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# Financial Strategy

## Cima F3

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# Topic Break Down

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QUESTION NO: 1

A company plans to raise $12 million to finance an expansion project using a rights issue.

Relevant data:

• Shares will be offered at a 20% discount to the present market price of $15.00 per share.

• There are currently 2 million shares in issue.

• The project is forecast to yield a positive NPV of $6 million.

What is the yield-adjusted Theoretical Ex-Rights Price following the announcement of the rights issue?

**A.** $16.00

**B.** $14.00

**C.** $9.00

**D.** $11.00

**ANSWER: A**

**Explanation:**

**$16.00** is the yield-adjusted theoretical ex-rights price. The rights are issued at a 20% discount to the current $15.00 market price, so the subscription price is $12.00 per share. To raise $12 million, the company must issue 1 million new shares. Following the issue, there will therefore be 3 million shares in issue: the existing 2 million plus the 1 million rights shares.

A standard theoretical ex-rights price incorporates the pre-issue market value of the existing shares and the cash raised. Here, the existing equity is worth $30 million (2 million × $15.00), and the issue raises a further $12 million. Because the question asks for a *yield-adjusted* price, the project's positive $6 million NPV must also be included: it represents value expected to be added for shareholders by undertaking the expansion. Total post-announcement equity value is consequently $48 million ($30 million + $12 million + $6 million). Dividing this by 3 million shares gives a yield-adjusted theoretical ex-rights price of $16.00 per share. This treatment reflects the financial-management principle that a positive-NPV investment increases shareholder wealth. See ACCA's rights issue guidance and Open University material on NPV and shareholder value.

**QUESTION NO: 2**

When valuing an unlisted company a P/E ratio for a similar listed company may be used but adjustments to the P/E ratio may be necessary.

Which THREE of the following factors would justify a reduction in the proxy p/e ratio before use?

**A.** The relative lack of marketability of unlisted company shares.

**B.** A lower level of scrutiny and regulation for unlisted companies.

**C.** Unlisted companies being generally smaller and less established.

**D.** Control premium not being included within the proxy p/e ratio used.

**E.** The forecast earnings growth being relatively higher in the unlisted company.

**F.** A profit item within the unlisted company's latest earnings which will not reoccur.

**ANSWER: A B C**

**Explanation:**

The relative lack of marketability of unlisted company shares justifies a discount because an investor cannot normally sell those shares quickly, easily, or at a transparent quoted price. A listed-company P/E multiple reflects the liquidity available in an active public market, so applying it without adjustment would overstate the value of an otherwise comparable private holding. A lower level of scrutiny and regulation for unlisted companies also supports a reduction. Listed entities are subject to continuing disclosure obligations, market oversight and greater external scrutiny; investors may therefore require a higher return for the additional information, governance and monitoring risk of an unlisted investment. Unlisted companies being generally smaller and less established is likewise relevant because smaller businesses often have less diversified revenues, more dependence on key individuals or customers, less financing capacity and a less proven operating record. These characteristics increase perceived risk relative to the quoted proxy and therefore reduce the earnings multiple that a buyer is willing to apply. This is consistent with fair-value measurement principles requiring valuation inputs and adjustments to reflect market-participant assumptions and the characteristics of the interest being valued. See IFRS 13 Fair Value Measurement and the CIMA Professional Qualification.

## QUESTION NO: 3

Which THREE of the following statements correctly distinguish transaction exposure from translation exposure?

**A.** Transaction exposure arises from contracted foreign-currency receipts and payments.

**B.** Translation exposure can arise when the financial statements of a foreign operation are consolidated.

**C.** A forward contract can be used to hedge transaction exposure.

**D.** Translation exposure always gives rise to an immediate cash loss or cash gain.

**E.** Transaction exposure only arises when a company owns a foreign subsidiary.

## ANSWER: A B C

**Explanation:**

**Transaction exposure arises from contracted foreign-currency receipts and payments**. For example, a company that has agreed to pay a supplier in a foreign currency is exposed to a change in the domestic-currency cost before settlement. **Translation exposure can arise when the financial statements of a foreign operation are consolidated**, because the foreign operation's assets, liabilities, income and expenses are translated into the group presentation currency.

**A forward contract can be used to hedge transaction exposure** by fixing the domestic-currency amount payable or receivable for a known future foreign-currency cash flow. Translation differences do not normally create an immediate cash flow: they arise from accounting translation of foreign operations and are commonly recognised in other comprehensive income when consolidation is undertaken.

IAS 21 distinguishes the treatment of foreign-currency transactions from the translation of foreign operations. See IAS 21: The Effects of Changes in Foreign Exchange Rates.

## QUESTION NO: 4

A company has 6 million shares in issue. Each share has a market value of $4.00.

$9 million is to be raised using a rights issue.

Two directors disagree on the discount to be offered when the new shares are issued.

• Director A proposes a discount of 25%

• Director B proposes a discount of 30%

Which THREE of the following statements are most likely to be correct?

**A.** The theoretical ex-rights price will be higher under Director B's proposal than under Director A's proposal.

**B.** More shares will be issued under Director B's proposal than under Director A's proposal.

**C.** The rights issue price will be $3.00 under Director A's proposal.

**D.** The terms of the rights issue will be one new share for every two existing shares under Director A's proposal.

**E.** Shareholder wealth will be higher under Director A's proposal than under Director B's proposal.

**ANSWER: B C D**

**Explanation:**

More shares will be issued under Director B's proposal than under Director A's proposal because a 30% discount gives an issue price of $2.80 per share, compared with $3.00 at a 25% discount. Raising the same $9 million at $2.80 requires approximately 3.214 million new shares, whereas raising it at $3.00 requires exactly 3 million new shares.

The rights issue price will be $3.00 under Director A's proposal because the discount is applied to the current cum-rights market price: $4.00 × (1 − 0.25) = $3.00. Since $9 million is raised at $3.00, 3 million new shares are issued. Against the existing 6 million shares, this produces terms of one new share for every two existing shares.

The theoretical ex-rights price follows from the total pre-issue market value plus the cash raised, divided by the enlarged number of shares. For Director A, this is ($24 million + $9 million) ÷ 9 million = $3.6667. The calculation reflects the standard rights-issue principle that the subscription price and the value of the right must be considered together. CIMA's Financial Strategy syllabus includes financing and equity-financing decisions: CIMA Professional Qualification syllabus. Further technical background is available from London Stock Exchange rights issues guidance.

## QUESTION NO: 5

A company's current earnings before interest and taxation are $5 million.

These are expected to remain constant for the forseeable future.

The company has 10 million shares in issue which currently trade at $3.60.

It also has a $10 million long term floating rate loan.

The current interest rate on this loan is 5%.

The company pays tax at 20%.

The company expects interest rates to increase next year to 6% and it's Price/Earnings (P/E) ratio to move to 9.5 times by the end of next year.

What percentage reduction in the share price will occur by the end of next year if the interest rate increase and the P/E movement both occur?

**A.** Reduction of 7%

**B.** Reduction of 5%

**C.** Reduction of 1%

**D.** Reduction of 0%

**ANSWER: A**

**Explanation:**

**Reduction of 7%** is correct. The current annual interest expense is $10 million × 5% = $0.5 million. From EBIT of $5 million, this gives profit before tax of $4.5 million and, after tax at 20%, earnings of $3.6 million. With 10 million shares, current earnings per share (EPS) are $0.36. Since the current share price is $3.60, the implied current P/E ratio is 10 times.

Next year, the higher floating-rate interest charge will be $10 million × 6% = $0.6 million. EBIT remains $5 million, so profit before tax becomes $4.4 million. Applying the 20% tax rate produces earnings of $3.52 million, or EPS of $0.352. Applying the expected P/E ratio of 9.5 times gives a projected share price of $3.344 ($0.352 × 9.5).

The reduction from $3.60 to $3.344 is $0.256 per share. As a percentage of the current price, this is $0.256 ÷ $3.60 = 7.11%, which rounds to 7%. This applies the standard valuation relationship that share price equals EPS multiplied by the P/E ratio. See the CIMA Professional Qualification and the U.S. SEC investor guide to stock investing.

## QUESTION NO: 6

An unlisted software development business is to be sold by its founders to a private equity house following the initial development of the software. The business has not yet made a profit but significant profits are expected for the next three years with only negligible profits thereafter. The business owns the freehold of the property from which it operates. However, it is the industry norm to lease property.

Which THREE of the following are limitations to the validity of using the Calculated Intangible Value (CIV) method for this business?

**A.** The business owns the freehold property from which it operates.

**B.** Significant profits are forecast for the next three years with only negligible profits thereafter.

**C.** The business has not yet made a profit.

**D.** The CIV method cannot be applied to an unlisted company.

**E.** The intellectual property representing the software development has not been included in the accounts.

## ANSWER: A B C

**Explanation:**

The Calculated Intangible Value method estimates intangible value from the earnings achieved above a normal return on the company's tangible assets. Its reliability therefore depends on using representative tangible assets and a credible, sustainable measure of maintainable earnings. "The business owns the freehold property from which it operates" is a limitation because freehold property is not normal for this industry, where businesses normally lease premises. The tangible asset base, and therefore the normal return attributed to tangible assets, would need substantial adjustment before excess earnings could be meaningfully calculated.

"Significant profits are forecast for the next three years with only negligible profits thereafter" is also a limitation. CIV capitalises excess earnings on the basis that they represent a continuing benefit from the intangible asset. A short, clearly finite period of strong earnings is better assessed using explicitly forecast cash flows rather than a continuing excess-earnings assumption.

"The business has not yet made a profit" further limits validity because CIV normally draws on historical, normalised earnings. Here, the valuation would rely largely on uncertain forecasts for an unproven business. The need to identify and measure internally generated software-related intangibles is consistent with the recognition principles in IAS 38 Intangible Assets; valuation methods should also reflect sustainable economic benefits, as covered in the CGMA Professional Qualification syllabus.

## QUESTION NO: 7

Which of the following statements are true with regard to interest rate swaps?

Select ALL that apply.

**A.** Some companies interest rate swap to deliberately increase their risks because they believe that they are better at predicting future interest rates than the market.

**B.** Risk of default is high from the floating interest rate payer if interest rates rise.

**C.** When interest rates are falling the risk of default by the fixed interest rate payer is low.

**D.** An interest rate swap is an internal hedging technique.

**E.** An interest rate swap is an external hedging technique.

**ANSWER: A E**

**Explanation:**

Some companies interest rate swap to deliberately increase their risks because they believe that they are better at predicting future interest rates than the market. This is correct because, although interest rate swaps are commonly used to manage exposure to changing borrowing costs, a company can deliberately take a view on the direction of interest rates. For example, it may exchange a fixed-rate obligation for a floating-rate obligation if it expects rates to fall, thereby accepting greater exposure to adverse rate movements in pursuit of a potential gain. This is speculation rather than hedging, but it remains a possible use of a swap.

