

# EXAMINATIONS

September 1997

**Subject B — Economics and Finance**

*Paper Two*

EXAMINERS' REPORT

## PART ONE

*The Board of Examiners decided that questions 2, 14 and 17 (amounting to 5 marks in total) were beyond that which could be expected from a reasonable interpretation of core reading and this was taken into account in the marking.*

*The remaining questions were generally well answered, although questions 1, 11 and 16 caused some difficulty.*

<b>1</b>	D
<b>2</b>	-
<b>3</b>	A
<b>4</b>	A
<b>5</b>	D
<b>6</b>	D
<b>7</b>	B
<b>8</b>	A
<b>9</b>	B
<b>10</b>	D
<b>11</b>	C
<b>12</b>	B
<b>13</b>	C
<b>14</b>	-
<b>15</b>	B
<b>16</b>	B
<b>17</b>	-
<b>18</b>	C
<b>19</b>	B
<b>20</b>	D
<b>21</b>	B
<b>22</b>	A
<b>23</b>	C
<b>24</b>	A
<b>25</b>	D

## PART TWO

*Question 26 was generally well answered.*

**26** A brief explanation of the following reasons was required:

- to raise capital for the company;
- to make it easier for the company to raise further capital;
- to give existing shareholders an exit route;
- to make the shares more marketable and easy to value.

*For Question 27, most candidates described the methods of calculating depreciation in company's accounts satisfactorily but few explained why it is needed in accounts and why it is calculated*

**27** Company accounts need to show the cost of using fixed assets as an operating expense. Depreciation measures the amount of the capital stock that has been used up in the year as a result of wear and tear. The calculation of depreciation for the accounts is not normally an attempt to assess accurately the real amount of depreciation. This is because asset values can be difficult to determine. Instead, it is normal to assume that a fixed asset is written off evenly over a number of years (the straight line depreciation method) or that the rate of depreciation is constant (the reducing balance method).

Using the straight line depreciation method, the amount of depreciation to be shown in the profit and loss account in each year is:

$$\frac{\text{initial value} - \text{residual value}}{\text{useful life in years}} = \text{annual depreciation charge}$$

Using the reducing balance method, the rate of depreciation would be calculated so that:

$$\text{initial value} \times (1 - \text{rate of depreciation})^{\text{no of years}} = \text{residual value}$$

Intangible assets may also suffer depreciation. Depreciation of intangible assets can be calculated in the same ways as depreciation of tangible assets.

*For question 28, only a few candidates mentioned all the points, consistency being the main omission.*

**28** There are a number of shortcomings of historic cost accounting in inflationary periods.

- Increase in stock values: the value shown in the profit and loss account for “increase in stocks of finished goods and work in progress” will be positive if the money value of stocks held is increased due to inflation even if the real volume of stocks held is constant. This will tend to overstate profits.
- Depreciation: the depreciation charge will be calculated using the historic cost of the assets. This will tend to overstate profits.
- Interest payments: a company may receive interest on its investments, and pay interest on its loan capital. In times of inflation, part of the interest payment is really compensation for the erosion of the real value of capital. For a company that pays out more interest than it receives, profits will tend to be understated in times of high inflation.
- Value of assets: the real value of all the company's assets will be eroded by inflation if their values stay constant in nominal terms. This will tend to overstate profits.
- Consistency over time: profits and asset values might be increasing in money terms. But it would not be immediately obvious how much was due to a real increase in the scale of a company's operations and how much was simply due to inflation. Comparison between years is therefore difficult when using historic cost accounts.

*For question 29, again, only a few candidates mentioned all the points in part (i), exchange rate being the main omission. Also some candidates just discussed the mathematics of calculating yields, e.g. coupon, term, price, rather than describe the various outside pressures.*

**29** (i) Inflation: expectations of higher inflation are likely to lead to higher gilt yields and vice versa;

Short term interest rates: reduction in short term interest will reduce yields on short gilts — longer gilts yields may reduce by less or even rise if reduction in interest rates is viewed as a sign of monetary easing;

Fiscal deficit: increasing PSBR is likely to put upward pressure on gilt yields, especially in the maturities in which the government is concentrating most of its funding;

Exchange Rate: changes in the exchange rate will affect the demand from overseas investors and will alter the relative attractiveness of domestic and overseas bonds for UK investors;

Financial institutions: changes to institutional cash flow and investment policy will affect demand for, and hence the price of, gilts;

Alternative Investments: the relative attractiveness of alternative investments — in particular the yield on US government bonds is particularly important.

(ii) Lower security;

Less marketable: mainly because the sizes of issues are much smaller.

*Question 30 was generally well answered.*

**30** Main points to make:

enable investors to obtain an interest in a professionally managed fund;  
fund is normally invested mainly in securities;  
fund may be well-diversified or specialised;  
no tax on capital gains as regards the fund itself.

