Subject CT2 — Finance and Financial Reporting
Core Technical

EXAMINERS' REPORT

September 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.

R D Muckart
Chairman of the Board of Examiners

November 2008

Comments

It was good to see some better results than in the previous diet.
There were some excellent papers.
As discussed above there are some areas where there could be an improvement and some areas where revision would be sensible.
On the whole a much better performance than last time.

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

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

Q1–10 comments: The MCQs were done well by most candidates. There was no noticeable problem with any question. Well done!

11 The output of a simulation will offer the directors an indication of the distribution of expected outcomes from the project . That will also indicate the project's sensitivity to different factors and assumptions . The output from the simulation might reduce the need to establish a hurdle rate in advance . Simulation may make it possible to evaluate projects that could not otherwise be analysed analytically.

The reliability of the simulation depends on the reliability of the underlying assumptions . If the model is specified badly then the resulting projections will be incorrect . There is a danger that a sophisticated analysis will have more credibility than it deserves and the directors will have undue confidence in the results .

Q11 comments: The majority of candidates could identify roughly what a simulation was, scoring marks for a distribution of outcomes and use to test sensitivity. A noticeable number discussed scenario testing, sensitivity analysis and monte carlo analysis separately rather than focusing on simulation but still showed enough understanding for two marks. Only a minority really discussed the drawbacks/difficulties of using it. Drawbacks were generally limited to use of an expert, cost and time constraints rather than difficulties with the input variables or over confidence in the results.

12 The main reason for being in business is to generate profit . A healthy profit is vital to a company's long-term viability . In the short term it is possible that investment and expansion will lead to an outflow of cash. Such outflows are not dangerous in themselves provided they are properly managed. If the company is profitable then it will generate net cash in the very long term. That means that it should be possible to borrow in order to deal with short-term cash crises. However, profitable companies can collapse if they are short of cash, so the situation should be monitored.

Cash flows are important to the short-term survival of the business, but they are not long term business objectives. A cash outflow might occur because of a deliberate decision to put surplus funds to work in the business.

Q12 comments: Generally high marks were scored. Most started with a discussion on accruals and realisation concepts and how cash is different to profit but went on to discuss plausible reasons that do not cause concern and discussed the pitfalls of running out of cash. The weaker candidates tended to list possible causes of a difference (e.g. purchase of assets — high cash outflow now but depreciation reduces profit over many years) without really explaining whether it was a cause for concern i.e. did not answer the question.

There were some excellent answers for this question. Well done!

13 Ratios provide insights into the policies and strategies followed by the company. An understanding of the business is necessary in order to make an informed decision as to the merits of a strategy or policy. For example, a company might have a very high gross profit percentage because it sells a premium brand. It might look as if the company is losing sales volume because of its pricing policy, but the company may know that its exclusivity and pricing is one of the factors that actually attracts business.

Some businesses are forced to accept certain costs and inefficiencies because of industry norms. For example, slow payment might be the norm in a particular industry. It would be dangerous to press for a reduction in a debtors' turnover ratio if that would mean offering less attractive credit terms than the rest of the industry.

Q13 comments: It was heartening to see that this question was answered well by many candidates. Generally good examples were provided.

14 A qualified audit report indicates that the auditor had a specific concern or concerns with the financial statements. This could arise because of material disagreement over the figures and the manner of their calculation or certain types of uncertainty concerning the audit, such as a limit on the information obtained.

Anyone reading a qualified audit report should be alerted to the auditor's particular concerns. The information in the audit report should be specific enough for the reader to have a clear idea of the potential problems with the accounts. The reader might reinterpret or restate the figures in response to any disagreement or might attach less confidence to them because of any uncertainty.

Q14 comments: The majority of candidates identified what a qualified audit report was and that there would be a lack of confidence (sale of shares was a common answer). However, generally the answers went into as much detail on the other forms of report. Many candidates discussed unqualified reports, this was not required, nor was a discussion on types of qualification.