An interest rate swap is an external hedging technique. The arrangement is a derivative contract made with a separate counterparty, often a bank or other financial institution, under which the parties exchange interest cash-flow obligations calculated on an agreed notional principal amount. It is therefore an external financial-risk-management instrument rather than an internal operational technique. Interest rate risk management and derivative instruments form part of the Financial Strategy syllabus context. See the CIMA Professional Qualification information and ISDA's overview of interest-rate derivatives definitions.

**QUESTION NO: 8**

Formed in 2010, the International Integrated Reporting Council

The primary purpose of the IIRC's framework is to help enable an organisation to communicate which of the following'?

**A.** How it creates value in the short medium and long term.

**B.** How it minimises the environmental impact of its business processes.

**C.** How it contributes positively to the economic wellbeing of the environment in which it operates.

**D.** How it ensures that the conflicting net sets of different stakeholder groups are met in an optimal manner.

**ANSWER: A**

**Explanation:**

**How it creates value in the short medium and long term.** is correct because value creation over time is the central purpose of the International Integrated Reporting Framework. Integrated reporting is intended to provide a concise account of how an organisation's strategy, governance, performance and prospects operate together within its external environment to create, preserve or erode value. This is not restricted to financial profit or to a single reporting period. It considers the organisation's use of, and effects on, a broad set of capitals: financial, manufactured, intellectual, human, social and relationship, and natural. The framework therefore helps providers of financial capital and other stakeholders understand the organisation's capacity to create value across the short, medium and long term. An integrated report should explain the business model and material factors that affect this capacity, linking them to strategic objectives, risks, opportunities and performance measures. This forward-looking, connected explanation of sustainable value creation is the defining aim of integrated reporting. The IFRS Foundation's Integrated Reporting materials describe this focus on communicating how an organisation creates, preserves or erodes value over time: Integrated Reporting. The framework itself is available from the IFRS Foundation Integrated Reporting Framework page.

**QUESTION NO: 9**

Clinic A provides free healthcare to all members of the community, funded by the central Government.

Clinic B provides healthcare which has to be paid for by the individual patients. It is a listed company, owned by a large number of shareholders.

In comparing the above two organisations and their objectives, which THREE of the following statements are correct?

**A.** Clinic A is a not-for-profit organisation while Clinic B is a for-profit organisation.

**B.** Clinic A and B have the same primary financial objective - to maximise shareholder wealth.

**C.** The performance of Clinic A will be appraised primarily on the basis of value for money.

**D.** Clinic B is likely to have a mixture of financial and non-financial objectives.

**E.** Clinic A and B will have the same primary non financial objective - provision of quality of health care.

**ANSWER: A C D**

**Explanation:**

“Clinic A is a not-for-profit organisation while Clinic B is a for-profit organisation” is correct because Clinic A is government funded to provide a public service rather than to generate distributable profits for owners. In contrast, Clinic B is a listed entity with shareholders, so it operates in the private, profit-seeking sector. This distinction is important in Financial Strategy because organisational purpose and stakeholder interests affect the objectives used in strategic financial decisions.

“The performance of Clinic A will be appraised primarily on the basis of value for money” is correct. Publicly funded bodies must demonstrate that they use scarce resources economically, efficiently and effectively while delivering the intended healthcare outcomes. Value-for-money assessment therefore provides a more suitable basis for evaluating Clinic A than measures focused solely on profit generation. The UK National Audit Office explains this public-sector framework in its Value for Money Framework.

“Clinic B is likely to have a mixture of financial and non-financial objectives” is also correct. As a listed healthcare provider, it will pursue financial outcomes such as sustainable profitability and shareholder value, while also needing objectives relating to clinical quality, patient safety, reputation, service standards and regulatory compliance. CIMA’s qualification materials place Financial Strategy within the wider context of balancing financial strategy, risk and organisational objectives; see the CGMA Professional Qualification resources.

## QUESTION NO: 10

Company A is proposing a rights issue to finance a new investment. Its current debt to equity ratio is 10%.

Which TWO of the following statements are true?

**A.** The issue price has to be at least 20% below the pre-rights share price.

**B.** The issue price of new shares should be set to guarantee the full take up of shares offered.

**C.** The actual ex-rights price may be higher than the theoretical ex-rights price due to the value created from the project.

**D.** Company A's current low gearing ratio may require a rights issue rather than a debt issue to finance the new project.

**E.** According to Modigliani and Miller's Theory of Capital Structure with tax the rights issue will result in a lower cost of equity for Company A.

**ANSWER: C E**

**Explanation:**

The actual ex-rights price may be higher than the theoretical ex-rights price due to the value created from the project. The theoretical ex-rights price is a mechanical, weighted-average calculation based on the existing market price and the rights issue price. It does not, by itself, incorporate a favourable market reassessment of the company’s future cash flows. If investors expect the new investment to earn a positive net present value, the announcement and subsequent implementation of that project can increase the value they place on the business. Consequently, the observed market price after the shares go ex-rights can exceed the theoretical ex-rights price.

According to Modigliani and Miller's Theory of Capital Structure with tax the rights issue will result in a lower cost of equity for Company A. Under Modigliani–Miller’s proposition with corporate tax, equity holders require compensation for financial risk arising from debt. The company’s very low current debt-to-equity ratio will fall further when equity is issued, assuming debt is unchanged. This reduction in financial leverage reduces the risk borne by shareholders and therefore reduces the required return, or cost of equity. The corporate-tax version of the model also recognises that debt interest is tax deductible, so leverage affects the relationship between financing mix, risk and required returns. See CFA Institute: Corporate Issuers and Investopedia: Modigliani–Miller Theorem.

## QUESTION NO: 11

Company C is a listed company. It is currently considering the acquisition of Company

D.

The original founder of Company C currently owns 52% of the shares.

Alternative forms of consideration for Company D being considered are as follows:

• Cash payment, financed by new borrowing

• issue of new shares in Company C

Which of the following is an advantage of a cash offer over a share-for exchange from the viewpoint of the original founder of Company C?

**A.** A share for share exchange would result in a significant change in control of Company C whereas a cash offer would not.

**B.** A share-for-share exchange would require the approval shareholders in Company C but a cash offer would not.

**C.** A share-for-share exchange would require the approval of the Competition Authorities but a cash offer would not.

**D.** A cash offer would result in a lower gearing ratio therefore reduce the weighted overage cost of capital whereas a cash offer would not.

## ANSWER: A

**Explanation:**

A share for share exchange would result in a significant change in control of Company C whereas a cash offer would not. This is advantageous to the original founder because their current 52% holding gives them majority voting control. If Company C issues new shares to the shareholders of Company D as acquisition consideration, the total number of Company C shares increases. The founder retains the same number of shares but owns a smaller percentage of the enlarged share capital. If sufficient shares are issued, the founder may lose majority control or face a materially reduced ability to pass ordinary resolutions and determine the composition of the board.

In contrast, a cash acquisition funded by borrowing does not create additional equity shares in Company C. Therefore, assuming no separate equity issue or share transaction, the founder's 52% proportionate shareholding and voting control are preserved. The acquisition may change Company C's financial risk because debt is introduced, but it does not dilute the founder's ownership interest. UK company-law rules distinguish the allotment of new shares from debt financing: directors need authority to allot shares, as set out in section 551 of the Companies Act 2006. See Companies Act 2006, section 551 and the FCA Listing Rules.

## QUESTION NO: 12

A company plans a four-year project which will be financed by either an operating lease or a bank loan.

Lease details:

• Four year lease contract.

• Annual lease rentals of $45 000 paid in advance on the 1st day of the year.

Other information:

• The interest rate payable on the bank borrowing is 10%.

• The capital cost of the project is $200 000 which would have to be paid at the beginning of the first year.

• A salvage or residual value of $100 000 is estimated at the end of the project's life.

• Purchased assets attract straight line tax depreciation allowances.

• Corporate income tax is 20% and is payable at the end of the year following the year to which it relates.

A lease-or-buy appraisal is shown below:

Which THREE of the following items are errors within the appraisal?

**A.** Lease payments are timed incorrectly

**B.** Tax relief on lease payments have not been lagged correctly

**C.** Using the 10% discount rate is incorrect

**D.** The project's operating cashflows should be included

**E.** The bank loan repayments should be included

**F.** The salvage value has been included within the lease option

**ANSWER: B C F**

**Explanation:**

Tax relief on lease payments have not been lagged correctly is an error because lease rentals are deductible for corporate-tax purposes, but the question explicitly states that tax is paid at the end of the year following the year to which it relates. The cash-tax saving from each rental must therefore be reflected at the appropriate later payment date, rather than in the period in which the rental is paid. This timing is especially important here because rentals are payable in advance.

Using the 10% discount rate is incorrect because the relevant lease-versus-buy cash flows are stated after tax. The appropriate rate is therefore the after-tax cost of borrowing: $10\% \times (1 - 0.20) = 8\%$, assuming interest relief is available in the same tax framework. Discounting after-tax cash flows at a pre-tax borrowing rate would produce an inconsistent comparison.

The salvage value has been included within the lease option is also an error. The residual value arises from owning the asset at the end of the project, so it is a cash flow of the purchase alternative only. A lessee under an operating lease does not own the asset and would not receive its disposal proceeds. Lease-or-buy analysis compares the incremental, tax-adjusted financing cash flows of the two alternatives on a consistent present-value basis. See OpenTuition's CIMA F3 lease-or-buy materials and CIMA's CGMA Professional Qualification resources.

## QUESTION NO: 13

A company is considering a divestment via either a management buyout (MBO) or sale to a private equity purchaser. Which of the following is an argument in favour of the MBO from the viewpoint of the original company?

**A.** Better co-operation post divestment.

**B.** Enhanced big data opportunities.

**C.** Improved relationships with management buyout team in the event of a sale to the private equity purchaser.

**D.** Higher price due to synergistic benefits.

**ANSWER: A**

**Explanation:**

Better co-operation post divestment is an important argument for an MBO from the original company's perspective. In an MBO, the purchaser is the business's incumbent management team. Those managers already understand the operation, its people, systems, customers and commercial history, and they have established working relationships with the selling group. This familiarity can make the sale process more straightforward and can support a constructive relationship after legal ownership has transferred.

That continuing relationship can have real value where the divested business will remain connected to the original company. For example, the parties may need transitional-service arrangements for IT, finance, premises or shared systems; they may continue to buy from or sell to one another; or they may need to coordinate customer, supplier and employee communications. A management team known to the seller is more likely to preserve operational continuity and work collaboratively through these arrangements. This aligns with the strategic focus of the Financial Strategy syllabus on evaluating corporate restructuring and divestment choices. See the CGMA Financial Strategy resources and ICAEW's overview of management buyouts.

