EXAMINATION

25 September 2008 (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 from the approved list.

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

1 Which of the following best explains why an excessively high current ratio is undesirable?

A the business might run out of cash
B too much cash will encourage overspending
C there is a cost associated with holding assets that do not generate a return
D too much working capital will lead to calls for higher dividends

[2]

2 Who bears the legal responsibility for the financial affairs of a limited company?

A the board of directors
B the external auditor
C the finance director
D the shareholders

[2]

3 A company's shares are trading at 20p on the open market. The shares have a par value of 25p. The directors wish to raise additional share capital, but have been told that this would be impossible at the moment. Why is the company unable to issue fresh shares?

A the company is obviously out of favour with the market
B the directors would have to offer too big a discount on the sale
C companies are not permitted to sell shares at a discount to their par value
D issuing shares when the price is depressed would dilute shareholders' holdings

[2]

4 A company has ordinary shares and preference shares in issue. If the company is wound up, how would the funds released from the liquidation be distributed?

A to all providers of finance in proportion to their holdings
B to lenders first, then to all shareholders
C to lenders first, then to preference shareholders, then to ordinary shareholders
D to preference shareholders, then to lenders, then to ordinary shareholders

[2]

5 Which of the following best describes the purpose of margin payments associated with futures contracts?

A to ensure that there can be never be any default in a contract
B to offset the clearing house's exposure to defaults
C to remind the parties to the contract of their potential exposure
D to keep track of gains and losses on contracts

[2]

6 A company issued 1m shares by tender. The tender offers received were as follows:

- 500,000 at £1.00
- 400,000 at £1.20
- 250,000 at £1.30

How much would you expect this issue to raise?

A £1,000,000
B £1,155,000
C £1,200,000
D £1,300,000

[2]

7 A company wishes to raise additional funds. Which of the following is most likely to reduce the company's weighted average cost of capital?

A debenture stock
B ordinary shares
C preference shares
D subordinated loan stock

[2]

8 Which of the following best explains why a company might borrow cash in order to maintain its dividend payments after a bad year?

A the company will be able to obtain tax relief on the loan interest

B shareholders with a particular set of tax circumstances are attracted to companies that provide income rather than capital gains

C the directors are concerned with maintaining the shareholders' wealth

D shareholders might overreact to a reduction or suspension of the dividend payment

[2]

9 A project has a very short payback period but a negative net present value. Which of the following best describes the action that should be taken?

A the project should be accepted

B the project should be rejected

C the project should be accepted only if the company has limited funds for investment

D the project should be accepted only if it is necessary for some other reason, such as meeting mandatory health and safety requirements.

[2]

10 A company has 5m ordinary shares in existence and 2m 7% convertible preference shares. Both categories of shares have a par value of 25p. The convertible shares can be exchanged for ordinary shares on a 1 for 1 basis. The company's net profit was £800,000.

What is the company's diluted earnings per share?

A 10.9p
B 11.4p
C 15.3p
D 16.0p

[2]

11 A company's directors are unable to decide whether to invest in a particular project. Discuss the extent to which a simulation exercise might help them to reach a conclusion. [5]

12 A company's income statement shows that it has generated substantial profits but its cash flow statement indicates that it has suffered a large outflow of cash during the same period. The figures are reliable and free from distortion.

Explain whether this set of circumstances warrants any major concern. [5]

13 Explain why the interpretation of a company's accounting ratios requires some understanding of the nature of the business and the industry in which it operates. [5]

14 Explain the implications to the reader of a qualified independent auditor's report. [5]

15 Explain the implications to the shareholders of issuing company directors with stock options as part of their remuneration package. [5]

16 Explain how the tax system might actively encourage taxpayers to make provision for their retirement. [5]

17 Three consultant actuaries have been in business, operating as a partnership, for several years. They are considering borrowing a substantial sum in order to expand and are considering incorporating their business as a limited company, with themselves as both shareholders and directors.

Explain the advantages of a limited company compared with a partnership for the three partners. [5]

18 Agency theory suggests that there is a great deal of conflict between the interests of various stakeholders. This has led to a set of observable and significant costs associated with monitoring and protecting individual interests. Arguably, all stakeholders would benefit if they could agree to work together in the best interests of the entity, without incurring these agency-based costs.

Explain why it would be difficult, if not impossible, to eliminate these agency costs. [5]

19 An investor has a policy of investing in a diversified portfolio. He has a wide range of investments in stocks and shares, all of which have low Beta coefficients. He is concerned that his returns have not been as healthy as he would have liked over the past several years and he has asked your advice on a number of issues.

- The return on his portfolio has generally been steady, but it has not been very much better than he might have obtained from certain bank deposit accounts.

- His return suffered a major setback in 2004 in the aftermath of the tsunami in the Indian Ocean. Investments in companies based in countries affected by the disaster and those linked to the travel industry were badly affected by the crisis.

- He has been offered the opportunity to liquidate his portfolio and invest in a new overseas property development in Bulgaria. The project has a very attractive forecast return and the Beta coefficient is close to zero.

(i) Explain why the return on this investor's portfolio is unlikely to be particularly high. [6]

(ii) Explain why his portfolio might have taken a major setback in the aftermath of the tsunami, despite the extent of the diversification. [6]

(iii) Explain whether it would be logical to reinvest the value of his portfolio in the Bulgarian development. State the assumptions that you have made in giving your advice. [8]

[Total 20]

20 Grow Ltd is a manufacturing company. The directors are meeting to discuss some aspects of corporate strategy and also to plan for the publication of the annual report on the current year's trading. The following set of draft financial statements, combining actual results to date and forecast figures for the remainder of the year, has been presented to the directors:

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

	£000
Revenue	5,000
Cost of sales	(2,000)
	3,000
Other operating costs	(500)
	2,500
Finance charges	(720)
Net profit	1,780

Grow Ltd
Forecast balance sheet
as at 31 December 2008

	£000	**£000**
Non-current assets		17,500
Current assets		
Inventory	167	
Trade receivables	417	
Bank	50	
		634
Total assets		18,134
Equity		
Share capital		5,000
Retained earnings		4,870
		9,870
Non-current liabilities		
Loans		8,000
Current liabilities		264
		18,134

The directors are considering the effects of a proposal to invest in a major new piece of equipment that will expand the company's capacity and will create the potential to generate substantial new cash flows. The equipment will have to be purchased almost immediately or the opportunity to take advantage of the potential sales will be lost.

The equipment will cost £10m. Its acquisition will be funded by a loan paying annual interest at a rate of 9%. The company will depreciate the new equipment at 10% of cost each year, with a full year's depreciation charged during the year ended 31 December 2008. Two months' interest will also be accrued on the loan. There will be very little additional business this year because of the need to install and set up the equipment.

The directors' only reservation about this proposal concerns the impact that it will have on the company's financial statements. They are concerned that they will look unprofitable and more risky.

(i) Recalculate Grow Ltd's figures to show the income statement and balance sheet as if the new equipment had been acquired on the terms stated above. [7]

(ii) (a) Calculate the return on capital employed and gearing ratios both before and after adjusting for the effects of the acquisition of the equipment.

(b) Comment on the results in (a). [6]

(iii) Explain whether it is logical for the directors to allow the proposal's impact on the financial statements to affect their decision about proceeding with the investment. [7]

[Total 20]

END OF PAPER