**31** Good answers varied considerably but typically mentioned the following:

Depends on the taxpayer in question;

Certain items of income are tax free;

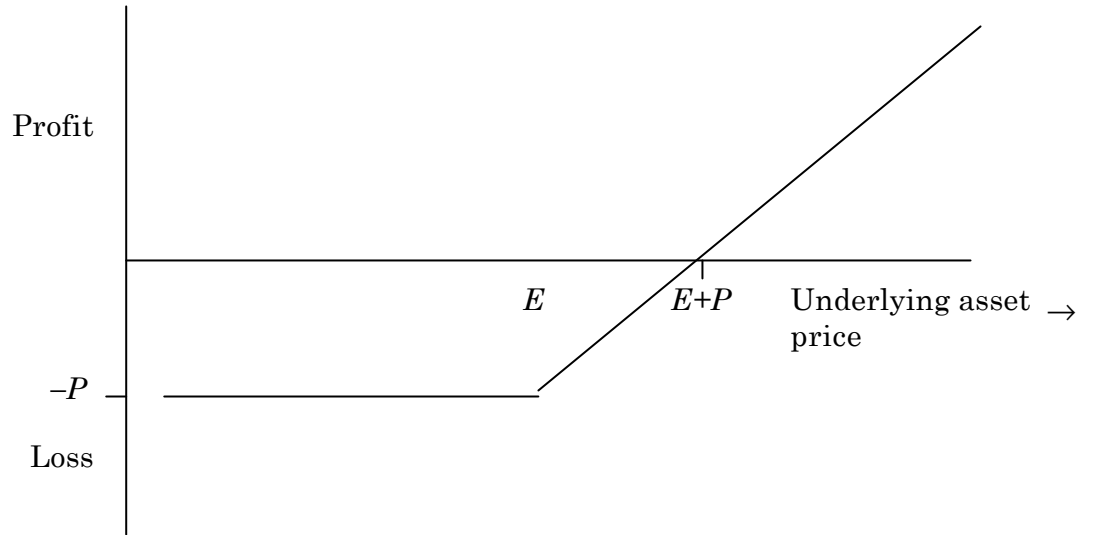
Certain assets are free from CGT;

Individuals pay CGT at the same rate as their marginal rate of Income Tax;

Exemption allowance and indexation allowance for gains;

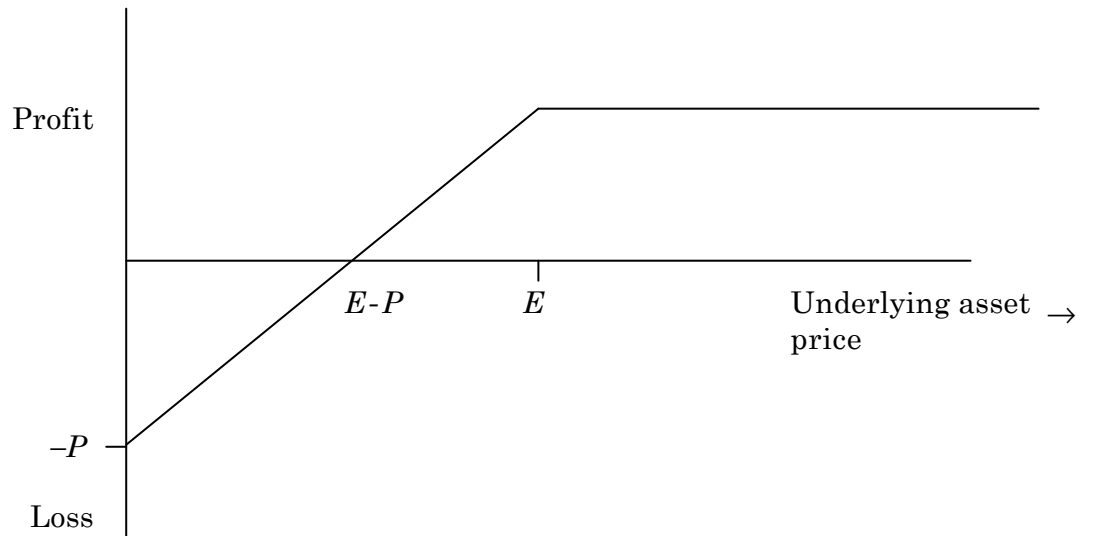
Capital losses can be offset against gains.

32 (a)