## QUESTION NO: 14

A company is considering acquiring a smaller competitor using a share-for-share exchange.

Which THREE of the following are likely advantages to the acquiring company of using share consideration rather than cash consideration?

**A.** It preserves the acquiring company's cash resources.

**B.** It avoids the immediate need to increase borrowing to fund the consideration.

**C.** It allows target shareholders to participate in the future performance of the combined company.

**D.** It prevents dilution of the acquiring company shareholders' voting rights.

**E.** It guarantees that the acquisition will increase earnings per share.

**ANSWER: A B C**

**Explanation:**

A share-for-share exchange conserves the acquirer's cash resources because no immediate cash payment is required for the consideration. It also avoids the need to raise additional debt solely to fund the purchase price, helping the acquirer avoid higher gearing and fixed interest obligations.

Share consideration enables the target shareholders to remain invested in the enlarged group. They can therefore share in future synergies, growth and dividends arising after the acquisition. This may make an offer more attractive where the target shareholders believe that the combined business has good prospects.

However, issuing new shares can dilute the percentage ownership and voting rights of the acquirer's existing shareholders. It may also be unattractive if the acquirer's shares are considered undervalued, because more shares would need to be issued to provide the required value of consideration.

The Takeover Code provides the framework for securities consideration in UK takeover offers. See the Takeover Code.

## QUESTION NO: 15

NNN is a company financed by both equity and debt. The directors of NNN wish to calculate a valuation of the company's equity and at a recent board meeting discussed various methods of business valuation.

Which THREE of the following are appropriate methods for the directors of NNN to use in this instance?

**A.** Total earnings multiplied by a suitable price-earnings ratio.

**B.** Cash flow to all investors discounted at WACC less the value of debt.

**C.** Cash flow to all investors discounted at WACC.

**D.** Cash flow to equity discounted at the cost of equity less the value of debt.

**E.** Cash flow to equity discounted at the cost of equity.

**ANSWER: A B E**

**Explanation:**

Total earnings multiplied by a suitable price-earnings ratio is an equity valuation approach because a price-earnings ratio expresses the market value of equity relative to earnings attributable to ordinary shareholders. Applying an appropriate comparable-company or sector multiple to maintainable earnings therefore estimates the value of shareholders' equity directly. The multiple must be selected with due regard to factors such as growth, risk, capital structure and the comparability of reported earnings.

Cash flow to all investors discounted at WACC less the value of debt is also appropriate. Cash flows available to both debt and equity providers are free cash flows to the firm. Discounting them at the weighted average cost of capital produces enterprise value. Deducting the market value of debt (and making any necessary adjustments for debt-like claims or non-operating assets) converts enterprise value to equity value. This enterprise-value-to-equity-value bridge is described in Corporate Finance Institute's enterprise value guidance.

Cash flow to equity discounted at the cost of equity directly estimates equity value because both the cash-flow definition and discount rate relate solely to ordinary shareholders. This is the free-cash-flow-to-equity method; its logic is consistent with the discussion of discounted cash-flow valuation in Corporate Finance Institute's DCF guide.

## QUESTION NO: 16

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.** The coupon rate on the convertible bond will be lower than that on a non-convertible bond.

**C.** When converted into shares the company will receive a cash inflow which can be used for future investments.

**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 B D

**Explanation:**

The convertible bond may not dilute control as the bond holder has an option to choose conversion. Until the holder exercises that option, the instrument remains debt and no new ordinary shares are issued. Conversion is therefore contingent on the holder's decision and on whether conversion is economically attractive. This gives the company access to financing without immediate dilution of shareholders' voting rights.

The coupon rate on the convertible bond will be lower than that on a non-convertible bond. Investors accept a lower contractual interest return because the conversion feature gives them potential participation in future growth in the company's share value. The lower coupon reduces the recurring cash interest burden, supporting liquidity while the instrument remains outstanding.

Issuing a convertible bond will have a more favourable impact on the gearing ratio than a non-convertible bond. A conventional bond is wholly debt. In contrast, a typical fixed-for-fixed convertible is accounted for by the issuer as a compound financial instrument: its liability component is separated from the equity conversion component. Consequently, the debt recognised is lower than for an otherwise comparable straight bond, which can produce a lower gearing measure and reduce reported financial risk. This treatment is set out in IAS 32 Financial Instruments: Presentation and is relevant to the financing and risk-analysis focus of the CGMA Professional Qualification.

## QUESTION NO: 17 - (SIMULATION)

A company ' s latest accounts show profit after tax of $20.0 million, after deducting interest of $5.0 million. The company expects earnings to grow at 5% per annum indefinitely.

The company has estimated its cost of equity at 12%, which is included in the company WACC of 10%.

Assuming that profit after tax is equivalent to cash flows, what is the value of the equity capital?

Give your answer to the nearest $ million.

$ ? million

**ANSWER: See the explanation for the answer**

**Explanation:**

**Equity capital value = $300 million.**

Profit after tax is treated as the cash flow available to equity holders. Apply the growing perpetuity formula using the cost of equity:

```
Equity value = Next year's cash flow / (Cost of equity − Growth rate)

= ($20.0m × 1.05) / (0.12 − 0.05)
= $21.0m / 0.07
= $300m
```

The WACC and interest expense are not used because the stated cash flow is profit after tax, which is already an equity cash flow.

## QUESTION NO: 18

A listed company follows a policy of paying a constant dividend. The following information is available:

• Issued share capital (nominal value $0.50) $60 million

• Current market capitalisation $480 million

The shareholders are requesting an increased dividend this year as earnings have been growing. However the directors wish to retain as much cash as possible to fund new investments. They therefore plan to announce a 1-for-10 scrip dividend to replace the usual cash dividend.

Assuming no other influence on share price what is the expected share price following the scrip dividend?

Give your answer to 2 decimal places.

**A.** 3.64

**ANSWER: A**

**Explanation:**

The expected share price is **$3.64**. First, the number of shares currently in issue is found from the issued share capital and nominal value: $60 million divided by $0.50 gives 120 million shares. With a market capitalisation of $480 million, the pre-scrip market value per share is therefore $480 million divided by 120 million, or $4.00.

A 1-for-10 scrip dividend gives shareholders one additional share for every ten currently held. Consequently, the number of shares increases by 10%, from 120 million to 132 million. On the stated assumption that there is no other effect on the company's total equity market value, market capitalisation remains $480 million immediately following the issue. The theoretical ex-scrip share price is thus $480 million divided by 132 million shares, which equals $3.63636. Rounded to two decimal places, this is $3.64.

This adjustment reflects that the same ownership value is represented by a larger number of shares; it does not represent an economic loss to shareholders at the point of issue. The calculation applies the Financial Strategy syllabus's equity-valuation and corporate-financing principles; see the CIMA Professional Qualification syllabus and the SEC Investor.gov definition of a stock dividend.

## QUESTION NO: 19

Which THREE of the following would be of most interest to lenders deciding whether to provide long-term debt to a company?

**A.** Quality of current management

**B.** Current gearing ratio

**C.** Earnings per share

**D.** Dividend cover

**E.** interest cover on existing debt

## ANSWER: A B E

**Explanation:**

Long-term lenders focus on the probability that contractual interest and principal will be paid when due, and on the borrower's capacity to remain financially resilient throughout the life of the loan. **Quality of current management** is therefore highly relevant because management's competence, integrity, strategic decisions and control of operations affect the sustainability and predictability of cash flows available for debt service. **Current gearing ratio** is important because it indicates the extent to which the company already relies on debt finance relative to equity or capital employed. A lender uses this information to assess financial risk, headroom for additional borrowing and the possible impact of further debt commitments. **interest cover on existing debt** directly measures the relationship between operating earnings and interest obligations. It is a core indicator of the company's ability to meet recurring finance costs from its business performance, with stronger cover generally indicating greater capacity to withstand reductions in profits or increases in borrowing costs. These factors support a credit assessment centred on repayment capacity, leverage and financial risk, consistent with the Financial Strategy emphasis on financing decisions and financial-risk management. See the CIMA Professional Qualification overview and the IFRS 7 financial-instruments disclosure requirements.

## QUESTION NO: 20

Company AAB is located in Country A with the A$ as its functional currency It plans to grow by acquisition and has identified Company BBA as a potential takeover candidate Company BBA is located in Country B with the BS as its functional currency.

The directors of Company AAB are concerned about foreign currency risk if the acquisition goes ahead

Which of the following will be most effective in reducing Company AAB's exposure to translation risk if the acquisition is successful1?

**A.** Financing the acquisition with equity in A$'s.

**B.** Setting up a mufti-currency bank account to net-off receipts and payments

**C.** Financing the acquisition with borrowings in BS's

**D.** Using forward contracts to fix the exchange rate between the AS and the B$

**ANSWER: C**

**Explanation:**

Financing the acquisition with borrowings in BS's is the most effective method because it creates a natural hedge against the translation exposure arising from the foreign operation. Following the acquisition, Company BBA's assets and liabilities will be translated from BS into A$ for inclusion in Company AAB's consolidated financial statements. The principal translation exposure is therefore the acquired business's net investment, or net assets, denominated in BS.

A BS-denominated borrowing provides an offsetting BS monetary liability. If BS weakens against A$, the A$-translated value of BBA's net assets decreases, but the A$ value of the BS borrowing also decreases. Conversely, if BS strengthens, both translated amounts increase. This substantially reduces the group's overall net asset exposure to movements in the A$/BS exchange rate and therefore reduces the impact on consolidated equity and other comprehensive income.

This approach is commonly described as a hedge of a net investment in a foreign operation. IAS 21 requires exchange differences on translating a foreign operation to be recognised initially in other comprehensive income, while IFRS 9 contains the hedge-accounting requirements applicable to qualifying net-investment hedges. See IAS 21 overview and IFRS 9 overview.

**QUESTION NO: 21**

A company is considering either exporting its product directly to customers in a foreign country or establishing a manufacturing subsidiary in that country.

The corporate tax rate in the company's own country is 20% and 25% tax depreciation allowances are available.

Which THREE of the following would be considered advantages of establishing the subsidiary in the foreign country?

**A.** The corporate tax rate in the foreign country is 40%.

**B.** There is a double tax treaty between the company's domestic country and the foreign country.

**C.** Year 1 tax depreciation allowances of 100% are available in the foreign country.

**D.** There are high customs duties payable on products entering the foreign country.

**E.** There are restrictions on companies wishing to remit profit from the foreign country.

**ANSWER: B C D**

**Explanation:**

There is a double tax treaty between the company's domestic country and the foreign country because tax treaties provide an agreed framework for allocating taxing rights between the two states and relieving or reducing double taxation of the same income. This can make cross-border investment through a foreign subsidiary more commercially viable and improves certainty over the tax treatment of profits and related payments. The OECD explains the function and structure of tax treaties in its tax treaties guidance.

