EXAMINATION

17 April 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 A company has a high return on capital employed but a low gross profit percentage. Which of the following is the best interpretation of these results?

A The company is profitable because it prices its sales aggressively.

B The company should increase its selling prices.

C The company is unprofitable despite a high return on capital employed.

D Gross profit is a very straightforward measure, so the company should disregard the return on capital employed.

[2]

2 A company has a high price earnings (P/E) ratio. Which of the following is the most likely explanation for this?

A The current share price is too high.

B The current share price is too low.

C If the directors could increase reported earnings then the share price would be even higher.

D The stock market is confident in the company.

[2]

3 A company's board of directors is considering an approach by a competitor who wishes to offer the shareholders an attractive price for their shares so that it can take the business over. Which of the following responses is most compatible with agency theory?

A The directors will probably recommend the acceptance of the offer because it will maximise the shareholders' wealth.

B The directors will probably recommend the rejection of the offer because it would threaten their job security.

C The directors will probably recommend the rejection of the offer because they have no desire to maximise the wealth of a competitor's shareholders.

D The directors will probably recommend the acceptance of the offer because the amount offered is greater than that set by market forces.

[2]

4 A company is planning to issue subordinated bonds. What rate of interest will have to be offered on them relative to that on the company's existing debt?

A zero interest
B lower than existing debt
C the same as existing debt
D higher than existing debt

[2]

5 A company has 500,000 warrants outstanding with a strike price of £2.00. The current share price is £1.90. The warrants are about to expire. How much money is the company likely to receive from the exercise of these warrants?

A nil
B £50,000
C £950,000
D £1,000,000

[2]

6 A project has a positive net present value when the cash flows are discounted at 10%. The project has two internal rates of return of 8% and 15%. What is the most likely explanation for this set of figures?

A The project should be accepted if the required rate of return is more than 8%.

B The project should be accepted if the required rate of return is more than 15%.

C The project should be accepted if the required rate of return is between 8% and 15%.

D The project should be accepted if the required rate of return is less than 8% or more than 15%.

[2]

7 To whom does the external auditor report?

A users of financial statements
B the shareholders
C providers of finance
D shareholders and regulatory bodies

[2]

8 A company paid £400,000 for a property. The property was depreciated at 2% of cost each year for ten years. The directors have had the property revalued at £700,000. How much is the gain on revaluation?

A £140,000
B £300,000
C £308,000
D £380,000

[2]

9 A company has 2,000,000 ordinary shares of £1 in issue. The current market price is £4.00 per share. The directors are about to make a scrip issue of 500,000 shares. What is the expected market price per share after the scrip issue?

A £0.80
B £1.00
C £3.20
D £4.00

[2]

10 A company's debentures have a face value of £1,000 and a market price of £900. Which of the following is NOT a potentially valid explanation for this difference?

A The debentures are close to redemption.

B The markets lack confidence in the company.

C The interest rates available on similar instruments are higher than the debenture coupon rate.

D The debentures were issued at a discount with an artificially low coupon rate.

[2]

11 Explain the advantages and disadvantages of showing properties at their current valuation rather than at cost less depreciation. [5]

12 Explain why financial statements must be supplemented and supported by notes to the accounts. [5]

13 Explain the purpose of accounting standards. [5]

14 A company wishes to raise additional finance but it has been prevented from borrowing by the conditions imposed by an existing loan agreement.

Explain why a lender might impose such a restriction before granting a loan. [5]

15 A company's board of directors is revising the company's investment appraisal criteria. The directors have asked for an explanation of the concept of opportunity cost and the manner in which it might impact on the selection of projects.

Outline the points you would make. [5]

16 A company is planning to raise additional funds by issuing shares.

Describe the advantages of doing so by means of a rights issue. [5]

17 Explain why shareholders might be worried because a quoted company's diluted earnings per share is significantly lower than its basic earnings per share. [5]

18 (a) Explain what is meant by the term "subsidiary company".

(b) Explain why a holding company is required to prepare a set of consolidated financial statements for its shareholders.

[5]

19 A major quoted company has had a policy of reinvesting earnings and paying very little in the way of dividends for many years. The company now finds itself with a significant cash balance and very few attractive projects in which to invest. The directors are debating the merits of paying a substantial dividend.

(i) Explain why the potential tax implications of receiving a dividend might make this proposal unpopular with this company's shareholders. [8]

(ii) Explain why it might not be viable for the company to simply retain the funds and to wait until some attractive investment opportunities arose. [8]

(iii) Explain why a quoted company might choose to release commercially sensitive information about investments and performance to the financial markets. [4]

[Total 20]

20 The latest balance sheet of Rough Ltd is as follows:

Rough Ltd
Balance sheet as at 31 March 2008

	£m	£m
ASSETS		
Non-current assets		
Intangible		8
Property, plant and equipment		7
		15
Current assets		
Inventory	2	
Trade receivables	3	
		5
Total assets		20
EQUITY AND LIABILITIES		
Share capital		4
Retained earnings		6
		10
Non-current liabilities		
Secured loans		7
Current liabilities		
Trade payables	2	
Bank	1	
		3
		20

Vest Ltd supplies raw materials to Rough Ltd. The finance director of Vest has just discovered that Rough has run into serious problems and is likely to be wound up. This is a matter of major concern because Rough owes Vest £500,000 which is included in the trade payables as at the latest balance sheet date.

The finance director of Vest is trying to estimate how much, if anything, the company will receive once Rough has been wound up. The following information has been gathered from various sources:

- Intangible non-current assets comprise the cost of buying a licence to manufacture a product that has been the cause of Rough's downfall. The product has been linked to a major consumer safety scare.

- Property, plant and equipment has been offered for sale and is likely to realise £6m.

- Inventory and trade receivables are likely to realise 50% of their book values.

The chief executive of Vest has suggested that it might be worth considering buying Rough as a going concern. It would cost approximately £8.5m to acquire and reorganise the company so that it could manufacture a new product range that would make heavy use of Vest's materials. This new line of business is expected to generate a net annual cash flow of £0.8m in perpetuity.

Vest's cost of capital is 8%. Enquiries of the directors of Rough suggest that their cost of capital prior to the collapse was 11%.

(i) Calculate the amount that Vest is likely to receive from Rough in the event that the company is wound up. [5]

(ii) (a) Calculate the value of Rough to Vest, assuming required rates of return of 8% and 11% on the estimated future cash flows.

(b) Comment on your findings in (a).

[3]

(iii) (a) Explain why the appropriate required rate of return for this investment is unlikely to be that of either Rough or Vest.

(b) Explain how Vest should go about valuing the proposed investment in Rough.

[12]

[Total 20]

END OF PAPER