EXAMINATION

2 October 2009 (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.

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

1 Mark has entered into a limited liability partnership (LLP) with three other consultants. Mark has invested £50,000 and has agreed to accept a 20% share of all profits and losses.

Which of the following best describes Mark's exposure as a result of entering into this agreement?

A He could lose his entire investment in the partnership.

B He could lose his entire investment in the partnership and be personally liable for up to 20% of any unrelieved liabilities after the partnership assets have been exhausted.

C He could lose his entire investment in the partnership and be personally liable for up to one quarter of any unrelieved liabilities after the partnership assets have been exhausted.

D He could lose his entire investment in the partnership and be personally liable for the whole of any unrelieved liabilities after the partnership assets have been exhausted.

[2]

2 Which of the following best describes the cost of trade credit as a source of finance?

A Trade credit is free.

B Trade credit is free provided the goods are paid for within the agreed period.

C Trade credit is free, but there is a reputational cost to buying goods on credit.

D Trade credit is not free, but the cost is included as part of the purchase price of the goods.

[2]

3 Company A has sold a put option for 1,000 shares in quoted Company B. The option exercise price is £5 per share. Company A received a premium of £500. The expiry date was set three months from the date the option was sold. What is Company A's maximum exposure to loss on this option contract?

A £500
B £4,500
C £5,000
D no specific upper limit

[2]

4 A shareholder of a quoted company has received an invitation to subscribe to a rights issue at a discount to the current share price. The shareholder cannot afford to take up this invitation. Which of the following best describes the protection available to the shareholder's position?

A The right to buy can be sold for an amount that should compensate for the loss in value due to the dilution.

B The shareholder can vote to block the issue.

C The stock market will react favourably to the news that the directors are raising funds with which to expand.

D The shareholder can sell the shares before the rights issue occurs.

[2]

5 A quoted company has been paying substantial dividends for several years. It recently announced that it would maintain its dividend compared to last year and that it would be making a rights issue in the very near future in order to finance an investment project. The amounts and timings of both the dividend payment and the rights issue are very similar.

Which of the following is the most likely explanation for this behaviour?

A A rights issue is perceived as a sign of confidence by the markets.

B It would be less expensive to raise finance by way of a rights issue rather than to suspend the dividend.

C It would be less expensive to finance the new investment with share capital rather than retained earnings.

D The directors are concerned that the shareholders will view a reduction in dividend as indicative of problems with the company.

[2]

6 Which of the following best describes current assets?

A all of the assets owned as at the balance sheet date

B physical assets that can be seen and touched

C non-physical assets

D cash and items that will be converted into cash in the normal course of business

[2]

7 A company has issued some fixed interest loan stock with a warrant attached. Which of the following is NOT an advantage of attaching a warrant to the stock?

A The warrant will not create any cash outflow.
B It might be easier to sell the loan stock.
C The company's equity may become diluted.
D The rate of interest offered to lenders may be reduced.

[2]

8 A company's income statement includes the cost of electricity that was consumed during the year, but was not paid for until some time during the following year. Which of the following accounting concepts requires this treatment of the electricity cost?

A accruals
B business entity
C going concern
D money measurement

[2]

9 A project has a very small positive net present value. Investing in this project will not prevent the company from investing in any of the other opportunities that are available to it. Which of the following best describes the manner in which the company should proceed?

A The project should be accepted because it is generating an acceptable rate of return.

B The project should be accepted because it will not involve a great deal of risk.

C The project should be rejected because it will not increase shareholder wealth by very much.

D The project should be rejected because the cash could be put to better use.

[2]

10 A company's loan stock has a nominal value of £10m and pays interest at a rate of 8% per annum on that amount. The market value of the loan stock is £7m. The company has made losses for tax purposes in excess of £2m per year and anticipates that it will continue to do so for at least the period up until the repayment of the loan stock.

Which of the following best describes the company's cost of debt?