Year 1 tax depreciation allowances of 100% are available in the foreign country because the subsidiary would obtain tax relief for the full qualifying capital expenditure immediately, rather than receiving only the 25% allowance available in the home country. Earlier relief reduces taxable profits and accelerates cash-flow benefits, improving the investment's post-tax value.

There are high customs duties payable on products entering the foreign country because local manufacture avoids, or substantially reduces, duties that would arise when finished goods are exported into that market. This can lower delivered cost, protect margins, and improve price competitiveness. The World Trade Organization describes customs duties as charges imposed on imported goods in its tariffs overview. These factors each create a direct economic advantage for establishing and operating the foreign manufacturing subsidiary.

## QUESTION NO: 22

A company has a 4% corporate bond in issue on which there are two loan covenants.

â€¢ Interest cover must not fall below 4 times

â€¢ Retained earnings for the year must not fall below S5 00 million

The Company has 100 million shares in issue. The most recent dividend per share was $0 10 The Company intends increasing dividends by 8% next year.

Financial projections tor next year are as follows:

Advise the Board of Directors which of the following will be the status of compliance with the loan covenants next year?

**A.** The company will be in breach of the covenant in respect of interest cover only.

**B.** The company will breach the covenant in respect of retained earnings only.

**C.** The company will be in compliance with both covenants.

**D.** The company will be in breach of both covenants

## ANSWER: B

**Explanation:**

The company will breach the covenant in respect of retained earnings only. Projected interest cover is calculated by dividing earnings before interest and tax of $25.00 million by finance costs of $3.20 million. This produces interest cover of approximately 7.8 times, which is comfortably above the required minimum of 4 times. The interest-cover condition is therefore satisfied.

For the retained-earnings condition, the proposed dividend per share is $0.108, calculated as the latest dividend of $0.10 increased by 8%. With 100 million shares, the planned total dividend is $10.80 million. Projected earnings after tax are $15.26 million, so the amount retained for the year is $4.46 million ($15.26 million less $10.80 million). This is below the stipulated minimum retained earnings of $5.00 million. The planned dividend increase therefore causes a covenant breach despite the business generating sufficient operating profit to meet its interest-cover requirement.

Loan covenants are financing terms that management must monitor when making financing and distribution decisions. This assessment applies the financial-management and funding principles covered within the CIMA Professional Qualification. Further context on presenting and assessing financial obligations is available from the IFRS Foundation's IAS 1 resource.

## QUESTION NO: 23

Company A plans to acquire Company B, an unlisted company which has been in business for 3 years.

It has incurred losses in its first 3 years but is expected to become highly profitable in the near future.

No listed companies in the country operate the same business field as Company B, a unique new high-risk business process.

The future success of the process and hence the future growth rate in earnings and dividends is difficult to determine.

Company A is assessing the validity of using the dividend growth method to value Company B.

Which THREE of the following are weaknesses of using the dividend growth model to value an unlisted company such as Company HHG?

**A.** The company has been unprofitable to date and hence, there is no established dividend payment pattern.

**B.** The future projected dividend stream is used as the basis for the valuation.

**C.** The future growth rate in earnings and dividends will be difficult to accurately determine.

**D.** The dividend growth model does not take the time value of money into consideration.

**E.** The cost of capital will be difficult to estimate.

**ANSWER: A C E**

**Explanation:**

The company has been unprofitable to date and hence, there is no established dividend payment pattern is a weakness because the dividend growth model values equity by estimating future dividends from a sustainable current dividend and a long-term growth assumption. A business that has only made losses has no established dividend record from which a credible distributable-dividend level can be inferred.

The future growth rate in earnings and dividends will be difficult to accurately determine is also a material limitation. The model is highly sensitive to its growth input: small changes in the assumed perpetual growth rate can produce substantial changes in value. Here, the business process is new, high risk and has no listed comparable companies, so forecasting a stable future rate with reasonable confidence is especially difficult.

The cost of capital will be difficult to estimate is correct because the required return in the model must reflect the risk of the equity investment. For an unlisted company there is no directly observable share-price data or beta, while the absence of comparable listed businesses makes a proxy beta and risk adjustment particularly judgemental. These limitations undermine the reliability of the resulting valuation. The dividend-discount approach and its sensitivity to growth and required return are outlined in CFA Institute’s equity valuation materials; CIMA’s qualification framework is available from AICPA & CIMA.

## QUESTION NO: 24

A company generates and distributes electricity and gas to households and businesses.

Forecast results for the next financial year are as follows:

| | $ million |
|---|---|
| Revenue from electricity sales at $2.50 per Kilowatt | 450 |
| Costs | 250 |
| Net profit | 200 |

The Industry Regulator has announced a new price cap of $2.00 per Kilowatt.

The company expects this to cause consumption to rise by 15% but costs would remained unaltered.

The price cap is expected to cause the company ' s net profit to fall to:

**A.** $8.75 million profit

**B.** $164.00 million profit

**C.** $43.00 million profit

**D.** $126.50 million loss

**ANSWER: B**

**Explanation:**

**$164.00 million profit** is correct. The forecast revenue of $450 million, earned at a price of $2.50 per kilowatt, implies forecast sales volume of 180 million kilowatts ($450m ÷ $2.50). The regulated cap reduces the selling price to $2.00 per kilowatt. However, consumption is expected to increase by 15%, so the revised sales volume is 207 million kilowatts (180m × 1.15). Applying the capped price gives revised revenue of $414 million (207m × $2.00). The question explicitly states that costs remain unaltered. Therefore, forecast costs stay at $250 million. Net profit is consequently revenue less costs: $414 million − $250 million = $164 million profit. This applies a core financial-strategy forecasting approach: derive the original activity level from revenue and price, revise the activity assumption for the expected demand response, calculate revised revenue using the new regulated price, and deduct the unchanged cost base. CIMA’s Financial Strategy learning area includes evaluating financial consequences of business decisions and applying quantitative analysis to forecasts; see [CIMA Study and Qualifications](). The fundamental relationship used is revenue = selling price × quantity, as outlined in [OpenStax's finance materials]().

## QUESTION NO: 25

A company based in Country A with the A$ as its functional currency requires A$500 million 20-year debt finance to finance a long-term investment The company has a high credit rating, but has not previously issued corporate bonds which are listed on the stock exchange Which THREE of the following are advantages of issuing 20 year bonds compared with simply borrowing for a 20 year period?

**A.** Larger capital market

**B.** Greater availability of debt of 20-year duration

**C.** Lower arrangement costs

**D.** Less administrative effort to arrange the new finance

**E.** Lower interest rate

**ANSWER: A B E**

**Explanation:**

**Larger capital market**, **Greater availability of debt of 20-year duration**, and **Lower interest rate** are advantages for this highly rated company. A public bond issue can access the capital-market investor base, including pension funds, insurers, investment funds and other institutional investors, rather than relying on the lending capacity and risk appetite of one bank or a small bank syndicate. This breadth is particularly valuable for a large A$500 million requirement.

Bonds are also well suited to matching a long-lived investment with long-term, fixed-maturity finance. Institutional investors commonly seek long-dated securities to match their own long-term liabilities, so the bond market may provide more capacity for a 20-year maturity than conventional bank lending. The bond's stated maturity also gives the issuer certainty about when principal repayment is due.

Finally, a company with a high credit rating may obtain a lower all-in interest cost by borrowing directly from investors. This is financial disintermediation: issuing bonds can avoid part of the bank intermediation margin and allow the issuer's credit quality to be priced directly in the market. The actual coupon will still depend on prevailing yields, market conditions, issue terms and investor demand. See the SEC's overview of [bonds]() and the Bank for International Settlements discussion of [corporate bond markets]().

## QUESTION NO: 26

Company P is a large unlisted food-processing company.

Its current profit before interest and taxation is $4 million, which it expects to be maintainable in the future.

It has a $10 million long-term loan on which it pays interest of 10%.

Corporate tax is paid at the rate of 20%.

The following information on P/E multiples is available:

| | Overall Stock Market | Food-Processing sector |
|---|---|---|
| P/E multiple | 20.0 times | 10.0 times |

Which of the following is the best indication of the equity value of Company P?

**A.** $80 million

**B.** $40 million

**C.** $48 million

**D.** $24 million

**ANSWER: D**

**Explanation:**

**$24 million** is the best indication of Company P's equity value because a price/earnings valuation applies an appropriate sector earnings multiple to the earnings attributable to equity holders. Starting with maintainable profit before interest and tax of $4 million, annual interest on the $10 million loan is $1 million (10%). Profit before tax is therefore $3 million. After corporation tax at 20%, maintainable earnings after tax are $2.4 million.

The food-processing sector multiple shown in the question should be used because it is the closest available comparator for the company's operating activities and business risk. Applying the food-processing price/earnings multiple of 10 to post-tax earnings gives an estimated equity value of $24 million ($2.4 million × 10). This approach is appropriate because interest and tax have already been deducted: the resulting earnings measure belongs to ordinary shareholders, and the price/earnings multiple produces an equity, rather than enterprise, value. The outstanding loan is consequently not deducted again. For background on the price/earnings ratio and its use in comparing similar businesses, see Investor.gov's definition of the P/E ratio and CFA Institute's Equity Asset Valuation resources.

## QUESTION NO: 27

A company has in a 5% corporate bond in issue on which there are two loan covenants.

• Interest cover must not fall below 3 times

• Retained earnings for the year must not fall below $3.5 million

The Company has 200 million shares in issue.

The most recent dividend per share was $0.04.

The Company intends increasing dividends by 10% next year.

Financial projections for next year are as follows:

Advise the Board of Directors which of the following will be the status of compliance with the loan covenants next year?

**A.** The company will be in compliance with both covenants.

**B.** The company will be in breach of both covenants.

**C.** The company will breach the covenant in respect of retained earnings only.

**D.** The company will be in breach of the covenant in respect of interest cover only.

**E.** Insufficient information is provided to determine compliance with the loan covenants.

**ANSWER: E**

**Explanation:**

Insufficient information is provided to determine compliance with either loan covenant. The question refers to financial projections but does not include the projected figures needed to calculate the two covenant measures. Interest cover normally compares earnings before interest and tax with finance costs. Therefore, the projected operating profit or EBIT and the projected interest charge are required. Although the bond coupon rate is stated as 5%, the bond's nominal value or projected finance cost is not given, so the interest expense cannot be established. For the retained-earnings covenant, the intended dividend can be calculated as $0.044 per share, producing total proposed dividends of $8.8 million for 200 million shares. However, projected profit after tax, together with any other movements that affect retained earnings, is still needed to determine the amount retained for the year and compare it with $3.5 million. A valid covenant conclusion must be based on the relevant projected financial data rather than on dividend information alone. The underlying approach is consistent with the use of interest cover as an earnings-to-interest measure and with retained earnings representing accumulated profit not distributed to shareholders. See Investopedia: Interest Coverage Ratio and IFRS: IAS 1 Presentation of Financial Statements.

