- A. The convertible bond may not dilute control as the bond holder has an option to choose conversion.
- B. When converted into shares, the company will receive a cash inflow which can be used for future investments.
- C. The coupon rate on the convertible bond will be lower than that on a non-convertible bond.
- D. Issuing a convertible bond will have a more favourable impact on the gearing ratio than a non-convertible bond.
- E. Over the life of the bond, a convertible will be more expensive than a non-convertible.

Answer: A,C,D

Explanation:

A). May not dilute control - A convertible bond does not cause immediate dilution. Bondholders only become shareholders if they choose to convert, usually when the share price performs well. So dilution is potential and future, not automatic at issue.

B). Lower coupon - A core feature of convertibles is that investors accept a lower interest (coupon) rate than on an equivalent straight bond, because they are being compensated by the conversion option. This directly rebuts the concern that interest payments will be higher.

D). More favourable impact on gearing - Compared with issuing a straight bond, a convertible is often viewed as "quasi-equity". Under modern financial reporting, part of the convertible may be classified as equity, and if conversion happens later, the bond liability disappears and is replaced by shares, reducing gearing. So, from a strategic financing perspective, convertibles are typically seen as less damaging to gearing than an equivalent non-convertible bond.

Options C (no cash inflow on conversion) and E (more expensive over life) are incorrect.

NEW QUESTION # 84

A company is considering hedging the interest rate risk on a 3-year floating rate borrowing linked to the 12-month risk-free rate. If the 12-month risk-free rate for the next three years is 2%, 3% and 4%, which of the following alternatives would result in the lowest average finance cost for the company over the three years?

- A. Do not hedge.
- B. Enter into an interest rate swap at 3.1% fixed against 12-month risk-free rate.
- C. Enter into an interest rate cap at an annual premium of 0.533% and a cap of 3%.
- D. Enter into a zero-cost collar with a floor of 2.9% and a ceiling of 4%.

Answer: A

NEW QUESTION # 85

The primary objective of a public sector entity is to ensure value for money is generated.

Value for money is defined as performing an activity so as to simultaneously achieve economy, efficiency and effectiveness

Efficiency is defined as:

- A. obtaining quality inputs at minimum cost.
- B. obtaining maximum output from minimum inputs
- C. performing activities in the least amount of time possible
- D. spending funds so as to achieve the objectives of the entity.

Answer: C

NEW QUESTION # 86

A venture capitalist invests in a company by means of buying

* 6 million shares for \$3 a share and

* 7% bonds with a nominal value of \$2 million, repayable at par in 3 years' time The venture capitalist expects a return on the equity portion of the investment of at least 20% a year on a compound basis over the first 3 years of the investment The company has 8 million shares in issue What is the minimum total equity value for the company in 3 years' time required to satisfy the venture capitalist's expected return?

Give your answer to the nearest \$ million

\$ million.



Answer:

Explanation:

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Workings Equity investment by the venture capitalist 6 million shares at \$3 each Equity invested = $6m \times \$3$

= \$18 million Required return on equity Target return = 20% per year, compound, for 3 years Future value of equity stake in 3 years: $18 \times (1.2)^3 = 18 \times 1.728 = 31.104$ million $18 \times (1.2)$

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