Subject CT2 — Finance and Financial Reporting Core Technical

September 2009 examinations

EXAMINERS' REPORT

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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Chairman of the Board of Examiners

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Comments for individual questions are given with the solutions that follow.

The results were somewhat disappointing this time as the paper seemed to be of the same standard as the previous diet. Many answers were very brief and lacked substance. The worst section was probably the short 5 mark questions , some of the answers to theses were very poor.

Candidates should study the whole syllabus so they can attempt each question, it is a dangerous strategy to only study some topics and expect to be able to make general comments for the rest of the questions.

Question 19 was done very well and is clearly a topic that candidates find straightforward which is very good.

1

The answer was A

2

The answer was D

3

The answer was B

4

The answer was A

5

The answer was D

6

The answer was D

7

The answer was C

8

The answer was A

9

The answer was A

10

The answer was D

The MCQs were done very well by most candidates which was excellent and very heartening.

11

A finance lease will normally last for the useful life of the asset. The lessee will bear the risks of the asset becoming obsolete during its lifetime or of it becoming surplus to requirements. As with a loan, the cash flows will, presumably, be sufficient to enable the lessor to recover the cost of the asset effectively with interest. The lessor will have the same rights to repossess the asset as a lender who had secured a loan against the asset.

From an accounting point of view, a finance lease is accounted for as if the asset had been purchased outright with a loan.

The answers to this question were usually very superficial. The most common mark was a marginal fail. Candidates should try to go into more detail in their answers.

12

Taxpayers may pay income tax at a higher marginal rate than the rate at which capital gains are taxed. Many taxpayers will have an unused allowance for capital gains. These factors combine to make capital gains tax less expensive than income tax for most taxpayers.

Capital gains are not normally taxed until the gains are realised, whereas income is taxed when it is earned. That means that there can be a lot more scope for planning the timing and payment of capital gains tax. Transactions can be brought forward or delayed to recognise a gain in the most suitable period.

This question was answered well with most candidates being well versed in capital gains tax.

13

The biggest advantage is that the penalties for any failure are less severe. The capital may not be repayable or redeemable, unlike a loan which is likely to be for a finite period. The dividends may be equivalent to interest, or even higher, but the penalties for any failure to pay the dividend are likely to be no worse than the company being forbidden to pay an ordinary dividend. In some cases, any unpaid dividends will be foregone and the company will have no ongoing commitment to pay these when it returns to profit.

Preference shares rank behind all liabilities in the event of failure. Thus, lenders will be happier to see preference shares issued rather than additional borrowing.

Some corporation tax payers can enjoy a higher return after tax from preference shares than from loan stock, thereby making it cheaper to issue preference shares to them.

This question was done reasonably well, again a little more detail would have improved the answers. Most candidates showed good knowledge of this topic which was great.

14

A property company can offer a lender security against its assets. That means that a lender would be less concerned about the risk of default because the collateral should ensure that the capital will be repaid.

A property company is also likely to raise a steady stream of income from tenants. That means that it can take on higher borrowing because it knows that it will be able to service them from rental income.

The investment in property is likely to yield a steady capital gain over the long term, with a relatively low risk. The returns are unlikely to be high and raising funds from borrowing will be cheaper than using equity.

The answers to this were very vague and waffly. Not a topic that was understood by the majority of candidates. This was surprising. Answers were just too general.

15

Calculating depreciation depends on major assumptions. The company has to estimate the useful life of the asset and the residual value. Both figures are subject to massive uncertainty. For example, useful life can be affected by physical characteristics such as wear and tear, by technical issues such as the possibility of obsolescence and even by commercial factors such as the possibility that demand might change and leave an asset worthless.

The company must also decide how the difference between cost and residual value should be written off. For example, the choice between straight line and reducing balance depreciation can significantly affect the annual depreciation charge.

This question was fairly straightforward and was done badly by many candidates. The question did not ask how to calculate depreciation which is what many candidates answered. This approach got low marks. Candidates must read the questions carefully and make sure they answer what is asked.

16

Capital project appraisal normally involves deciding on the shareholders' behalf whether an investment should be undertaken. That involves having a decision rule such as NPV or IRR and investing in projects that best meet the criteria**.**

The shareholder value approach takes account of how that project will be received by the shareholders and markets. In theory, any positive NPV project should enhance shareholder value, but the shareholders will not have all of the information available to the directors. Even if they had, they would not necessarily process that information in the same way. The directors have to consider how news of the project is likely to be received by the markets. That might involve considering how the indicators used by shareholders might be affected, such as the EPS or dividend.

This question was answered well. Project appraisal is a topic that candidates had studied and gave good clear answers which is hearening.

17

The money measurement concept means that the financial statements only reflect those assets that can be valued objectively in monetary terms. This means that the balance sheet may well exclude extremely valuable assets such as customer loyalty. It is highly unlikely that it would be possible to buy the company without paying for such assets, with their value being determined by a process of negotiation between the buyer and the seller.

Consolidation implies the acquisition of a controlling interest. It might be sensible to pay more than the book value in order to obtain control if the buyer feels that a change of management would enable the company to perform more effectively. Individual shareholders would normally expect the buyer to pay a premium for control and so the share price will tend to rise when the possibility of a takeover is announced.

