Subject CT2 — Finance and Financial Reporting
Core Technical

EXAMINERS' REPORT

April 2008

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

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June 2008

Comments

There were some excellent marks achieved on this paper; well done to all those candidates who scored high marks. It was however disappointing that the pass rate was poor compared to the last diet. There were also some very poor scripts at the bottom of the spectrum.

Candidates generally achieve high marks in the questions where knowledge is the main requirement; it is however disappointing to note that where application of knowledge is required there are some very poor answers.

As usual, in this exam, it is the two long questions at the end where some candidates get very low marks.

It is very beneficial to practise past exam questions and I would recommend that all candidates try to complete past papers within the time constraints required when revising.

Comments on individual questions are given after each of the solutions that follow.

1 A
2 D
3 B
4 D
5 A
6 C
7 B
8 D
9 C
10 A

Comments: Generally Q1–10 were done very well. Many candidates scored full marks. This was gratifying, as the marks for the MCQs were fairly poor for the previous two diets.

11 Advantages:
The balance sheet will better reflect the underlying worth of the company's assets **.** This will enable shareholders to have a better appreciation of management's stewardship (because there is a more realistic measure of the value of the assets entrusted to them) . Lenders will have a better understanding of the value of assets being pledged as collateral. It fits in with more recent emphasis on 'fair value'.
Disadvantages:
Valuations will always be more subjective than stating figures at cost less depreciation. There will be costs, such as valuers' fees, associated with showing valuations. Values are likely to be more volatile than cost less depreciation and the associated fluctuations might make the business appear more risky.

Comments: This question was done very well by most candidates. It was good to see such good answers to this question.

12 The notes provide additional detail concerning the underlying figures. These analyses will provide the shareholders with a better understanding.
Notes might deal with qualitative matters and disclosures that could not be reflected in the financial statements. For example, descriptions of contingent liabilities could be vitally important.
Many of the disclosures in the notes are required by law. The rules and regulations associated with accounting effectively require the publication of notes to the accounts.
Providing an overview in the main statements and supplementing that with the notes gives shareholders and other readers the choice of reading further if they wish. Expert readers can consult the notes while non-experts can stick to the statements themselves.

Notes and appendices avoid burdening the income statement and balance sheet with excessive information.

Comments: This question was done well by many candidates. Few candidates mentioned that many of the notes are statutory requirements or that qualitative matters could be discussed by note and this would be very informative for users of financial statements.
On the whole there were some very good answers for this question which was good to see.

13 Accounting standards provide a basis for consistent treatment between companies. They are the accountancy profession’s response to inconsistent treatment or to accounting practices that are controversial or potentially misleading.
Accounting standards provide companies with a benchmark against which to measure the validity of their accounting policies and to demonstrate that their accounts give a “true and fair” view. That may reduce agency costs due to shareholders and other readers being concerned that the accounting policies in force are incorrect. The fact that financial statements are supported in this way should enhance shareholder confidence in the resulting figures and so the share price should be higher.
The publication of accounting standards also enhances the accountancy profession’s reputation. The resources invested in the process provide proof that the profession is taking its responsibilities seriously and provide a mechanism for debating important issues.

Comments: There were a few very good answers to this question but on the whole it was poorer than expected. The answers were very short and lacked any detail.

14 Further loans might rank alongside or even ahead of the existing lender’s rights in the event of liquidation. Barring the borrower from taking out further loans will reduce the risk of assets being diluted in the event of a foreclosure or claim. The payment of additional interest will have an impact on cash flows.
The additional debt might increase the risk of the company failing. Even if that does not directly threaten the existing lender’s rights, the lender would rather have its customers survive and repay their debts on time.
If the company cannot raise fresh funds from borrowing then it will have to raise equity. Equity provides a “buffer” between the value of assets and liabilities and the higher the equity the safer all lenders’ positions become.

Comments: This question was done reasonably well. Most candidates mentioned the possibility of the company failing and of raising capital by equity rather than debt if they could not raise a loan.