## QUESTION NO: 28

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.** 5% Bond repayable at par in 7 years' time.

**C.** 3% Commercial Paper.

**D.** 4% Convertible bond with a conversion ratio of 350 ordinary shares per bond.

**ANSWER: D**

**Explanation:**

The most appropriate finance is **4% Convertible bond with a conversion ratio of 350 ordinary shares per bond.** The company's proposed investment has a long development horizon and is inherently uncertain: meaningful income from the new drug is not expected for around six years. A convertible bond provides debt funding initially, enabling the company to obtain finance without an immediate issue of ordinary shares. This is important where the doctor-shareholders wish to retain control at the point the funds are raised.

Conversion gives investors the right to exchange the bonds for ordinary shares under the stated terms. That feature can make the instrument more attractive to investors in a research-led business with few tangible assets available as security, because investors can participate in future equity value if the drug development succeeds. In return for that potential upside, the company can usually offer a lower coupon than it would need on comparable non-convertible debt. The 4% rate therefore helps limit cash interest commitments while research expenditure is high and cash generation from the new product has not yet begun.

The approach also aligns funding with the company's risk profile: debt is used now, while potential equity participation is deferred until a future conversion event. CIMA Financial Strategy includes evaluating financing choices, cost of capital, and the implications of debt and equity funding. See the CGMA Professional Qualification syllabus and the UK Government's overview of convertible loan notes.

## QUESTION NO: 29

Providers of debt finance often insist on covenants being entered into when providing debt finance for companies.

Agreement and adherence to the specific covenants is often a condition of the loan provided by the lender.

Which THREE of the following statements are true in respect of covenants?

**A.** Covenants are entered into to penalise the company.

**B.** Covenants are entered into to give the lender added protection on the loan extended to the company.

**C.** Covenants are entered into to impose financial discipline on the company.

**D.** Covenants enable the lender to demand immediate repayment or to renegotiate terms if it is breached.

**E.** Covenants are entered into to eliminate the tax liability of the company.

## ANSWER: B C D

**Explanation:**

Covenants are contractual conditions attached to lending arrangements and are designed to protect the lender's position after funds have been advanced. Accordingly, "Covenants are entered into to give the lender added protection on the loan extended to the company" is correct: covenants can restrict actions that could increase credit risk, such as excessive additional borrowing, asset disposals, or distributions to shareholders. "Covenants are entered into to impose financial discipline on the company" is also correct because financial covenants commonly require the borrower to maintain agreed levels or ratios relating to leverage, interest cover, liquidity, or net worth. Monitoring these measures encourages timely management action and provides early warning of financial deterioration. Finally, "Covenants enable the lender to demand immediate repayment or to renegotiate terms if it is breached" is correct, subject to the precise loan agreement and any waiver granted by the lender. A breach will commonly constitute an event of default, giving the lender enforcement rights that may include acceleration, renegotiation, additional security, or revised pricing. The significance of covenant compliance is also reflected in financial-reporting requirements concerning liabilities where the right to defer settlement depends on complying with covenants; see IAS 1: Presentation of Financial Statements. Further lending context is available from ACCA's debt finance guidance.

## QUESTION NO: 30

XYZ is a multi-national group with subsidiary AA in Country A and subsidiary BB in Country B. The capital structures of AA and BB are set up to take advantage of the lower tax rate in Country A Thin capitalisation rules in Country B will limit the ability for either AA or BB to claim tax relief on:

**A.** interest earned by BB.

**B.** interest earned by AA

**C.** interest paid by BB

**D.** interest paid by AA

## ANSWER: C

**Explanation:**

Thin capitalisation rules address the tax risk that a company is funded with an excessive level of debt, particularly debt from related parties, so that large interest deductions reduce taxable profits in the country where the company operates. As the rules specified are those of Country B, they apply to the taxable position of BB, the subsidiary resident or carrying on business in Country B. Therefore, the relevant relief that may be restricted is the deduction for **interest paid by BB**.

The group's intention to exploit Country A's lower tax rate is consistent with a structure in which profits are shifted out of Country B through financing costs. A restriction on BB's interest deduction protects Country B's tax base by limiting the amount of finance cost it will recognise for corporation-tax purposes, commonly by reference to an arm's-length debt amount, a debt-to-equity ratio, or an earnings-based interest limitation. The Organisation for Economic Co-operation and Development identifies excessive interest deductions as a key base-erosion concern in its BEPS Action 4 guidance. Further practical context on how thin-capitalisation arrangements are assessed is available from HMRC's International Manual.

## QUESTION NO: 31

An unlisted company.

• Is owned by the original founders and members of their families

• Pays annual dividends each year depending on the cash requirements of the dominant shareholders.

• Has earnings that are highly sensitive to underlying economic conditions.

• Is a small business in a large Industry where there are listed companies with comparable capital structures

Which of the following methods is likely to give the most accurate equity value for this unlisted company?

**A.** Dividend valuation model.

**B.** Net asset valuation

**C.** P/E based valuation using the P/E of a similar company.

**D.** Discounted cash flow analysis at WACC (based on cash flows after tax but before financing) plus the market value of debt.

## ANSWER: C

**Explanation:**

**P/E based valuation using the P/E of a similar company.** is the most appropriate method because there are listed businesses in the same industry with comparable capital structures. This provides observable market evidence of how investors value the earnings generated by comparable businesses. Applying a suitably selected and adjusted quoted-company price/earnings multiple to the unlisted entity's maintainable earnings produces an equity valuation grounded in current market pricing.

The stated ownership and dividend policy are especially relevant: dividends are determined by the cash requirements of dominant family shareholders rather than by a policy designed to distribute sustainable economic returns. Consequently, an earnings-based market multiple is a more useful indicator of the value attributable to shareholders. The company's exposure to economic conditions means that the earnings figure used should be normalised where necessary—for example, by considering sustainable earnings across the business cycle—while the chosen comparable multiple should reflect relative size, liquidity, growth prospects, risk, and any lack-of-marketability discount applicable to an unlisted shareholding.

This approach is consistent with the CIMA Financial Strategy focus on using appropriate valuation techniques and market comparators when relevant data are available. See CIMA Professional Qualification resources and Aswath Damodaran's valuation resources.

## QUESTION NO: 32

A listed company is considering whether to finance a long term expansion using a rights issue or retained earnings.

Which THREE of the following statements are correct?

**A.** Retained earnings have an opportunity cost to shareholders.

**B.** A shareholder who takes up all rights will normally maintain the same percentage ownership.

**C.** A rights issue creates a contractual obligation to pay dividends each year.

**D.** Retained earnings are costless because no cash is paid to external providers of finance.

**E.** A rights issue can provide permanent capital without mandatory interest payments.

**ANSWER: A B E**

**Explanation:**

Retained earnings are not free finance. If profits are retained rather than distributed, shareholders forgo a dividend or other distribution that they could have invested elsewhere. Retained earnings therefore have an opportunity cost broadly equivalent to the return required by shareholders on equity of similar risk.

A rights issue allows existing shareholders to maintain their relative percentage ownership if they take up their rights in full. It can also raise substantial permanent capital without introducing mandatory interest payments or a repayment obligation. This may be particularly relevant where projected operating cash flows are uncertain.

Both methods represent equity finance. Neither increases debt principal directly, although the market consequences of the financing decision and the proposed investment may influence gearing ratios measured using market values.

See the London Stock Exchange guidance on rights issues and the OpenStax discussion of dividend policy.

**QUESTION NO: 33**

PYP is a listed courier company. It is looking to raise new finance to fit each of its delivery vans with new equipment to allow improved parcel tracking for customers The senior management team of PYP have decided on a 10-year secured bond to finance this investment-

Which TWO of the following variables are most likely to decrease the yield to maturity of the bond?

**A.** Changing the term of the bond from 1 0 years to 5 years to match the expected life of the new equipment

**B.** The announcement of a new contract for PYP that will increase operating profits by 5°/o over the next 5 years.

**C.** The senior management team decide to issue a convertible bond rather than a conventional bond

**D.** The senior management team decide to issue an unsecured bond rather than a secured bond

**ANSWER: B C**

**Explanation:**

The announcement of a new contract for PYP that will increase operating profits by 5°/o over the next 5 years is expected to reduce the return investors require because stronger, more predictable operating cash flows improve PYP's capacity to meet interest and principal payments. This lowers perceived credit and default risk. Where the market views the contract as credible and material, investors will accept a higher bond price for a given coupon; bond price and yield to maturity move inversely, so the required yield falls.

The senior management team decide to issue a convertible bond rather than a conventional bond also reduces the yield investors are likely to require. A convertible bond gives its holder the usual debt claim plus an embedded right to convert into shares under specified terms. That conversion feature provides potential participation in future growth in PYP's share value. Because investors receive this additional valuable feature, they can rationally accept a lower coupon and lower yield to maturity than they would demand for an otherwise comparable conventional bond. This is consistent with CIMA's treatment of convertible debt as a hybrid financing instrument and with the inverse price–yield relationship for bonds. See CIMA and the SEC's corporate-bond guidance.

**QUESTION NO: 34**

Holding cashÂ in excess of business requirementsÂ rather than returning the cash to shareholders is most likely toÂ result inÂ lower:

**A.** liquidity.

**B.** vulnerability to a takeover bid.

**C.** net profit.

**D.** return on equity.

**ANSWER: D**

**Explanation:**

**return on equity.** is correct because return on equity measures the return generated for ordinary shareholders relative to the equity they have invested or that has been retained in the business. It is commonly expressed as profit after tax divided by shareholders' equity. When a company keeps cash that is not needed for operations, investment, debt servicing, or a prudent liquidity buffer, the retained funds remain within shareholders' equity. Excess cash will usually earn only a modest return, particularly compared with the returns expected from productive operating assets or investments. Consequently, profit does not normally rise by enough to match the additional equity retained in the company, reducing the return generated per unit of shareholders' funds. Returning genuinely surplus cash through a dividend or share repurchase reduces the equity capital left in the business and can therefore avoid this dilution of the equity return measure, provided the distribution does not harm the entity's ability to fund its requirements. This relationship is consistent with the Financial Strategy focus on shareholder value, financing policy and the efficient deployment of capital. See CIMA's Financial Strategy subject information and the definition and calculation of shareholder returns.

**QUESTION NO: 35**

A company is reporting under IFRS 7 Financial Instruments: Disclosures for the first time and the directors are concerned about whether this will lead to the disclosure of information that could affect the company's share price.

The company is based in a country that uses the A$ but 40% of revenue relates to export sales to the USA and priced in US$.

