EXAMINATION

16 April 2007 (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 A project has an internal rate of return of 12%. It has a positive net present value at 10%. The project will be funded by means of the issue of loan stock, which has already been arranged and to which the company is committed. The finance raised from the loan stock issue will cost 8% per annum. If the company does not invest in the project then it will invest the proceeds in a financial instrument which carries a rate of return of 6% per annum. What is the opportunity cost of investing in this project?

A 6%
B 8%
C 10%
D 12%

[2]

2 Which of the following is the best measure of the cost of retained profits in a business?

A Retained earnings are a cost-free source of finance.

B The cost of retained earnings is the same as that of the weighted average cost of capital (WACC).

C The cost of retained earnings is the same as that of ordinary share capital.

D The cost of retained earnings is the same as that of secured loan stock.

[2]

3 Which of the following is the most correct summary of the reasons behind Modigliani and Miller's argument that capital markets are indifferent to a company's financial structure?

A Tax effects undermine the cost of different sources of finance in different ways.

B Shareholders can adjust gearing at minimal cost.

C Companies must always follow the optimal gearing strategy in order to attract finance.

D Institutional investors can "see through" the effects of different financing strategies.

[2]

4 Which of the following is an economically sound reason for a company to enter into a share repurchase?

A Earnings per share tends to be inflated.
B Share repurchases can be efficient from a tax point of view.
C Share repurchases are a powerful signal of confidence to the stock market.
D A repurchase is simpler than increasing the dividend.

[2]

5 Which of the following is the most appropriate basis for determining the required rate of return on a major project being considered by a quoted company?

A The company's weighted average cost of capital (WACC).

B The interest rate on the bank loan raised in order to finance the project.

C A specific rate for the project determined according to the project's total risk.

D A specific rate for the project determined according to the project's systematic risk.

[2]

6 An external auditor is preparing the audit report on a company's financial statements. The auditor believes that the financial statements are potentially misleading unless readers pay close attention to one of the notes to the accounts. Which form of audit report is likely to be most appropriate in these circumstances?

A Unqualified opinion.
B Unqualified opinion with emphasis of matter.
C Qualified opinion.
D Disclaimer of opinion.

[2]

7 Which of the following is true of limited liability partnerships (LLPs) in the UK?

A They have no separate legal identity.
B They are taxed as companies.
C They are profit seeking ventures.
D Members have joint and several liability.

[2]

8 Who bears the responsibility for the preparation of a company’s financial statements?

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

[2]

9 Which of the following would NOT be removed from the calculation of a UK company’s accounting profits in order to arrive at the taxable profit for corporation tax purposes?

A Overseas earnings.
B Franked investment income.
C Depreciation.
D Entertaining costs and similar expenses that are not allowable for tax.

[2]

10 Finance theory suggests that individuals who own shares often find the tax treatment of capital gains on shares preferable to the tax treatment of a dividend of the same amount. Which of the following is NOT a potential reason for this preference?

A Capital gains are not taxed until they are realised.

B Income on dividends is typically taxed in its entirety for taxpayers who have income from other sources.

C Taxpayers who do not report capital gains are unlikely to be discovered by the authorities.

D Capital gains are sometimes adjusted by reliefs that take length of ownership into account.

[2]

11 Explain how and why the interests of the stakeholders in a company may be in conflict with one another. [5]

12 Explain the differences between the risk management characteristics of options and futures. [5]

13 Explain how tax might influence the shareholders’ preference for debt financing versus equity financing in the company’s gearing decision. [5]

14 A company’s operating profit was £500,000. Depreciation of £150,000 was charged in arriving at this figure. Comparing the balance sheet at the beginning and end of the period showed the following movements:

Inventories	increase of £30,000
Trade receivables	decrease of £10,000
Trade payables	increase of £8,000

Calculate the cash generated from operations for this company. [5]

15 A company’s cash flow statement showed that it had sustained a major outflow of cash, despite the fact that it had made a healthy profit during the year.

Explain how this could be possible. [5]

16 Explain why balance sheets always “balance”. [5]

17 Explain why the going concern assumption may simplify the preparation of financial statements. [5]

18 Outline the difficulties associated with preparing financial statements that give a “true and fair view”. [5]

19 The directors of a major quoted company have been working towards a greater spirit of openness in the interest of improving investor relations. As part of this, they released a great deal of information about a major investment project that the company had committed itself to. The directors had conducted a detailed analysis and were of the opinion that the project's net present value (NPV) was worth roughly 10% of the company's market capitalisation. They were, therefore, disappointed that the publication of this information had little or no observable impact on the share price. The published information had not included detailed cash flow projections or details of the required rate of return used to evaluate the cash flows, but it should have been sufficient for shareholders to have been able to determine that the project represented a significant and profitable expansion, with a low risk.

(i) Explain why it is theoretically correct to assume that accepting a project with a positive NPV should increase the value of a company by the NPV of the project. [7]

(ii) Explain why the movement predicted in (i) is unlikely to be the case in practice. [7]

(iii) Explain why companies are often keen to provide shareholders with information about plans and future prospects. [6]

[Total 20]

20 The directors of Cash Ltd are in the process of conducting a risk assessment of the financial aspects of the management of their business. They have decided to analyse ratios relating to liquidity and gearing and to compare the results with those of similar businesses.

The company's latest balance sheet is as follows:

Cash Ltd
Balance sheet as at 31 March 2007

	£000
ASSETS	
Non-current assets	2,500
Current assets	
Inventories	200
Trade receivables	150
	350
Total assets	2,850
EQUITY AND LIABILITIES	
Ordinary share capital	500
Preference share capital	300
Revaluation reserve	200
Retained earnings	400
Total equity	1,400
Non-current liabilities	
Long-term borrowings	1,200
Current liabilities	
Trade payables	120
Current tax payable	100
Bank overdraft	30
	2,850

The directors have obtained the following averages for ratios based on their competitors' financial statements:

- Gearing (based on borrowings/total long term finance) 35%
- Current ratio 2:1
- Quick ratio 1:1

The directors have a secondary reason for their interest in the gearing ratio. The company's long-term borrowings are in the form of a bank loan. A condition of the loan was that the company's gearing ratio would be kept below a specific percentage. If the gearing ratio exceeds that limit then the bank has the right to demand immediate repayment.

The directors have already evaluated the company's profitability. Cash Ltd's return on capital employed is in line with the industry average. The directors are satisfied that they are as efficient and profitable as the other companies in their industry.

(i) Calculate Cash Ltd's gearing ratio, current ratio and quick ratio. [4]

(ii) Explain the implications of the ratios and other information provided for the assessment of the risks faced by Cash Ltd. [10]

(iii) Explain why a bank would impose a loan condition that set a maximum level for a borrower's gearing ratio. [6]
[Total 20]

END OF PAPER