



INSTITUTE OF ACTUARIAL
& QUANTITATIVE STUDIES

Subject: Business finance 1

Chapter: Unit 3

Category: Practice question

1. Subject CT2 September 2010 Question 14

Explain why a company's gearing ratio calculated from the company's annual accounts might not be sufficient on its own to provide an interested party with an understanding of its capital structure.

2. Subject CT2 September 2010 Question 20 (part)

Koolclean plc was founded several years ago by the inventor of an innovative consumer product. The product has been very successful in the UK and the inventor has decided to seek a quote on the Alternative Investment Market (AIM). At present 60% of Koolclean plc's shares are held by the inventor and the remaining 40% are held by a venture capitalist who is keen for the company to list in this way so that his block of shares can be sold.

The company has been managed by the inventor herself, assisted by a part-time director appointed by the venture capitalist. The part-time director will step down when the venture capitalist's block of shares is sold.

- i. Explain the advantages and disadvantages of seeking the initial funding for a new business in the form of equity from a venture capitalist rather than borrowing.

3. Subject CT2 April 2011 Question 18

The directors of a quoted company have the opportunity to invest in a profitable project, but will be unable to raise sufficient finance in the required timeframe unless they substantially reduce the next dividend payment compared with that paid in previous years.

Discuss the implications of reducing the dividend under these circumstances.

4. Subject CT2 September 2011 Question 13

A company requires finance in order to expand.

Explain how the company's tax position may affect the decision to use debt rather than equity

5. Subject CT2 September 2012 Question 20

Hatton is a quoted company in the entertainment industry. The company's directors are extremely ambitious and strive to maximise Hatton's rate of growth. The directors have identified the availability of finance as the company's biggest constraint.

The directors have been offered the opportunity to invest in two projects, each involving the development of a new games console. The projects involve competing products and so they are effectively mutually exclusive because there would be no commercial justification in investing in both.

Project A requires an investment of £20 million and has a projected net present value of £80 million. Project B requires an investment of £50 million and has a projected net present value of £200 million. Hatton does not have any spare cash and so it will have to raise finance in order to invest in either project.

The directors of Hatton are unable to decide which of the two investments is better for the company. Each is relatively risky, but the two projects are exposed to virtually the same factors that will determine success or failure and, in that sense, the risks are virtually identical.

Hatton is heavily geared. The company's equity has a book value of £900 million and its debt has a book value of £350 million. Hatton made a large share issue last year and the directors do not believe that they could seek further equity in the short term. The company's debt includes a major loan from a commercial bank that carries a debt covenant under which the loan is repayable in the event that

gearing (measured as debt as a percentage of total finance) exceeds 30%.

Hatton's marketing director is keen to proceed with Project B on the basis that it offers the greatest opportunity to enhance the company's share price.

Hatton's chief executive is keen to proceed with Project A on the basis that it will be possible to finance that project without taking the company to the very brink of its debt covenant.

Hatton's finance director has urged caution and recommends refusing both opportunities on the grounds that the only cost of doing so is the opportunity cost. His reasons for this recommendation is that the company is already heavily involved in the games business and it might be better to diversify into other areas of entertainment. In his opinion, refusing the projects will not risk harm to Hatton's share price.

- (i) Outline the reasons why a bank might impose a debt covenant such as that affecting Hatton's borrowing capacity.
- (ii) Discuss the risks associated with Hatton permitting its borrowings to rise to the maximum gearing level agreed with its bank.
- (iii) Discuss the validity of comments made by the finance director that:
 - a. the share price will not be harmed by the opportunity cost associated with turning down an investment project with a positive NPV.
 - b. the share price could be improved by Hatton diversifying its investment base.

6. Subject CT2 September 2013 Question 12

A quoted company has a policy of making relatively small dividend payments, with profits being reinvested in the business. A period of slow growth in the industry has left the company with a substantial cash surplus as a result of this policy.

Discuss the advantages to the company and shareholders of reducing this surplus by means of a share buyback rather than a dividend payment.

7. Subject CT2 April 2014 Question 15

A company's current share price is £2.70. The company has written to shareholders to offer a choice between a cash dividend of £0.50 per share or a scrip dividend of two fully paid shares for every nine shares held.

Discuss the factors that shareholders would have to take into account when deciding whether to take the cash or the scrip dividend.

8. Subject CT2 September 2014 Question 19

Trevor and Simone have taken early retirement. Their retirement package has left each of them with a lump sum that is substantial, but they have decided to start a business together in the hope of accumulating significant wealth before reaching normal retirement age in eight to ten years.

