EXAMINATION

6 April 2006 (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 It has been suggested that capital markets can motivate directors to maximise the financial performance of their companies. Which of the following is likely to have the most immediate effect on directors' motivation?

A Companies with poor performance might pay more interest on new borrowings.

B Poor performance can lead to lower credit ratings.

C All companies are in competition for limited investment funds.

D Declining share price makes the company vulnerable to takeover.

[2]

2 Bank overdrafts can remain outstanding for many years. When does a bank overdraft normally become repayable?

A At the request of the bank.

B At the conclusion of the term agreed when the overdraft facility was first granted.

C After five years.

D When the company's gearing ratio exceeds agreed limits.

[2]

3 A limited liability partnership (LLP) was founded by four members, but subsequently admitted two additional partners. The partnership has become insolvent and has been wound up owing net debts of £600,000. What is the personal liability of *T*, one of the founder partners?

A nil
B £100,000
C £150,000
D £600,000

[2]

4 A company is considering raising a loan, which would increase the company's gearing ratio to a significant level, rather than issuing equity. In which of the following situations would such a decision be most appropriate?

A Interest rates are low.

B The company owns valuable land and buildings that can be pledged as security.

C The company's operating revenues and costs are relatively stable.

D The company has a good relationship with its principal lender.

[2]

5 A quoted company issued loan stock which is publicly traded. Which of the following would have no effect on the real rate of return offered by this loan stock?

A A change in the rate of corporation tax.
B A change in the rate of inflation.
C A change in rates offered by Treasury Bills.
D A change in the perceived risk of the company defaulting.

[2]

6 A company evaluates all potential investment projects by ensuring that the internal rate of return exceeds the company's weighted average cost of capital. Which of the following reasons is the soundest justification for such a policy?

A Rejects unacceptable proposals.
B Incorporates stock market sentiments.
C Most consistent with finance theory.
D Provides a simple decision rule.

[2]

7 Which of the following is not required by Companies Act 1985 disclosure requirements?

A Balance sheet
B Profit and loss account
C Cash flow statement
D Directors' report

[2]

8 A company's balance sheet excludes the value of a major patent that was registered after a research breakthrough by its own employees. Which of the following accounting concepts best justifies the exclusion of this patent?

A Money measurement
B Going concern
C Business entity
D Realisation

[2]

9 Company B has 1,000 shares in issue. An investment bank holds 999 of these. The remaining share is held by Company A. Company A's share is in a special category that carries 51% of the voting rights. Which of the following best describes the relationship between Company A and Company B for consolidation purposes?

A The relationship is immaterial
B Company B is an investment of Company A
C Company B is an associate of Company A
D Company B is a subsidiary of Company A

[2]

10 Which of the following problems is most likely to be overlooked by a ratio analysis of a company's financial statements?

A Poor profitability
B Liquidity problems
C High gearing
D Substantial contingent liabilities

[2]

11 The directors of a medium sized company are concerned that their gross profit % and net profit % are both far lower than the industry average. They have asked for recommendations to improve matters. The company's chief accountant has responded that the only really important profitability ratio is the return on capital employed (ROCE) and that, as the ROCE is the highest in the industry, the directors should not be too concerned about gross profit % and net profit %.

Explain why ROCE might be considered the most important profitability ratio and explain how a company could have a high ROCE despite poor gross profit % and net profit %. [5]

12 A company has, historically, paid a steadily increasing dividend from one year to the next. The company has had a difficult year and has generated very little profit and has had slight cash flow problems. The directors are considering borrowing cash in order to maintain the dividend for the current year in order to maintain the company's share price.

Discuss the implications for the share price of borrowing to meet dividend expectations. [5]

13 In theory, companies exist to maximise shareholder wealth. In practice, the relationship between shareholders and the directors whom they appoint to manage their companies appears to suggest that the directors have other motives.