15 Stock options give the directors an incentive to work on improving the company's share price. The options will only have value if the share price exceeds the strike price when the options reach their maturity. This should have the effect of reducing many of the agency concerns that the shareholders might perceive. Maximising shareholder wealth should have the effect of enhancing the value of the stock options.

If a significant number of options is issued in this way then the shareholders risk the dilution of their equity when they are exercised. This could make the options a very expensive form of remuneration.

Q15 comments: Most candidates did this question very well and scored high marks. Well done!

16 The government may seek to encourage private and institutional pension arrangements by offering tax relief (or even subsidy) on contributions and, possibly, investment earnings within the pension scheme. The tax relief will make it particularly attractive for individuals on higher rates of tax to invest in a pension plan. The relief offered to the schemes themselves makes it easier to build up a solid asset base with a view to making it possible to provide better pensions in the longer term.

While the final pension benefit will be subject to tax, when paid, the individual recipient will often benefit from a lower personal tax regime when in retirement. This prospect makes it very tax-efficient to put off taking income during employment and putting as much as can be afforded into a pension.

Q16 comments: Answers varied widely. Surprisingly a large number limited their answers to tax relief on contributions and ISAs. A noticeable number took a theoretical standpoint and discussed possible measures the government could take e.g. increasing taxes on expenditure. This question was answered badly by many candidates.

17 In theory, the switch to a company will protect the personal assets of the partners. Any claims made against them will be limited to the assets of the company itself. In practice, that might not always work because lenders might insist that the directors/shareholders of a small company give a personal guarantee against the company's assets.

It might be easier to expand in the future because the company structure will make it easier to admit an additional owner. The new partner would have been jointly and severally liable for the partnership's liabilities, but would not be liable for anything as a member of the company unless s/he signed a guarantee.

The creation of a company will also give other parties dealing with it a clearer idea of whom they are involved with. For example, a new employee will work for the company, which has a separate legal identity, rather than a collection of partners.

Q17 comments: This question was generally answered well but often candidates wasted time discussing disadvantages of Ltd companies or advantages of partnerships. Apart from that this was well answered.

18 Discretionary monitoring costs and covenanting costs could only be eliminated if the stakeholders could trust one another. In principle, this would simply require mutual confidence in one another's integrity. In practice, there would always be observable conflicts of interest and that would create room for doubt. These doubts would grow because of information asymmetries. Concerns about attitudes and commitment would grow because those whose behaviour and intentions were in doubt would be the source of any assurances offered.

In reality, it can be seen that these pressures often lead to additional, non statutory monitoring and disclosure that is designed to reduce the uncertainties arising from information asymmetry.

Q18 comments: Candidates tended to provide examples of how different stakeholders had differing interests in the business and their requirements and goals varied as a result which would cause mistrust and conflict. This was an equally valid approach. On the whole this question was answered well.

19 (i) Returns from financial investments are set by market forces. The market rewards investors for delaying consumption and for bearing risks. Market prices rise as risk falls, thereby correcting any excessive return for a given level of risk. This investor is bearing relatively little risk and so his returns are unlikely to be high. The market would offer a better return if he wished to bear greater risk through investing in a more volatile set of securities.

In a CAPM world, the markets restrict the return for risk to systematic risks only. Our investor has built a portfolio with a relatively low systematic risk.

Q19 (i) comments: The majority of candidates provided CAPM equations and explained these and generally candidates explained low risk = low return. This question was done well by the majority of candidates.

(ii) A portfolio of low beta shares will have a relatively low volatility relative to the market as a whole. If the average beta is 1.0 then the portfolio should move in line with the market as a whole. If it is less than 1.0 then market fluctuations will still work through, but they will be lower than the volatility in the market. The investor will still bear some systematic risk.

Diversification cannot ever eliminate every risk that adversely affects all securities to some extent. The tsunami is an example of such an event because it affected economies and costs (e.g. of insurance coverage) and so the markets as a whole experienced a downturn.

Our investor's diversification is also likely to be imperfect. Dealing costs mean that investors have to spread their capital across a restricted number of shares, and each will be over-represented relative to the market as a whole. Thus, a diversified investor may still have too much invested in travel companies and be unduly affected by a disaster that affects that industry.

