

EXAMINATIONS

30 September 2004 (pm)

Subject 108 — Finance and Financial Reporting

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*
2. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*
3. *Mark allocations are shown in brackets.*
4. *Attempt all 17 questions. From question 11 onwards begin each answer on a separate sheet.*

Graph paper is not required for this paper.

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.

<p><i>In addition to this paper you should have available Actuarial Tables and your own electronic calculator.</i></p>
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For questions 1–10 indicate in your answer book which one of the answers A, B, C or D is correct.

- 1** What is the main purpose of charging depreciation in the accounts of a business?
- A To ensure that funds are available for the eventual replacement of the asset.
 - B To reduce the cost of the asset in the balance sheet to its estimated market value.
 - C To allocate the cost of the fixed asset over the accounting periods expected to benefit from its use.
 - D To show the fixed asset at its true value to the business.
- [2]
- 2** A company has ranked four mutually exclusive projects, each requiring an equal initial investment, using four different criteria. Each criterion identifies a different project as best. Which project should the company select?
- A The project with the highest internal rate of return.
 - B The project with the highest net present value.
 - C The project with the highest surplus over annual capital.
 - D The project with the shortest payback period.
- [2]
- 3** Z plc has just published its financial statements, which show a gross profit for the year of £7.5 million. A major error in the stock valuation has just been discovered. The opening stock is overstated by £0.8 million, and the closing stock has been understated by £1.2 million. What should be Z plc's correct gross profit for the year?
- A £5.5m
 - B £7.1m
 - C £7.9m
 - D £9.5m
- [2]

- 4** Rights issues are normally associated with a decrease in the share price immediately following the issue. Which of the following is the most likely reason for this?
- A The market will be uncertain about the merits of the investment that is to be funded by the issue.
 - B The new shares are issued at a discount to their current market value.
 - C The use of a rights issue implies a lack of confidence on the part of management.
 - D Rights issues involve substantial professional fees and other expenses.
- [2]
- 5** Which of the following best describes the purpose of an external audit of financial statements?
- A The auditor advises on accounting matters.
 - B The auditor ensures that the company's financial statements comply with all relevant legislation.
 - C The auditor expresses an opinion on corporate governance matters.
 - D The auditor expresses an opinion on the truth and fairness of the financial statements.
- [2]
- 6** A company must raise finance in order to acquire a piece of machinery. Which of the following is likely to be the least appropriate form of finance for this purpose?
- A Borrow the cost of the machine from a bank.
 - B Lease the machine from a finance company.
 - C Purchase the machine by cheque, increasing the company's overdraft by the cost of the machine.
 - D Purchase the machine on hire purchase from the manufacturer.
- [2]

- 7** Y plc has a high price earnings ratio. Which of the following best describes the market's opinion of Y plc?
- A High risk and expectations of strong future growth.
 - B High risk and expectations of weak future growth.
 - C Low risk and expectations of strong future growth.
 - D Low risk and expectations of weak future growth.
- [2]
- 8** Which of the following defines a limited company's relationship with the outside world?
- A Annual report and accounts
 - B Articles of association
 - C Memorandum of association
 - D Share certificates
- [2]
- 9** Which of the following organisations is responsible for the issue of Treasury bills?
- A Gilt-edged market makers
 - B The Bank of England
 - C The Debt Management Office
 - D The Financial Services Authority
- [2]
- 10** A company owns 30% of the ordinary share capital of another. Which of the following is most likely to be the correct description of the investment in the first company's balance sheet?
- A An associate company
 - B A fixed asset investment
 - C An intangible asset
 - D A subsidiary company
- [2]
- 11** Explain the role of simulation as an element of appraising an investment project. [6]
- 12** Explain the role of investment trusts as vehicles for investors. [8]
- 13** Explain the purpose of consolidated financial statements. [6]

- 14** V plc is a quoted company. The directors are discussing the final dividend for the year ended 31 December 2004. The company has recently been forced to make a series of structural and financial changes. Even though the financial year has not yet ended, it has become apparent that the company will not be able to pay the same level of dividend as in previous years.

Explain how the directors should proceed if they decide to reduce the dividend temporarily and explain the possible implications for the company's share price.

[10]

- 15** Many equity investment decisions made by individual investors are affected by tax considerations. Some equities offer greater potential for income while others are more likely to generate capital growth. Explain how the UK tax system differs between its treatment of dividend income and capital gains and explain which form of return is likely to be the more tax efficient for investors.

[10]

- 16** The Marco family own 100% of Marco Trading Ltd, a major company that has been established for many years. The directors, all members of the family, are considering floating the company on the London Stock Exchange.

- (i) Identify the matters that the directors and shareholders of this company ought to consider in deciding whether to seek a flotation and explain the importance of each.
- (ii) Assuming that the company does decide to proceed with the flotation, describe the major decisions that will have to be taken by the directors of the company.

[10]

[Total 20]

- 17** H plc manufactures household appliances. Most of its purchases are of generic parts and materials that are widely available. H plc has a policy of developing a very close working relationship with one supplier for each category of material and relying heavily on that supplier to deliver in quantities and at times that enable H plc to meet its manufacturing deadlines without carrying a great deal of stock.

H plc is looking for a new supplier of light sheet steel. It has obtained the financial statements of two possible companies, each of which can supply steel of the necessary quality for an acceptable price. H plc's chief buyer is comparing the financial statements of both companies to identify the one which is at least risk of becoming insolvent. The statements have been summarised below:

**Profit and loss accounts
for the year ended 31 August 2004**

	P Ltd	Q Ltd
	£000	£000
Sales	2,900	1,800
Operating expenses	-2,030	-1,460
Earnings before interest and tax	870	340
Interest	-16	- 44
Tax	-370	-280
Ordinary dividend	-120	-12
Preference dividend	-72	
Retained for year	292	4

Balance sheets
as at 31 August 2004

	P Ltd	Q Ltd
	£000	£000
Tangible fixed assets	3,800	1,210
Current assets		
Stock	40	34
Debtors	238	170
Bank	5	7
	<hr/> 283	<hr/> 211
Current liabilities		
Creditors	–190	–160
Proposed dividend	–96	–6
Tax	–350	–270
	<hr/> –636	<hr/> –436
Net current liabilities	<hr/> –353	<hr/> –225
	3,447	985
Loans	–200	–400
	<hr/> 3,247	<hr/> 585
	<hr/> <hr/>	<hr/> <hr/>
Ordinary share capital	1,000	300
Preference share capital	900	
Retained profit	1,347	285
	<hr/> 3,247	<hr/> 585
	<hr/> <hr/>	<hr/> <hr/>

P Ltd owns its factory premises. Q Ltd rents a factory unit, paying £200,000 per annum in rent.

Requirements

- (i) Calculate the following ratios for each of the above companies:
- (a) Gearing
 - (b) Interest cover
 - (c) Current ratio (excluding tax from current liabilities)
- [6]
- (ii) Identify the company which is at greatest risk, referring to the ratios that you calculated above. You should also refer to any other relevant information contained in the question. All of Q Ltd's tangible fixed assets are in the form of plant and equipment. [12]
- (iii) Explain why the tax liability was excluded from the current ratio in the above comparison. [2]
- [Total 20]

END OF PAPER