15 Opportunity cost is the cost of passing up the next best choice when making a decision. If a company has mutually exclusive projects then the opportunity cost of accepting one project is that it will be impossible to accept any of the others. For example, building a bridge with an NPV of £1m might mean that there is no real point in building a tunnel which would have an NPV of £1.5m if built on its own. Companies might also face capital rationing. Accepting a positive NPV project might involve using funds that could be applied more profitably elsewhere.
Considering opportunity costs complicates the investment appraisal process because of the need to determine the NPV of competing projects. However, it may be difficult to spot opportunities that have been missed or overlooked and so there may be very little risk of criticism arising from a missed opportunity.

Comments: This was a fairly standard question and was done well by most candidates.

16 Rights issues are less complicated than making an issue to members of the public. There are fewer regulatory requirements to be dealt with and the company can therefore pay less in fees and other costs. There may be less need to underwrite the issue. This may make rights issues more cost-effective for dealing with smaller amounts of equity.
Rights issues simplify the issues associated with setting prices. Any discount will be enjoyed by existing shareholders. This will avoid diluting the equity of existing shareholders if the shares are issued at a discount.

Comments: This type of question has been asked many times in previous diets, it was therefore very disappointing to see so many poor answers. While many candidates could mention the basic points few achieved a high mark.

17 The basic earnings per share reflects both the earnings for the most recent year and the number of shares with a right to participate in those earnings. Ultimately, the shares only have value because earnings create the potential for the company to pay dividends and generate cash for the shareholders.

The diluted earnings per share adjusts for the potential effects of converting or exercising any instruments in issue that give their holders the right to obtain ordinary shares. If there is a large quantity of such instruments in issue then there is the potential for a major dilution of the earnings enjoyed by existing shareholders. Conversion will normally involve an inflow of cash, and eliminate some other outgoings, such as interest on a convertible bond, but the gains from doing so are unlikely to fully compensate for the larger number of shares in issue. Apart from anything else, the rights associated with such instruments have to be attractive to buyers or they will have to be offered at a lower price.

Comments: This question was not very well done. Some candidates wrote very short answers for this. Many candidates were unsure what diluted earnings per share meant and gave poor answers to this. This is an area of the syllabus that candidates should revise for the next attempt.

18 (a) A subsidiary is a company that falls under the control of a holding company. This normally happens through ownership of a majority of shares carrying voting rights, but there is no need to own any shares in order to create this relationship.

(b) Consolidated financial statements are necessary in order to show the holding company shareholders how their wealth is being invested. The group is an economic entity. The financial statements of the individual companies give no real insight into the performance of the group as a whole.

A consolidated balance sheet is required to avoid the group from misreporting the resources available to the directors and the associated liabilities that have been used to finance their acquisition. Internal relationships need to be identified and cancelled.

Comments: This question was answered well by many candidates. Part (a) was well done but part (b) less so. Again some revision of this area of the syllabus would be useful before the next attempt. This question was straightforward and very high marks should have been achieved by candidates.

19 (i) Generally, shareholders who have significant taxed income from other sources prefer that companies do not pay dividends. This is because the additional income from the dividend will be taxed at the taxpayer's highest rate.

In theory, if a company reinvests profits rather than paying them out in dividends then the value of shares should increase, and the shareholders will then receive a capital gain equivalent to the dividend that has been foregone. Thus, pre-tax, shareholders are indifferent between dividends and capital gains However, the tax treatment of capital gains is different for a number of reasons. Firstly, the taxpayer will probably have a separate annual allowance for capital gains. Secondly, the marginal rate of tax paid on capital gains may be lower than that on income. Thirdly, the tax payable on capital gains can be deferred by retaining the shares and selling only when it is deemed advantageous to do so. Tax on income has to be paid almost immediately, with no real opportunity to manage this.

Companies that have known and predictable dividend policies are likely to attract shareholders with a particular preference for income versus capital gains. If the company switches from one approach to the other without giving substantial warning then shareholders could be disadvantaged.

(ii) The basic accounting equation is Assets = Capital + Liabilities. Every asset has to be financed by either equity or borrowing and every source of finance carries a cost. Holding assets that do not yield any return means that the company is incurring a cost of capital for nothing .