Q19 (ii) comments: This part of the question was done badly by many candidates. Most candidates were struggling to give more than a brief answer. The majority of answers were limited to mentioning that the tsunami was a systematic risk that could not be diversified away. Marks were fairly poor for this section.

(iii) A beta of zero means that an investment will not be affected by a movement in the market. That means that, in theory, the investment is risk free. However, that is only true in the context of a diversified portfolio. Our investor will have full exposure to all of the specific risks associated with this development.

If the project has an attractive forecast return then it is reasonable to expect the associated risks to be equally high. Otherwise, there would be so much competition to buy property on the development that supply and demand would push prices up and potential returns down.

Our investor appears to have a low appetite for risk. This is a risky investment and so probably will not appeal. Investments in overseas properties can be particularly dangerous because of misunderstandings about legal rights and obligations and because of the danger of oversupply in certain markets.

The property development would also cost our investor all of the liquidity that he presently enjoys. Quoted shares can be bought and sold freely, but a property investment requires capital to be tied up in the long term and it can be difficult to release equity.

Q19 (iii) comments: There were some good answers which provided a solid explanation and provided examples of specific risks the investor would be exposed to. However, too many candidates saw the low beta and decided that the risk was low and the returns high so it was a good idea. This topic should be revised in depth by future candidates it comes up again and again and is never well answered.

20 (i)

Extra depreciation
£10m × 10% = £1.0m

Extra interest
£10m × 9% × 2/12 = £150,000

Grow Ltd
Forecast income statement
for the year ended 31 December 2008

	£000
Revenue	5,000
Cost of sales	(3,000)
	2,000
Other operating costs	(500)
	1,500
Finance charges	(870)
Net profit	630

Grow Ltd
Forecast balance sheet
as at 31 December 2008

	£000	**£000**
Non-current assets		26,500
Current assets		
Inventory	167	
Trade receivables	417	
Bank	50	
		634
Total assets		27,134
Equity		
Share capital		5,000
Retained earnings		3,720
		8,720
Non-current liabilities		
Loans		18,000
Current liabilities		414
		27,134

Q20 (i) comments: Errors were in the calculations rather than the placement of the adjustments e.g. interest may have been miscalculated but the incorrect figured was carried forward correctly and adjusted in the I/S and the B/S. Therefore candidates tended to score high marks. The main error was miscalculation of the interest and failing to adjust the current liabilities.

(ii) (a)

	Without asset	*With asset*
ROCE	2,500/(9,870 + 8,000) = 14%	1,500/(8,720 + 18,000) = 6%
Gearing	8,000/(9,870 + 8,000) = 45%	18,000/(8,720 + 18,000) = 67%

(b) The investment will make the company appear far less profitable (due to the lower ROCE) and far more risky (because of the much higher gearing ratio). Thus, the investment might undermine shareholder confidence.

Q20 (ii) comments: Generally well answered.

(iii) Shareholder wealth is a function of future cash flows. Future cash flows are not affected by accounting choices or the accounting treatment of transactions. Entering into a transaction that has an adverse impact on the financial statements in the short term should not affect the long term prosperity of the company. The directors should be able to explain the short-term distortions arising from investments and other events.

Unfortunately, in the real world shareholders will not always accept explanations of temporary downturns. Companies usually claim that bad results should not be taken too seriously because they do not wish shareholders to panic, so explanations and reassurances often carry very little weight. Shareholders may well pay more attention to a concrete set of reported results that have been audited than to a statement that the company is pursuing long-term goals.

The directors might feel that their personal positions are threatened by the effects of the transaction on the income statement and balance sheet. If the share price is depressed by concerns about the figures then the company could be taken over and the directors replaced.

Q20 (iii) comments: There were many good answers here. Some weaker candidates misunderstood the question and discussed the ethics behind accounts manipulation, or deduced that as gearing had gone up and ROCE down the project was less profitable and was not worthwhile. On the whole this was done reasonably well.

END OF EXAMINERS' REPORT