When the company reports under IFRS 7 for the first time the share price is most likely to:

**A.** Increase due to greater clarity of information available on the extent of US$ risks and how they are managed.

**B.** Stay the same since US$ risk can already be quantified from segmental analysis disclosures included elsewhere in the annual report.

**C.** Decrease since investors place a lower value on higher risk businesses.

**D.** Either increase or decrease depending on market reaction to new information on how financial risk is managed.

**ANSWER: D**

**Explanation:**

Either increase or decrease depending on market reaction to new information on how financial risk is managed. IFRS 7 requires entities to disclose information that enables users of the financial statements to evaluate both the significance of financial instruments to the entity and the nature and extent of risks arising from them. For a business with substantial US-dollar-denominated export revenue but an Australian-dollar functional environment, foreign-currency risk is likely to be a significant area of disclosure. The first IFRS 7 disclosures may provide investors with clearer quantitative information about the entity's exposure to exchange-rate movements, its risk-management objectives and policies, the use of hedging instruments, and sensitivity to reasonably possible currency changes. This information can alter investors' assessment of expected cash flows, volatility, and the effectiveness of management's controls. The market response is therefore not predetermined: investors may value robust hedging and transparent risk management positively, or react adversely if the disclosures reveal material unhedged exposure or risk previously not fully understood. IFRS 7 is a disclosure standard, not a rule that mechanically determines valuation; the price effect depends on the content of the newly available information and investor interpretation. See the IFRS Foundation's IFRS 7 overview and IAS Plus summary of IFRS 7 disclosures.

## QUESTION NO: 36

A company has 30 million shares in issue and an equity market value of $240 million.

It has debt with a market value of $160 million.

The company intends to borrow a further $40 million and use the proceeds to repurchase shares at their current market price.

Assuming that there are no taxes, transaction costs or changes in operating risk, what will be the company's gearing after the repurchase, measured as debt/(debt + equity) using market values?

**A.** 40%

**B.** 44%

**C.** 50%

**D.** 56%

## ANSWER: C

**Explanation:**

The gearing after the repurchase will be **50%**. Before the transaction, total market-value capital is $400 million, comprising $160 million debt and $240 million equity.

The company borrows an additional $40 million and immediately distributes that cash through a repurchase. Debt therefore increases to $200 million. Equity falls by the $40 million cash paid to shareholders, from $240 million to $200 million. Total capital remains $400 million.

Post-repurchase gearing is consequently $200 million ÷ ($200 million + $200 million) = **50%**. The transaction substitutes debt finance for equity finance and increases financial gearing. This is consistent with capital-structure analysis based on market values of debt and equity. See OpenStax, Capital Structure.

## QUESTION NO: 37

A listed company is planning a share repurchase.

The following data applies:

• There are 10 million shares in issue

• The share repurchase will involve buying back 20% of the shares at a price of $0.75

• The company is holding $2 million cash

• Earnings for the current year ended are $2 million

The Directors are concerned about the impact that this repurchase programme will have on the company's cash balance and current year earnings per share (EPS) ratio.

Advise the directors which of the following statements is correct?

**A.** The cash balance will decrease by 75% and EPS will decrease by 25%.

**B.** The cash balance will decrease by 75% and EPS will increase by 25%.

**C.** The cash balance will decrease by 20% and the EPS will decrease by 25%.

**D.** The cash balance will decrease by 20% and the EPS will increase by 25%.

## ANSWER: B

**Explanation:**

The cash balance will decrease by 75% and EPS will increase by 25%. The company will repurchase 20% of its 10 million shares, meaning that it buys back 2 million shares. At $0.75 per share, the total cash paid is $1.5 million (2 million × $0.75). Relative to the opening cash balance of $2 million, this is a 75% reduction: $1.5 million ÷ $2 million × 100. Cash remaining after the repurchase is therefore $0.5 million.

Assuming that the stated current-year earnings remain $2 million and applying the question's implied full-year share-count basis, shares in issue fall from 10 million to 8 million. EPS before the repurchase is $0.20 per share ($2 million ÷ 10 million shares). EPS after the repurchase is $0.25 per share ($2 million ÷ 8 million shares). The increase is $0.05 per share, which is 25% of the original $0.20 EPS. This follows the basic EPS principle that profit attributable to ordinary shareholders is divided by the number of ordinary shares; in published financial statements, the denominator is ordinarily the weighted-average number of shares during the period. See IFRS: IAS 33 Earnings per Share and IAS 33 standard text.

## QUESTION NO: 38

A listed entertainment and media company produces and distributes films globally. The company invests heavily in intellectual property in order to create the scope for future film projects. The company has five separate distribution companies, each managed as a separate business unit The company is seeking to sell one of its business units in a management buy-out (MBO) to enable it to raise finance for proposed new investments

The business unit managers have been in discussions with a bank and venture capitalists regarding the financing for the MBO The venture capitalists are only prepared to invest a mixture of debt and equity and have suggested the following:

| | $ million |
|---|---|
| Agreed selling price | 100 |
| Equity invested by managers | 35 |
| Equity invested by venture capitalists | 30 |
| Borrowing from venture capitalist – secured, 5% interest, redeemable in 5 years | 35 |

The venture capitalists have stated that they expect a minimum return on their equity investment of 3Q°/o a year on a compound basis over the first 5 years of the MBO No dividends will be paid during this period.

Advise the MBO team of the total amount due to the venture capitalist over the 5-year period to satisfy their total minimum return?

**A.** $155.14 million

**B.** $111.39 million

**C.** $120.14 million

**D.** $146.39 million

## ANSWER: B

**Explanation:**

**$111.39 million** is the total amount required to meet the venture capitalist's minimum return on its equity investment. The financing information identifies a $30 million equity contribution by the venture capitalist. Since the required return is 30% per year, compounded annually for five years, and no dividends are paid during that time, the return accumulates entirely within the equity value. The appropriate compound-growth calculation is therefore $30 million × $(1.30)^5$. This produces $111.3879 million, which rounds to $111.39 million.

This is a future-value calculation: it represents both the return of the original equity capital and the compounded investment return due at the end of year five. No annual cash distributions are deducted because the scenario expressly states that dividends will not be paid. In an MBO, a venture capitalist's equity return is commonly realised when the investment is sold, refinanced, or otherwise exited, so calculating the required future equity value is essential when assessing whether the proposed transaction can deliver the investor's target return. This applies the time value of money and compound-interest principles covered in Financial Strategy. See the CGMA Professional Qualification syllabus and the SEC Investor.gov explanation of compound interest.

## QUESTION NO: 39

The Board of Directors of a listed company wish to estimate a reasonable valuation of the entire share capital of the company in the event of a takeover bid.

The company's current profit before taxation is $4.0 million.

The rate of corporate tax is 25%.

The average P/E multiple of listed companies in the same industry is 8 times current earnings.

The P/E multiple of recent takeovers in the same industry have ranged from 9 times to 10 times current earnings.

The average P/E multiple of the top 100 companies on the stock market is 15 times current earnings.

Advise the Board of Directors which of the following is a reasonable estimate of a range of values of the entire share capital in the event of a bid being made for the whole company?

**A.** Minimum = $36 million and maximum = $40 million.

**B.** Minimum = $27 million and maximum = $30 million.

**C.** Minimum = $32 million and maximum = $60 million.

**D.** Minimum = $24 million and maximum = $45 million.

## ANSWER: B

**Explanation:**

Minimum = $27 million and maximum = $30 million. is the reasonable estimate because a price/earnings valuation applies the selected earnings multiple to earnings available to ordinary shareholders after corporate tax. Starting with profit before taxation of $4.0 million, tax at 25% is $1.0 million, giving current post-tax earnings of $3.0 million. For a bid for the whole company, the most relevant market evidence supplied is the range of multiples paid in recent comparable takeovers in the same industry. Those transactions reflect the pricing of control and are therefore more suitable than the ordinary listed-company average when estimating a takeover value. Applying the lower takeover multiple of 9 to $3.0 million gives $27.0 million, while applying the upper multiple of 10 gives $30.0 million. This produces a supportable valuation range for the entire equity share capital. The price/earnings approach and the need to select comparables relevant to the transaction are consistent with the valuation techniques covered in CIMA Financial Strategy; see the [CIMA Professional Qualification resources] and this overview of the [price-to-earnings ratio].

## QUESTION NO: 40

Listed Company A has prepared a valuation of an unlisted company. Company B. to achieve vertical integration Company A is intending to acquire a controlling interest in the equity of Company B and therefore wants to value only the equity of Company B.

The assistant accountant of Company A has prepared the following valuation of Company B's equity using the dividend valuation model (DVM):

Where:

• S2 million is Company B's most recent dividend

• 5% is Company B's average dividend growth rate over the last 5 years

• 10% is a cost of equity calculated using the capital asset pricing model (CAPM), based on the industry average beta factor

$$\text{Valuation of Company B's equity} = \frac{\$2\,million \times 1.05}{0.10-0.05} = \$42\,million$$

Where:

Which THREE of the following are valid criticisms of the valuation of Company B's equity prepared by the assistant accountant?

**A.** The DVM calculation should use Company A's cost of equity rather than Company B's cost of equity

**B.** It is better to use the present value of earnings rather than present value of dividends to value a controlling interest

**C.** The 5% growth rate may not reflect the future growth of Company B.

**D.** The beta factor used may not reflect Company B's financial risk.

**E.** An unlisted company cannot use the capital asset pricing model to calculate its cost of equity

**ANSWER: B C D**

**Explanation:**

It is better to use the present value of earnings rather than present value of dividends to value a controlling interest because an acquirer obtaining control can determine the target's future dividend policy and has access to the economic benefits generated by its earnings. Dividends may be retained, deferred or altered for reasons unrelated to operating performance; therefore, forecast maintainable earnings or cash flows provide a more relevant basis for assessing the value available to a controlling purchaser. The 5% growth rate may not reflect the future growth of Company B because a historical average is not necessarily representative of prospective conditions. Changes in market demand, margins, investment requirements, competition and the effect of the proposed vertical integration can all change the sustainable growth rate. The beta factor used may not reflect Company B's financial risk because beta is affected by financial gearing as well as business risk. An industry-average beta may reflect companies with capital structures materially different from Company B's. For valuation, a comparable beta should be adjusted, or relevered, to reflect Company B's own debt-to-equity position before using it in CAPM. CAPM can nevertheless be applied to an unlisted business by using an appropriate quoted-company proxy beta. See ACCA: Business valuations and Damodaran: Beta and capital structure.

## QUESTION NO: 41

A company is planning a share repurchase programme with the following details:

• Repurchased shares will be immediately cancelled.

• The shares will be purchased at a premium to the market share price.

The current market share price is greater than the nominal value of the shares.

Which of the following statements about the impact of the share repurchase programme on the company's financial statements is correct?