They have identified an opportunity to import consumer electronics from the Far East. They have established that there is a substantial niche market in the UK for products such as mobile phones and tablet computers that are produced for the Chinese market and which are rarely exported.

Trevor and Simone have negotiated the exclusive UK rights to import a new line of products that is presently in the final development stage. They have a few months to establish their company and to ensure that all of their distribution lines are in place. Their retirement payments will only provide approximately 60% of their funding requirements. They are unsure whether to raise additional funds

by inviting investors to become minority shareholders in this venture, or to seek a bank loan, or a combination of the two.

- i. Discuss the relative merits of the bank loan or additional equity from minority shareholders for Trevor and Simone's company.
- ii. Discuss the difficulties associated with determining the optimal gearing level for Trevor and Simone's company.

9. Subject CT2 April 2015 Question 13

A software development company is considering raising funds to expand the business. The company's only significant asset is the office block that it uses to accommodate its programming and administrative functions.

Explain the potential implications of raising funding through a sale and leaseback arrangement on the company's office block.

10. Subject CT2 April 2015 Question 14

A quoted company has had a difficult year and the directors believe that it may be too risky to maintain previous levels of dividend. However, they are considering maintaining the dividend in order to preserve stock market confidence.

Describe the implications for the directors of maintaining the dividend in these circumstances.

11. Subject CT2 April 2016 Question 11

Describe the role of tax in determining whether an individual shareholder would prefer to receive a dividend or a capital gain.

12. Subject CT2 September 2016 Question 17

Jolt is a quoted company that has pursued a policy of reinvesting profits in order to fund growth. As a result, the company has attracted a body of shareholders whose tax positions tend to favour capital gains over dividends. Jolt's industry faces some difficulties that will inhibit investment opportunities for the next three or four years.

Explain:

- a. whether Jolt is likely to change its dividend policy over the period of limited investment opportunities.
- b. how it should communicate this change.

13. Subject CT2 April 2017 Question 13

Describe why some individual taxpayers may prefer to receive investment returns in the form of capital growth rather than dividend.

14. Subject CT2 April 2017 Question 15

Describe why a company might buy back its own shares rather than make a distribution in the form of a dividend.

15. Subject CT2 April 2017 Question 16

Explain why the maximum acceptable level of gearing ratio might vary from country to country.

16. CT2 April 2018 Q20

Mountain plc is a quoted company with a year end of 31 December. The directors have traditionally published the financial statements in the second week of February following the year end and have always announced the dividend for the year alongside the publication of the financial statements.

Mountain plc's dividend has grown by between 3% and 5% each year for the past eight years.

During September 2016 the directors updated their projections of Mountain plc's financial position. They realised that it would probably not be prudent to increase the dividend compared to last year. Indeed, it may be desirable to reduce the dividend by 5% compared to that for the year ended 31 December 2015.

Mountain plc continues to be profitable. However, a large loan has been negotiated in order to fund expansion. If the market's expectations concerning the dividend for the year ended 31 December 2016 are met then the company's projected gearing ratio will be at the upper limits of the terms specified by the lender. The directors themselves would be uncomfortable with a gearing ratio that was that high.

The directors are debating the best way to address the question of the dividend. Three suggestions have been made:

- Announce the expected reduction in dividend immediately (i.e. in September 2016) with a clear explanation of the reasons.
- Wait and announce the reduced dividend, again with an explanation of the reasons, at the publication of the financial statements (i.e. in February 2017).
- Maintain the dividend growth, but organise a rights issue in order to ensure that there is sufficient equity to maintain the gearing ratio at an acceptable level.

(i) Explain why both the lender and Mountain plc's directors would wish to set an upper limit for the company's gearing ratio.

(ii) Discuss the advantages and disadvantages of announcing the proposed reduction in the dividend in September 2016 or in February 2017.

(iii) Discuss the advantages and disadvantages of conducting a rights issue to raise equity in order to continue the trend of dividend growth.

17. CT2 September 2018 Q14

Discuss the assertion that a company's optimal gearing ratio could be affected by its line of business.

18. CB1 April 2020 Q18

A private company's directors collectively own 100% of the company's share capital. For the past 3 years the company has paid an annual dividend equal to the annual profit after tax. Describe the implications of this dividend policy.

19. CB1 September 2021 Q12

The directors of a quoted company plan to make a major investment in a factory that will be used to manufacture a new product that is in development. This will be financed by a rights issue. The company's Finance Director believes that the share price will fall below the theoretical ex-rights weighted average price and has warned the board of this.

Explain the factors that would determine the share price after the rights issue.

20. CB1 September 2021 Q17

Explain whether businesses should aim to keep their working capital cycles as short as possible.



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