Explain why it is difficult for shareholders to be assured that directors are consistently working to serve their interests. [5]

14 A firm of actuaries has previously operated as a partnership. The firm is considering raising a large loan in order to buy office premises instead of renting them. One of the partners has suggested incorporating the firm as a limited company in order to avoid personal risk for the partners at minimal cost.

Explain whether incorporation as a limited company is likely to achieve the objectives suggested by the partner.

[5]

15 The directors of a major quoted company are considering raising funds by means of a rights issue.

Describe the matters that will have to be decided by the directors if they decide to proceed with the issue.

[5]

16 An investor purchased convertible loan stock in a small company. The exercise period for converting the stock into equity is two years in the future. However, the company has written to the investor offering to permit the conversion to go ahead immediately and on slightly more favourable terms than had been originally offered.

Describe the factors that should be taken into account by the investor in deciding whether to accept this offer. [5]

17 J is a major company that invests in a range of high technology projects. The chief financial officer has recommended that all future investment proposals should be supported by an "objective" form of evaluation such as the results of a simulation or a decision tree before the board should even consider whether to proceed with the proposal.

Explain whether decision aids used in investment decisions are capable of providing "objective" decisions. [5]

18 A company has traditionally had a high price / earnings (P/E) ratio. Its directors are discussing the merits of a new accounting policy that will increase reported earnings per share. They hope that this will increase the share price when it is multiplied by the P/E ratio.

Discuss the logic of the directors' proposal. [5]

19 A close family member has inherited a sum of money equivalent to two years' payments of his salary. He has decided to invest this sum in shares of the large quoted company for which he works because he feels that he has a good understanding of that industry. He wishes to invest this money so that it will achieve a high yield on his investment, but at minimal risk. He has two children, one of whom will be going to university in three years' time and the other in five years. He wishes to use his inheritance to support them through their studies.

(i) Explain, using the principles of diversification (as used in the Capital Asset Pricing Model) how your family member's proposed investment strategy will lead to a sub-optimal balance between risk and return. [7]

(ii) Explain why it is unlikely that any investment policy will yield a combination of both a high return and a low risk. [7]

(iii) Your family member is aware that some companies pay substantial dividends out of earnings and others aim for reinvestment and capital growth. Explain the tax implications for him of investing for dividends rather than capital growth. [6]

[Total 20]

20 The following list of balances has been extracted from the bookkeeping records of Trolley Ltd at 31 December 2005:

	£000
Sales	22,356
Purchases	15,250
Stock at 1 January 2005	1,700
Administrative salaries	1,240
Delivery drivers' wages	800
Factory rent, rates and insurance	438
Telephone expenses	420
Advertising	350
Debenture interest paid	70
Factory heat and light	426
Bank overdraft interest	70
Audit fees	150
Preference dividend paid	32
Ordinary shares of 50p each	1,600
8% Preference shares of £1 each	800
Profit and loss account at 1 January 2005	1,360
Bank overdraft	860
10% Debentures 2009	1,400
Property at cost	3,800
Depreciation of property at 1 January 2005	500
Machinery at cost	3,000
Depreciation of machinery at 1 January 2005	900
Delivery vehicles at cost	960
Depreciation of delivery vehicles at 1 January 2005	160
Debtors	1,920
Creditors	690

Additional information:

- The closing stock at 31 December 2005 was valued at £ 1,870,000.
- Depreciation is to be charged on the following bases:

Property	2% of cost
Machinery	10% of cost
Delivery vehicles	20% of reducing balance

- All vehicles are used by delivery and sales staff.
- Electricity used in the year but not paid for was £6,000.
- Debenture interest unpaid must be provided for, as well as a corporation tax liability of £500,000.
- The annual insurance policy of £90,000 was paid in full to 30 June 2006.

- The directors have proposed that the remaining preference dividend be paid in full, and that a dividend of 5 pence per share be paid to the ordinary shareholders.

Prepare the profit and loss account of Trolley Ltd for the year ended 31 December 2005, and its balance sheet at that date. These should be in a form suitable for publication as far as possible from the information provided.

[20]

END OF PAPER