**A.** The premium to the nominal value would be charged to retained earnings.

**B.** The share capital figure would reduce by the nominal value of the shares purchased.

**C.** The total value of the equity in its Statement of Financial Position would remain unchanged.

**D.** The premium to the market value would be charged to the Income Statement.

**ANSWER: B**

**Explanation:**

The share capital figure would reduce by the nominal value of the shares purchased. Cancellation means that the repurchased shares cease to exist as issued shares, so their nominal (par) value is removed from the company's share-capital balance. The repurchase is an owner transaction rather than an operating expense or source of income. Accordingly, it is accounted for within equity and does not give rise to a charge in profit or loss merely because the company pays more than the current market price.

Under IAS 32, consideration paid to acquire an entity's own equity instruments is recognised as a deduction from equity. Where shares are cancelled, the nominal amount represented by those shares is consequently eliminated from issued share capital; the overall cash payment also reduces equity. The detailed allocation of the remainder of the payment within equity can depend on the company's applicable legal and accounting framework and available reserves, but it does not alter the fundamental reduction in share capital by the shares' nominal value. This is the direct financial-statement consequence identified in the question.

IAS 32's requirements for treasury shares and transactions in an entity's own equity instruments are available at IFRS Foundation: IAS 32 Financial Instruments: Presentation. The CIMA Financial Strategy syllabus is published at AICPA & CIMA: Professional Qualification syllabus.

## QUESTION NO: 42

Which THREE of the following prevent the Purchasing Power Parity Model from operating effectively in practice?

**A.** Arbitrage

**B.** Consumer tastes

**C.** Differing tax regimes

**D.** Import tariffs

**E.** Transport costs

## ANSWER: B D E

**Explanation:**

Consumer tastes, import tariffs and transport costs are practical reasons why purchasing power parity (PPP) does not hold precisely. PPP relies on the tendency for comparable goods to have equivalent prices once expressed in a common currency. Consumer tastes can produce materially different consumption baskets across countries: consumers may place different values on product characteristics, brands, quality or locally supplied alternatives, so national price indices are not necessarily measuring like-for-like expenditure. This weakens the comparability required when PPP is applied to broad consumer price baskets.

Import tariffs create a direct policy-driven wedge between the domestic and foreign price of an imported good. Even where the underlying producer price is identical, the tariff raises the landed domestic price and prevents prices from converging fully. Transport costs have a similar practical effect because moving goods between markets consumes real resources. A price difference must be sufficiently large to cover shipping, insurance, handling and distribution costs before trade can profitably narrow it. Consequently, price gaps can persist without creating an exploitable opportunity. The World Bank discusses PPP price comparisons and price-level measurement at https://www.worldbank.org/en/programs/icp/brief/PPP; the IMF also outlines the role of trade costs and other frictions in exchange-rate behaviour at https://www.imf.org/external/pubs/ft/fandd/basics/ppp.htm.

## QUESTION NO: 43

X exports goods to customers in a number of small countries Asia. At present, X invoices customers in X's home currency.

The Sales Director has proposed that X should begin to invoice in the customers currency, and the Treasurers considering the implications of the proposal.

Which TWO of the following statement are correct?

**A.** X may be able to sell the receipts forward.

**B.** If the proposal is adopted, X will have a lower effective sales price per unit due to exchange rate fluctuations.

**C.** X will know in advance the amount of home currency it will receive for the export sales.

**D.** The overseas customers may have difficulty obtaining X's home currency with which to make the purchases, so the Sales Director's proposal may increase sales.

**E.** The customer will bear the foreign exchange risk and will only buy from X if they are prepared to accept this.

**ANSWER: A D**

**Explanation:**

“X may be able to sell the receipts forward” is correct because invoicing customers in their local currencies creates foreign-currency receivables for X. Once the invoiced amount and expected receipt date are known, X can normally enter a forward foreign-exchange contract to sell the expected foreign-currency receipt and buy its home currency on that date. This enables X to lock in the home-currency value of the receivable, subject to the availability of a suitable forward market or bank quotation for the particular currency and maturity. Managing the currency exposure generated by trade receivables in this way is a central treasury activity in financial strategy.

“The overseas customers may have difficulty obtaining X's home currency with which to make the purchases, so the Sales Director’s proposal may increase sales” is also correct. Customers currently need to acquire X’s home currency before settlement, exposing them to conversion costs, administrative inconvenience, and exchange-rate uncertainty. Quoting and invoicing in the customers’ own currencies removes that payment obstacle from the buyer and can make X’s products more attractive, potentially supporting sales volume or market access. The commercial benefit is therefore plausible, while the associated exchange risk is transferred to X and can be managed separately through hedging. See the CGMA Professional Qualification resources and the Bank of England’s overview of foreign-exchange markets.

**QUESTION NO: 44**

Extracts from a company's profit forecast for the next financial year as follows:

| | $ million |
|---|---|
| Operating profit | 1000 |
| Profit before taxation | 875 |
| Profit after taxation | 625 |
| Profit after preference dividend | 500 |

Since preparing the forecast, the company has decided to return surplus cash to shareholders by a share repurchase arrangement.

The share repurchase would result in the company purchasing 20% of the 1,250 million ordinary shares currently in issue and canceling them.

Assuming the share repurchase went ahead, the impact on the company's forecast earnings per share will be an increase of:

**A.** $0.100

**B.** $0.125

**C.** $0.175

**D.** $0.200

## ANSWER: A

**Explanation:**

**$0.100** is correct. Earnings per share is calculated by dividing the earnings attributable to ordinary equity holders by the weighted average number of ordinary shares in issue. The forecast profit attributable to ordinary shareholders is $500 million after allowing for the preference dividend. Before the repurchase, forecast EPS is therefore $500 million divided by 1,250 million ordinary shares, or $0.40 per share.

The company will buy back and cancel 20% of its ordinary shares: 20% × 1,250 million equals 250 million shares. The resulting number of ordinary shares is 1,000 million. On the stated assumption that the profit forecast is unchanged, revised EPS becomes $500 million divided by 1,000 million shares, or $0.50 per share. The forecast EPS increase is consequently $0.50 less $0.40, which is **$0.100 per share**.

This treatment reflects the core EPS principle in IAS 33: earnings available to ordinary shareholders are related to the ordinary shares outstanding, with cancelled shares no longer included in the denominator. See the IFRS overview of IAS 33 Earnings per Share and the IAS 33 standard text.

## QUESTION NO: 45

A company is currently all-equity financed.

The directors are planning to raise long term debt to finance a new project.

The debt:equity ratio after the bond issue would be 30:60 based on estimated market values.

According to Modigliani and Miller's Theory of Capital Structure without tax the company's cost of equity would:

**A.** stay the same.

**B.** decrease.

**C.** increase.

**D.** increase or decrease depending on the bond's coupon rate.

## ANSWER: C

**Explanation:**

**increase.** Under Modigliani and Miller's no-tax capital-structure proposition, introducing debt does not change the overall value of the firm or its weighted average cost of capital, assuming perfect capital markets and no taxation. However, debt creates financial risk for ordinary shareholders because debt interest and repayment obligations have priority over distributions to equity holders. Equity investors therefore require a higher expected return to compensate for the greater volatility and residual risk of their cash flows.

This relationship is commonly expressed as: $k_e = k_{eu} + (k_{eu} - k_d)D/E$, where $k_{eu}$ is the cost of equity in an ungeared company, $k_d$ is the cost of debt, and $D/E$ is the market-value debt-to-equity ratio. Since the company moves from no debt to a positive market-value gearing ratio of 30:60, its equity cost rises. This increase exactly offsets the benefit of substituting lower-cost debt for equity, leaving the no-tax WACC unchanged under the model. The analysis relies on market values, as specified, because investor required returns and capital-structure proportions are market-based concepts. See Aswath Damodaran's capital structure materials and Corporate Finance Institute's overview of the Modigliani–Miller theorem.

## QUESTION NO: 46 - (SIMULATION)

A listed company follows a policy of paying a constant dividend.  The following information is available:

- Issued share capital (nominal value $0.50) $60 million
- Current market capitalisation $480 million

The shareholders are requesting an increased dividend this year as earnings have been growing. However, the directors wish to retain as much cash as possible to fund new investments. They therefore plan to announce a 1-for-10 scrip dividend to replace the usual cash dividend.

Assuming no other influence on share price, what is the expected share price following the scrip dividend?

Give your answer to 2 decimal places.

$ ?

**ANSWER: See the explanation for the answer**

**Explanation:**

**Expected share price: $3.64**

Number of existing shares = $60m / $0.50 = **120 million shares**.
Current share price = $480m / 120m = **$4.00**.
A 1-for-10 scrip dividend gives one additional share for every ten held, increasing the number of shares by 10%.
Expected ex-scrip price = $4.00 / 1.10 = **$3.636...**.

Therefore, rounded to two decimal places, the expected price following the scrip dividend is **$3.64**.

## QUESTION NO: 47

A company's gearing is well below its optimal level and therefore it is considering implementing a share re-purchase programme.

This programme will be funded from the proceeds of a planned new long-term bond issue.

Its financial projections show no change to next year's expected earnings.

As a result the company plans to pay the same total dividend in future years.

If the share re-purchase is implemented which THREE of the following measures are most likely to decrease?

**A.** The Weighted Average Cost of Capital

**B.** The cost of equity

**C.** The interest cover

**D.** Next year's dividend per share

**E.** The gearing based on book value (debt ÷ (debt + equity))

**F.** The number of shares in issue

**ANSWER: A C F**

**Explanation:**

The Weighted Average Cost of Capital is likely to decrease because the company is currently geared below its optimum level. Replacing some equity with long-term debt increases the proportion of finance provided by debt, which is normally cheaper than equity, particularly once the tax deductibility of interest is reflected. Although additional gearing raises equity investors' financial risk and therefore the cost of equity, the company's position below its optimal gearing means the overall weighted cost of capital is expected to fall. This is consistent with the capital-structure principle that debt can provide a tax shield, subject to the trade-off against financial-distress costs. See ACCA: Cost of capital.

The interest cover will decrease because projected earnings are unchanged while the new bond issue creates additional interest expense. Interest cover measures operating profit or earnings relative to finance costs, so a higher interest charge reduces the coverage ratio. The number of shares in issue will also decrease directly: a share repurchase cancels or removes the repurchased shares from those remaining in public issue. The unchanged total dividend is consequently spread over fewer shares, which is relevant to the expected dividend per share. For an overview of repurchases and their effect on shares outstanding, see [Investor.gov: Share repurchase].

## QUESTION NO: 48

Company AD is planning to acquire Company DC. It is evaluating two methods of structuring the terms of the bid, which will be ether a debt-funded cash offer or a share exchange

The following Information is relevant

• The two companies are of similar size and in related industries

• AB ' s gearing ratio measured as debt to debt plus equity, is currently 30% based on market values. This Is the company ' s optimum capital structure set to reflect the risk appetite of shareholders.