A less than 8%, but subject to an adjustment for tax
B less than 8% without any adjustment for tax
C more than 8%, but subject to an adjustment for tax
D more than 8% without any adjustment for tax

[2]

11 Explain why a finance lease has effectively all of the attributes of taking out a loan in order to purchase an asset outright. [5]

12 Explain why many taxpayers have a preference for capital gains over earned income when the choice arises. [5]

13 Explain why a company might wish to issue preference shares rather than loan stock. [5]

14 Explain why property companies frequently raise a high proportion of their long term financing from debt rather than from equity. [5]

15 Discuss the difficulties associated with accounting for the depreciation of property, plant and equipment in a company's financial statements. [5]

16 Explain how the shareholder value approach to capital project appraisal relates to more traditional net present value approaches. [5]

17 Goodwill on consolidation arises when a buyer pays more than the book value of the net assets for an investment in a subsidiary.

Explain the circumstances in which it might be logical to pay more for a company than its balance sheet indicates that it is worth. [5]

18 Explain the role of the external auditor of a limited company. [5]

19 One of your friends has inherited a substantial investment in an unquoted company that manufactures electrical components. Your friend has asked you to analyse the last two years' financial statements in order to obtain an understanding of the company's profitability and risk profile.

Your friend has provided you with the following information:

Makegoods PLC
Income statement for the year ended 31 August

	2009	**2008**
	£000	**£000**
Revenue	8,400	6,000
Cost of sales	(3,360)	(2,820)
Gross profit	5,040	3,180
Distribution costs	(504)	(180)
Administrative expenses	(168)	(90)
Operating profit	4,368	2,910
Finance costs	(632)	(187)
Net profit before tax	3,736	2,723
Tax expense	(1,020)	(766)
Profit for the year	2,716	1,957
Dividend paid	2,000	1,000

Makegoods PLC
Balance sheet as at 31 August

	2009 £000	2008 £000
ASSETS		
Non-current assets		
Property	5,000	5,000
Plant and equipment	7,000	2,000
Total non-current assets	12,000	7,000
Current assets		
Inventories	280	235
Trade receivables	700	500
Cash at bank	10	10
	990	745
Total assets	12,990	7,745
EQUITY AND LIABILITIES		
Equity		
Share capital	2,000	2,000
Retained earnings	2,816	2,100
Total equity	4,816	4,100
Non-current liabilities		
Long-term borrowings	6,934	2,675
Current liabilities		
Trade payables	240	190
Current tax payable	1,000	780
	1,240	970
Total liabilities	8,174	3,645
Total equity and liabilities	12,990	7,745

The company sells goods to specialist suppliers for resale to end users. During the year ended 31 August 2009 it introduced a new range of products.

(i) Discuss the profitability and risks faced by this company. Your discussion should be supported by relevant ratios. [14]

(ii) Discuss the usefulness of the information contained in a typical company's annual report for the type of analysis that you conducted in part (i) above. [6]

[Total 20]

20 The directors of Homevac plc are considering a major investment proposal. The company was established 12 years ago to manufacture innovative consumer goods, such as food mixers that enable amateur cooks to produce professional results. The company was founded by Ivy Lee, who invented the basic product range. Much of the company's long-term funding came from venture capitalists and some banks. It has grown rapidly, but remains unquoted. Ms Lee is still the majority shareholder, although the venture capital organisations are represented on the board.

The venture capitalists are keen to see the company expand with a view to it seeking a stock market quotation. They have conducted some initial research into the possibility of relocating the company's factory to a developing country where labour is relatively inexpensive. The net present value of this proposal is positive under a range of assumptions about costs and revenues, including the worst likely case and using a realistic discount rate.

Ms Lee is concerned about this proposal on two grounds:

- Homevac plc makes most of its sales in its home country and has been successful in part because the company is very strongly identified as a "local business". She feels that there are risks that cannot be captured in a typical discounted cash flow analysis and that a higher-level risk analysis should be conducted.

- All of her wealth is tied up in the company. She is not opposed to relocating the factory in principle, but she would require far more than a "realistic" rate of return. She wishes the proposed investment to be evaluated at a required rate of return of 25%.

(i) Explain why it might be appropriate for the directors to identify the major higher-level risks that might affect the outcome of this project. [3]

(ii) Outline the main risks facing this project. [7]

(iii) Explain why it might be reasonable for Ms Lee to require a higher rate of return than one that had been determined by traditional investment appraisal techniques. [4]

(iv) Discuss the advantages and disadvantages to the owners of Homevac plc of seeking a stock market quotation. [6]

[Total 20]

END OF PAPER