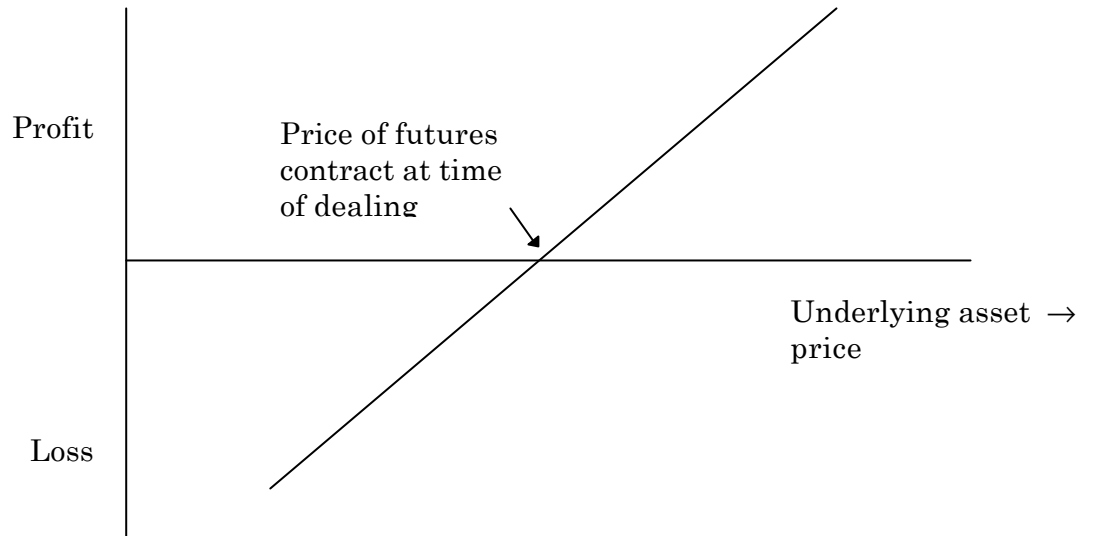
$E$  = Exercise price of call  
 $P$  = Call premium

(b)

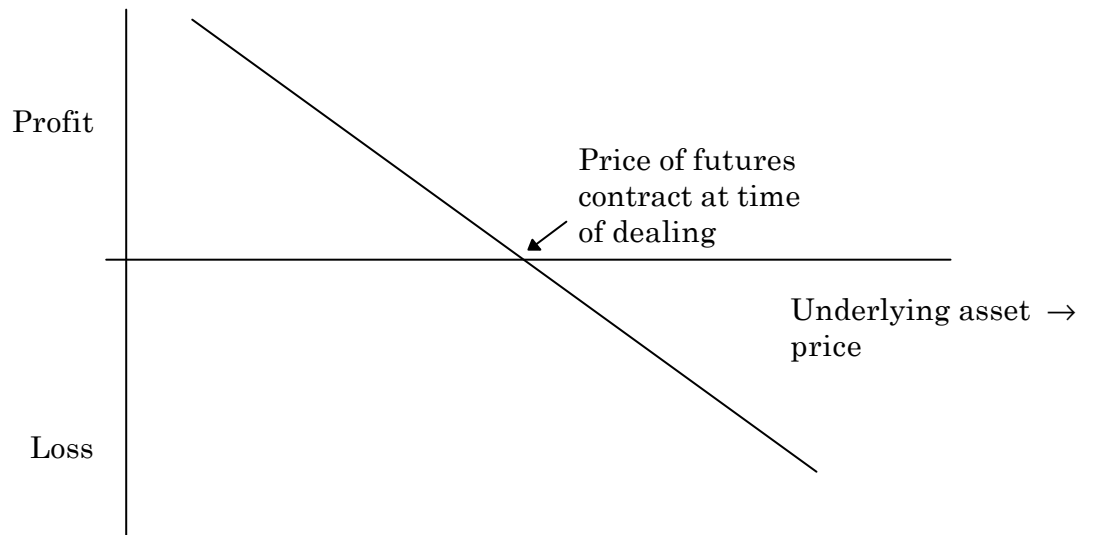


$E$  = Exercise price of put  
 $P$  = Put premium

(c)



(d)



## PART THREE

*Question 33 was reasonably well answered although many candidates did not emphasise the main problem that the profit margin had greatly reduced.*

### 33 Ratios — examples

	1997	1996
Return on equity	$91/520 = 17.5\%$	$96/490 = 19.6\%$
Profit margin	$139/1028 = 13.5\%$	$150/923 = 16.3\%$
Net asset turnover	$1,028/697 = 1.47$ times	$923/664 = 1.39$ times
Gearing	$161/(520 + 161) = 23.6\%$	$148/(490 + 148) = 23.2\%$
Interest cover	$152/15 = 10.1$ times	$158/14 = 11.3$ times
Current ratio	$531/239 = 2.22$ times	$536/230 = 2.33$ times
Acid test	$326/239 = 1.36$ times	$358/230 = 1.56$ times
P/E ratio	$136/14.0 = 9.7$	$142/14.7 = 9.7$
Dividend cover	$14.0/6.3 = 2.22$ times	$14.7/5.1 = 2.88$ times

### Comments — examples

- Return on equity of PQR Ltd has declined.
- The main problem which is affecting the company is that of greatly reduced profit margins.
- Net asset turnover has improved due to lower liquid resources, and an 11% increase in sales turnover. (The turnover of fixed assets, stock and debtors have all declined slightly.)
- Gearing is fairly steady, but with lower profit the interest cover has declined.
- The current and acid test ratios are both lower reflecting the reduced liquid resources.
- The PE ratio is unchanged, but with profit after tax down and dividends up, the dividend cover has declined.