• The combined company is expected to generate savings and synergies

Which THREE of the following are advantages to AB ' s shareholders of a debt-funded cash offer compared with a share exchange?

**A.** Shareholder control will remain with AB’s current shareholders

**B.** More of the synergistic benefits of the acquisition will accrue to AB ' s current shareholders.

**C.** Gearing will increase.

**D.** EPS Mil Increase

**E.** WACC will increase f credit worthless falls too low, further increasing the returns to shareholders.

**ANSWER: A B D**

**Explanation:**

“Shareholder control will remain with AB’s current shareholders” is an advantage because a debt-funded cash offer does not require AB to issue new ordinary shares to DC’s shareholders. AB’s existing shareholders therefore retain their relative voting rights and ownership of the enlarged business. This is particularly relevant where the companies are similar in size, since a share exchange could result in a substantial transfer of influence to the former shareholders of the target.

“More of the synergistic benefits of the acquisition will accrue to AB ' s current shareholders.” is also an advantage. In a cash acquisition, DC’s shareholders receive the agreed cash consideration and do not participate as equity holders in the future combined entity. Consequently, savings and synergies arising after completion belong to AB’s existing equity holders, subject to the fixed claims of debt providers.

“EPS Mil Increase” is an advantage where the incremental earnings from the acquired business and anticipated synergies exceed the after-tax finance cost of the additional borrowing. Because no new AB shares are issued, those additional earnings are not spread across a larger number of shares. This reflects the financial-strategy distinction between cash and share consideration in takeover funding. The UK Takeover Code sets the framework for cash and securities consideration in offers: [The Takeover Code]. CIMA’s professional qualification overview is available at [AICPA & CIMA].

## QUESTION NO: 49

Company A plans to acquire Company B an unlisted company which has been in business for 3 years.

It has incurred losses in its first 3 years but is expected to become highly profitable in the near future.

No listed companies in the country operate the same business field as Company B a unique new high-risk business process.

The future success of the process and hence the future growth rate in earnings and dividends is difficult to determine.

Company A is assessing the validity of using the dividend growth method to value Company B.

Which THREE of the following are weaknesses of using the dividend growth model to value an unlisted company such as Company B?

**A.** The company has been unprofitable to date and hence there is no established dividend payment pattern.

**B.** The future projected dividend stream is used as the basis for the valuation.

**C.** The future growth rate in earnings and dividends will be difficult to accurately determine.

**D.** The dividend growth model does not take the time value of money into consideration.

**E.** The cost of capital will be difficult to estimate.

**ANSWER: A C E**

**Explanation:**

The company has been unprofitable to date and hence there is no established dividend payment pattern. This is a significant limitation because dividend-growth valuation needs a credible current or near-term dividend base from which future distributions can be forecast. A business with a loss-making history may have retained all available cash to fund operations and growth, so any assumed future dividend policy is especially uncertain.

The future growth rate in earnings and dividends will be difficult to accurately determine. The constant-growth dividend model is highly sensitive to its growth assumption, particularly where the growth rate is close to the required return. Here, the process is novel, high risk and has no directly comparable listed businesses, meaning that sustainable earnings, payout capacity and long-term dividend growth cannot be estimated reliably.

The cost of capital will be difficult to estimate. The required return is a central input to the model, but an unlisted business has no observable share-price returns or directly observable equity beta. Its unique activity also limits the usefulness of proxy comparators. Estimating an appropriate risk-adjusted discount rate therefore requires substantial judgement and can materially affect value. These dependencies are consistent with the dividend-discount model's reliance on expected dividends, growth and required return, as outlined by CFA Institute's dividend discount model overview and Aswath Damodaran's valuation resources.

## QUESTION NO: 50

Company C has received an unwelcome takeover bid from Company P.

Company P is approximately twice the size of Company C based on market capitalisation.

Although the two companies have some common business interests, the main aim of the bid is diversification for Company P.

The offer from Company P is a share exchange of 2 shares in Company P for 3 shares in Company C.

There is a cash alternative of $5.50 for each Company C share.

Company C has substantial cash balances which the directors were planning to use to fund an acquisition.

These plans have not been announced to the market.

The following share price information is relevant. All prices are in $.

| | Company P | Company C |
|---|---|---|
| | $ | $ |
| 3 months ago | 9.50 | 4.25 |
| 1 month ago | 8.75 | 4.75 |
| Today | 7.75 | 5.25 |

Which of the following would be the most appropriate action by Company C ' s directors following receipt of this hostile bid?

**A.** Write to shareholders explaining fully why the company ' s share price is undervalued.

**B.** Change the Articles of Association to increase the percentage of shareholder votes required to approve a takeover.

**C.** Pay a one-off special dividend.

**D.** Refer the bid to the country ' s competition authorities.

**ANSWER: A**

**Explanation:**

Write to shareholders explaining fully why the company ' s share price is undervalued. This is the most appropriate response because the directors' central responsibility is to give shareholders sufficient, relevant information and a properly reasoned recommendation so they can decide whether to accept the offer. Company C's substantial cash resources and its prospective acquisition strategy may be material to an assessment of the company's standalone value. If the market price does not yet reflect value attributable to those resources and plans, the board should explain the basis on which it considers the bid inadequate, while ensuring that any disclosure is accurate, supportable and consistent with applicable market-disclosure requirements.

Under the UK Takeover Code, the target board must circulate its opinion on the offer and the reasons for that opinion, supported by competent independent advice. The board should therefore communicate a clear valuation case rather than take action whose principal effect is to obstruct shareholders' ability to consider the bid. A detailed explanation of undervaluation enables shareholders to compare the offered cash or share consideration with the directors' assessment of the value and prospects of continuing to hold Company C shares. See the Takeover Code, Rule 25 and the Takeover Code.

**QUESTION NO: 51**

A large listed company is planning a major project that should greatly improve its share price in the long term.

These plans require a significant capital cost that the company plans to finance by debt.

All of the debt options being considered are for the same duration of time.

Which of the following sources of debt finance is likely to be the most expensive for the company over the full term of the debt?

**A.** Bonds

**B.** A finance lease

**C.** Convertible bonds

**D.** Bank loan

**ANSWER: C**

**Explanation:**

Convertible bonds are likely to be the most expensive source over the full term because their economic cost is not limited to the interest coupon. A convertible gives its holder the right to exchange the debt for a specified number of ordinary shares, normally at a conversion price determined when the bond is issued. Here, the company expects the project to increase its share price substantially. The conversion right is therefore likely to become highly valuable: investors can acquire shares at the pre-agreed conversion terms even though those shares will have a much higher market value by then.

The company may pay a lower stated coupon on convertible bonds because it has granted that conversion right. However, if conversion occurs following the anticipated share-price increase, existing shareholders bear a significant economic cost through dilution and the transfer of future equity value to bondholders. When the interest cost and the value of this embedded conversion feature are considered together, the overall cost can exceed the apparent cost suggested by the coupon alone. The forecast improvement in share price is the key fact that makes this outcome particularly likely. Convertible instruments are also treated as potential ordinary shares in assessing dilution under IAS 33 Earnings per Share. Further background on the CGMA qualification's Financial Strategy subject is available from AICPA & CIMA.

**QUESTION NO: 52**

The directors of a financial services company need to calculate a valuation of their company's equity in preparation for an upcoming initial Public Offering (IPO) of shares. At a recent board meeting they discussed the various methods of business valuation.

The Chief Executive suggested using a Price-earing (P./E) method of valuation, but the finance Director argued that a valuation based on forecast cash flows to equity would be more appropriate.

Which THREE of the following are advantages of valuation based on forecast cash flows to equity, compared to a valuating using a price earnings methods?

**A.** Using cash is theoretically superior to using profits in a valuation calculation.

**B.** It give on estimate of the likely shareholder value that will be created.

**C.** The calculations are much simpler.

**D.** It incorporates the time value of money.

**E.** It avoids the problem of having to forecast a sustainable level of future growth.

**ANSWER: A B D**

**Explanation:**

"Using cash is theoretically superior to using profits in a valuation calculation," "It give on estimate of the likely shareholder value that will be created," and "It incorporates the time value of money" are advantages of a forecast-cash-flows-to-equity valuation. The fundamental principle of valuation is that an equity interest is worth the present value of the future cash amounts available to its owners. Cash flows are therefore more directly relevant to shareholder returns than accounting earnings, which can be affected by non-cash items, accounting policies, and the timing of recognition.

Forecast cash flows to equity also estimate the value attributable specifically to ordinary shareholders: the future cash flows remaining after operating requirements, tax, interest, and debt-related cash flows have been taken into account. Discounting those forecast amounts using the required return on equity produces a present equity value and therefore an indication of shareholder value created by the business's expected future performance.

Crucially, the discounting process explicitly recognises that cash received sooner has a higher value than the same nominal cash received later. This treatment of timing is central to discounted-cash-flow valuation. The CFA Institute provides an overview of the discounted-cash-flow approach at https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/discounted-dividend-valuation, and the UK government's appraisal guidance explains discounting and present values at https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government/the-green-book-2020.

## QUESTION NO: 53

A company's annual dividend has grown steadily at an annual rate of 3% for many years. It has a cost of equity of 11%. The share price is presently $64.38.

The company is about to announce its latest dividend which is expected to be $5.00 per share.

The Board of Directors is considering an attractive investment opportunity that would have to be funded by reducing the dividend to $4.50 per share. The board expects the project to enable future dividends to grow by 5% every year and the cost of equity to remain unchanged.

Calculate the change in share price assuming that the directors announce their intention to proceed with this investment opportunity.

Give your answer to 2 decimal places.

**A.** 14.37

## ANSWER: A

**Explanation:**

14.37 is correct. The constant-growth dividend valuation model values a share as the next year's dividend divided by the difference between the cost of equity and the perpetual dividend-growth rate: $P_0 = D_1/(k_e - g)$. This is the Gordon growth model, as outlined in Aswath Damodaran's dividend-discount-model materials.

The stated current price is consistent with the existing policy. The imminent dividend is $5.00, so the following dividend under 3% growth would be $5.15. Therefore, the value is $5.15/(0.11 − 0.03) = $64.375, which rounds to the given $64.38.

Following the investment announcement, the imminent dividend becomes $4.50. The next dividend is consequently $4.50 × 1.05 = $4.725. With the unchanged 11% cost of equity and the new perpetual growth rate of 5%, the revised share value is $4.725/(0.11 − 0.05) = $78.75. The change in value is therefore $78.75 − $64.38 = $14.37. This application depends on using the dividend one period ahead in the numerator and on the required return exceeding the perpetual growth rate, a core condition of the model; see also Corporate Finance Institute's overview of the dividend discount model.