EXAMINATION

9 September 2005 (am)

Subject CT2 — Finance and Financial Reporting Core Technical

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 20 questions. From question 11 onwards begin your answer to each question on a separate sheet.*

5. *Candidates should show calculations where this is appropriate.*

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.

In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator.

For questions 1–10 indicate in your answer book which one of the answers A, B, C or D is correct.

1 The following information is available for A Ltd:

	Authorised shares	*Issued shares*
25p ordinary shares	£2,000,000	£1,000,000
6% 50p preference shares	£500,000	£250,000

In addition to providing for the preference dividend for a financial year, an ordinary dividend of 2p per share is to be paid. What is the total amount of dividends for the year?

A £35,000
B £95,000
C £110,000
D £190,000 [2]

2 Which of the following is NOT true of a Limited Liability Partnership (LLP)?

A A LLP must have a Memorandum and Articles of Association.
B Any firm consisting of two or more members may be a LLP.
C The LLP is a separate legal entity.
D A LLP is treated in the same way as a partnership for taxation purposes.

[2]

3 Which of the following is NOT true of the Internal Rate of Return (IRR) method of project appraisal?

A IRR can sometimes have mutiple solutions.

B IRR is less popular than Net Present Value as a measure of project worth.

C IRR has the benefit of highlighting the return achieved by the project.

D IRR is the most realiable means of choosing between mutually exclusive projects.

[2]

4 You have a diversified portfolio. You are offered an opportunity to invest in an oil exploration venture in the South Atlantic. Which of the following risks associated with this project is a systematic risk?

A Bad weather might hamper operations until the cash runs out.

B The geological surveys which suggest the existence of oil might be wrong.

C The price of crude oil on the world markets might fall, making any finds uneconomic.

D Interest rates might rise, pushing up the costs of borrowing for the enterprise.

[2]

5 During the year ended 30 September 2002 a company bought a fixed asset for £125,000. The company charges depreciation at the rate of 20% per annum on the reducing balance basis, with a full year's depreciation in the year of acquisition and none in the year of disposal. During the year ended 30 September 2005 the asset was sold for £45,000.

What was the loss on sale of the asset?

A £5,000
B £6,200
C £19,000
D £35,000

[2]

6 The purchase of a business for more than the aggregate of the fair value of its separate identifiable assets less liabilities results in the creation of a:

A share premium account
B reserve account
C suspense account
D goodwill account

[2]

7 Which of the following best describes a "bulldog"?

A A bond denominated in sterling on an overseas bond market, issued by a UK company.

B A bond denominated in the local currency on an overseas bond market, issued by a UK company.

C A bond denominated in sterling on the UK bond market, issued by a foreign borrower.

D A bond denominated in its local currency on the UK bond market, issued by a foreign borrower.

[2]

8 Q Ltd has a stock turnover of 40 days, debtors' turnover of 45 days and creditors' turnover of 47 days. How long, on average, does each £1 invested in working capital stay tied up?

A 38 days
B 42 days
C 85 days
D 132 days

[2]

9 Which of the following is NOT a valid ratio for the calculation of return on capital employed?

A $\dfrac{\text{Net profit before tax and interest}}{\text{Share capital + reserves + long term debt}}$

B $\dfrac{\text{Net profit before tax}}{\text{Share capital + reserves}}$

C $\dfrac{\text{Net profit before tax}}{\text{Share capital + reserves + long term debt}}$

D $\dfrac{\text{Net profit before tax and interest}}{\text{Total assets}}$

[2]

10 A company has had a substantial overdraft for several years. When is this loan likely to become repayable in full?

A At the end of the period specified in the overdraft facility.
B At the bank's discretion.
C At the company's discretion.
D Never.

[2]

11 Explain why quoted companies might make scrip issues as they raise no finance and they involve some cost. [5]

12 A company's external auditor has warned that the next audit report might be "qualified" unless the financial statements are amended prior to publication. Explain the significance of a qualified audit report. [5]

13 The board of a quoted company has asked for a report on the cost of equity finance. Explain one method of estimating the cost of equity, identifying the assumptions inherent in the method. [5]

14 The group finance director of a major quoted company has approached a bank for a substantial loan to the group. Explain why the financial statements of the individual companies in the group might be a more suitable basis for the loan negotiations than the consolidated financial statements prepared by the company. [5]

15 Agency theory underpins many of the theoretical models used in finance. Explain the logic underlying agency theory, briefly referring to the role of monitoring in managing the relationship between principal and agent. [5]

16 The following ratios have been calculated from the financial statements of two companies of similar size that operate in the same industry:

	D plc	*P plc*
Return on capital employed	14%	11%
Gross profit %	40%	60%
Net profit %	32%	54%

Explain why most commentators would regard D plc as the more profitable company.

[5]

17 Much of the recent discussion of the role of the firm deals with a range of stakeholder interests, rather than the previous emphasis on the shareholder only. Identify two stakeholders other than the shareholders and briefly explain why their interests might conflict with those of the shareholders. [5]

18 Many large companies issue debentures as a means of raising long term finance. These are often quoted on the stock exchange. Describe the risks associated with investing in such debentures. [5]

19 A major quoted company has announced that it has amassed a cash "mountain". It proposes to return this cash to the shareholders 18 months after the date of the announcement. Rather than do so by means of a dividend, the company will buy a proportion of each shareholders' shares back at a small premium to the prevailing market price.

(i) Explain why management might want to return cash to the shareholders instead of retaining it in the company. [4]

(ii) Explain how the company's share price might react to this purchase:

(a) on the announcement of the buy-back
(b) at the time of the buy-back

[8]

(iii) Explain why the company might have chosen to purchase shares rather than make a dividend payment of the same amount. [4]

(iv) Explain why the company has announced this transaction 18 months in advance. [4]

[Total 20]

20 The following balances have been extracted from the books of JK plc, as at 31 August 2005:

	£000
Advertising	90
Cash at bank	8
Creditors	52
Debtors	134
Directors’ remuneration	85
Head office running costs	200
Interest on long term loans	9
Investment income	20
Investments (long term)	450
Long term loans	400
Materials and other manufacturing costs	800
Ordinary dividend paid	60
Ordinary share capital	900
Plant and machinery — cost	250
Plant and machinery — depreciation at 31 August 2004	100
Premises — cost	1,200
Premises — depreciation at 31 August 2004	15
Profit and loss at 31 August 2004	374
Sales	2,200
Stock at 31 August 2004	210
Wages and salaries — administrative staff	110
Wages and salaries — manufacturing staff	400
Wages and salaries — sales staff	55

Additional information:

1. Premises are to be depreciated at the rate of 2% on cost and plant and machinery at 20% reducing balance.

2. Corporation tax based on the year’s profit is estimated at £25,000.

3. The company’s ordinary share capital is 900,000 £1 ordinary shares, fully paid. The directors have proposed that no final dividend will be paid.

4. Stock at 31 August 2005 was £180,000.

(i) Prepare JK plc’s profit and loss account for the year to 31 August 2005, and a balance sheet at that date. These should comply with Companies Act presentation requirements. [15]

(ii) Explain how the estimated corporation tax on the year’s profits would have been calculated. [5]

[Total 20]

END OF PAPER