This question was not done very well. Many candidates gave very vague low level answers which got low marks.It was clear that many candidates were just making up a general answer and had very little idea about this area.

18

The external auditor's primary role is to express an opinion on the truth and fairness of the published financial statements. This is necessary because these statements are used to resolve many of the agency issues that arise between the directors and the shareholders. The shareholders can only rely on the statements if they can be satisfied that the financial statements have not been distorted or manipulated by the directors. The auditor gathers evidence on the accuracy of the information in the bookkeeping records and examines the accounting policies used in the preparation of the financial statements. A clean audit opinion is not a guarantee, but it does give the readers some reassurance that the statements have been prepared properly and are a credible basis for making decisions.

This question was done very well by most candidates which was excellent.

19

(i)

	2009	**2008**
Profitability		
Return on capital employed	4,368/(4,816+6,934) = 37%	2,910/(4,100+2,675) = 43%
Gross profit percent	5,040/8,400 = 60%	3,180/6,000 = 53%
Distribution costs/sales	504/8,400 = 6%	180/6,000 = 3%
Revenue/fixed assets	8,400/12,000 = £0.70	6,000/7,000 = £0.86

Risk		
Gearing	6,934/(4,816+6,934) = 59%	2,675/(4,100+2675) = 39%
Current ratio	990/1,240 = 0.8:1	745/970 = 0.8:1
Quick ratio	710/1,240 = 0.6:1	510/970 = 0.5:1

At first glance, the company seems to have boosted revenue and profit. The move to a new range of products has boosted the gross profit percentage. The company has, however, become less profitable because return on capital employed has declined. This decline appears to have arisen because of the investment in machinery. Each £1 of machinery generated £0.70 of revenue, which is rather less than the £0.86 that was generated in 2008. Another factor is the doubling of the percentage of revenue spent on distribution. The new product range may require a greater sales effort.

The important question to ask is whether this is a transitional period. If the company only installed the equipment during the year and then operated it at less than full capacity then the return on capital employed and revenue to fixed assets ratios will both be artificially depressed.

The risks have also increased significantly. Gearing has gone up from 39% to 59%, thereby increasing any volatility to the shareholders. The liquidity ratios are low, although that may be less of a problem because the company had a similar set of liquidity ratios in 2008 and it has survived since.

(ii) The main problem with the annual report is that it provides only limited amounts of detail. It would be extremely useful to have had a full analysis of the new venture in the annual report, but none would have been provided. Companies are reluctant to publish information that could be used by their competitors. It would be useful to know how management feels that the new product will develop over time, but such predictions are fraught with difficulties. If management is over pessimistic then the shareholders might question the wisdom of the investment, but optimism could lead to disappointment and an overreaction if things do not work out.

Some of the information in the annual report will also date very quickly. For example, the liquidity position will change from day to day.

This question was done very well by candidates which was excellent.

The calculations were excellent in most cases but the written explanation was usually brief and lacking substance. The calculations pulled the marks up and made this one of the best answered questions.

20

(i) This investment is a major strategic decision. It is not really sufficient to set a single criterion for this and then analyse the project because the decision is far more complicated and requires a far richer analysis. This decision has the capacity to cause the company a great deal of harm if its implications are not thought through and managed.

(ii) There are many different frameworks that can be used to analyse this proposal. The following categories of risk should be considered:

Political The government in the home country might be rather disturbed by the fact that it is outsourcing production. The local government might also be concerned about the implications of relying on multinational corporations for employment. Either government could act against the company's interests, either through legislation or through the activities of government departments such as the tax authorities.

BusinessThe company seems to be very strongly identified with the home country. The brand's popularity might decline as a result of the move offshore.

EconomicManufacturing in one country for sale in another will create a series of currency risks that did not arise before. If the economy of the new location is weak then there could be problems with inflation.

(iii) Individuals have their own personal risk preferences. The "rational" analysis of an investment project often uses market prices and thereby uses norms set as an average by the market as a whole. Ms Lee could easily be more risk averse than the average investor.

Ms Lee does not have a balanced and diversified portfolio. She will be exposed to the total risk, whereas market preferences are often arrived at using portfolio theory.

There are non-economic issues that could affect her decision. She may have a sense of attachment to the original business model and might be unwilling to change that unless there is a significant reward for doing so.

(iv) The biggest advantage of seeking a quotation is that all parties will have a clear exit route. The venture capitalist will be able to sell their stake on the open market and move on. Ms Lee will be able to scale down her stake in the company.

The quotation will make it easier to seek fresh equity in the future.

There are potential disadvantages. Seeking the quotation will be an expensive matter. The company will have to invest heavily in professional fees, underwriting, etc. Ms Lee will also have to sacrifice a great deal of control of the company. She may be able to remain the largest shareholder, but will not be able to retain a majority shareholding. She will be answerable to a body of shareholders who may have a different attitude towards the way in which the company should be run.

Answers to this question were generally poorer than expected. Some parts were very weak.

Part i was poor and should have been straightforward. Part ii was not as bad but some candidates had difficulty identifying suitable risks.

Part iii was done well by some candidates but weaker candidates were poor in this part also. More detail was required to get a good mark in this part of the question. Part 4 was reasonable but again many candidates scored a borderline fail mark as they did not have much detail in their answer.

END OF EXAMINERS' REPORT