The shareholders will view a "wait and see" policy as a low return on their equity. The directors have a responsibility to maximise the owners' wealth. If they cannot offer a realistic return on cash holdings then they should give the funds back to the shareholders. To do otherwise imposes an opportunity cost in terms of delaying consumption or in terms of leaving shareholders unable to invest elsewhere to greater effect.

There are also market forces at work . A substantial cash balance would make the company attractive to a predator. The directors' apparent inefficiency would make such a bid more attractive. These disciplinary forces are one of the most powerful motivators to ensure that the directors focus on the company's profitability.

(iii) The directors face a dilemma when deciding what information to release. Competitors will use anything that they release to gain an advantage. However, withholding information will create uncertainty in the minds of shareholders (the agency costs of information asymmetry). That uncertainty will translate into a reluctance to trust the directors and so share prices will fall and loan agreements will become more difficult to complete. That will push up the cost of capital.

In theory, keeping the markets informed should protect the company from some of the disciplinary forces that might threaten the directors' positions.

Comments: This question was generally done badly. Part (i) was poor; although candidates could mention how capital gains were taxed that was really all that was said. It was disappointing that few candidates mentioned anything about the advantages of companies with a steady dividend policy.
Part (ii) was also very poor with many candidates giving very short answers. Very few candidates seemed to understand that holding assets that do not create any return was a poor idea.
Part (iii) was also poor. A number of candidates did not answer this at all and others gave very short answers along the lines of "information is important". This was not rewarded. It was disappointing that few candidates had thought about this issue. Some revision of this topic would be useful before the next attempt.

20 (i) Proceeds of winding up:

Intangible assets	0
Property, plant and equipment	6.0m
Current assets	2.5m
	8.5m
Applied:	
Secured loans	7.0m
Unsecured lenders	1.5m

Thus, unsecured lenders will share £1.5m in settlement of their £3m liabilities, so they will receive 50% of the amount due. Vest will received £250,000 .

(ii) (a) Initial outflow = £8.5m
Inflow = £0.8m in perpetuity.
At 8% this has a net present value of £0.8m/0.08 - £8.5m = £1.5m
At 11% this has a net present value of £0.8m/0.11 - £8.5m = (£1.2m)

(b) The desirability of this project depends on the discount rate that is to be applied. Thus, it is not entirely clear cut whether it would be a good investment.

(iii) (a) The required rate of return should be related to the risks associated with the project itself. The proposal is going to take Vest into completely new territory because it does not manufacture this range of products. Thus Vest's normal required rate of return is not appropriate. The strategic fit of the proposal also has to be considered . There might be synergies or inefficiencies associated with working in this way and so the cash flows from the project ought to be looked at in conjunction with those of Vest**.**

Vest's shareholders will not necessarily share their directors' impression of the investment. The investment could have a knock-on effect on Vest's share price and its overall cost of capital.

Rough's required rate would not be appropriate, partly because the company will be reorganised and be manufacturing a different product and partly because the company's collapse gives additional insights into its risks.

(b) Ideally, Vest will be able to identify an appropriate rate by finding a quoted company whose business is similar to that of the reorganised Rough. That company's cost of equity would be an ideal basis for setting the required rate of return .

Alternatively, Vest might be able to obtain a beta coefficient for a similar investment, thereby determining the systematic risk of the project and setting an appropriate required rate of return.

Vest might attempt a simulation exercise for the company. Designing a model that estimates cash flows under different situations and inputting a range of assumptions would give some idea of the extent to which the company is exposed to different risks. The resulting output would give an indication of the expected distribution of outcomes that might be expected and so the value might be more easily determined.

Comments: This was a fairly standard question and it was answered very badly. This type of question has been asked in the past so it should not have come as a surprise.
Part (ii) was done reasonably well but part (i) was very poor. It was very disappointing to see many candidates doing (i) so badly. It would be an excellent idea to look closely at past exam papers and attempt them under exam conditions before the next attempt.

In (iii) (a) very few candidates mentioned the possible effect on the cost of capital or the share price. This point demonstrated understanding and was an excellent point to make but very few candidates mentioned this.

END OF EXAMINERS' REPORT