Faculty of Actuaries **Institute of Actuaries**

EXAMINATION

September 2005

Subject CT2 — Finance and Financial Reporting
Core Technical

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.

M Flaherty
Chairman of the Board of Examiners

15 November 2005

1 B
2 A
3 D
4 D
5 C
6 D
7 C
8 A
9 C
10 B

11 The arguments to support scrip issues are largely psychological.

Marketability: By having more, lower priced shares, the marketability is improved.

Something for nothing: Shareholders might like the idea of being given extra shares free of charge.

Past profitability: Scrip issues can take place only if there are sufficient reserves to be capitalised. This means that scrip issues tend to be associated with successful companies which have built up large reserves from retained profits.

Future confidence: The minimum price at which a rights issue can occur is the par value of the shares. Yet rights issues must occur at a discount. Therefore, a rights issue is only possible if the current share price is above the par value of the shares. A scrip issue reduces the price of a share. Therefore, having a scrip issue may reduce a company's ability to have a future rights issue if its share price declined following the scrip issue. So, if the directors decide to have a scrip issue, they must be confident about the company's future prospects.

Increased dividends: Some companies have a habit of having light scrip issues (e.g. 1 for 10) and subsequently keeping the same dividend per share. In these cases, a scrip issue may lead to, or be a sign of, higher dividends.

More reasonable rate of dividend: If dividends are expressed as a percentage of the nominal value the figure may seem excessive. This could cause public relations problems, or problems with employees who feel that dividends are too high. This could be avoided by a scrip issue.

It is a requirement of the Companies Act 1985 that a company must have a minimum issued share capital of £1m before it can act as a trustee. A scrip issue converts reserves into share capital, so may allow a company to meet this requirement.

12 A qualified audit report means that the auditor has expressed some reservations about the truth and fairness of the financial statements.

The most common reason for a qualified report would be that the auditor disagrees to a material extent with the information in the statements.
The audit report would normally state that the financial statements give a true and fair view "except for" the subject matter of the disagreement.
In extreme cases the auditor might state that the financial statements do not give a true and fair view.

The significance of such an audit report depends on the reaction of readers. In principle, they must decide whether to rely on the figures provided by the directors or the auditor.
The fact that the auditors have disagreed with the directors so publicly might undermine investor confidence in the integrity of the board
and so the share price might fall.
The directors might also be left with a weaker reputation in future years.

13 One approach to deriving the cost of equity is based on the capital asset pricing model.
Cost of equity = Risk free rate + (Equity risk premium × Beta for stock).

The risk free rate is determined by analysing the real rates of return on risk-free investments such as government securities.
The equity risk premium is determined by the historical average return on equities.

The beta is determined by analysing the historical sensitivity of the return on the company's securities to the returns on the market as a whole.
If the company's returns fluctuate more widely than market returns the company's shares will be regarded as more risky and a higher rate of return will be required.

This model assumes that historical sensitivity is a valid measure of the market's perception of the future risk.
It also assumes that the markets are interested only in systematic risk.

Note — accept alternative models such as dividend growth or APT, even if not covered in core reading.

14 The "group" has no legal identity; it is merely an accounting abstraction.
It is not possible to enter into a contract with the group as such, only with one or more of the individual companies in the group.
Each group member is protected by limited liability and is not liable for the debts of its fellow group members.

Lenders might ask for guarantees so that group members had a contractual duty to support their fellows.

That will only be effective if the funds in the group are freely available for that purpose. For example, an overseas subsidiary might be unable to remit funds to the head office.

Or the minority shareholders in a subsidiary might be able to interfere with a transfer to another group member.

The financial statements for a group of companies are more complex than those for an individual company, which are usually easier to understand.

15 Agency theory, which considers the relationship between a principal and an agent of that principal, includes issues such as the nature of the agency costs, conflicts of interest (and how to avoid them) and how agents may be motivated and incentivised.

These issues arise because the principal must put the agent in a position of trust, but the agent will usually have an incentive (or at least a perceived interest) to act in his or her own interests at the expense of the principal's.

The need to rely on agents arises because of the development of a commercial environment which requires the separation of ownership and control.
Many companies are simply too large and complex for them to be funded by a small group of shareholders and managed by the same small group.

In practice, the various mechanisms for making the agent's interests coincide with those of the principal are flawed.
This means that principals often have to rely on monitoring the actions of the agents with the underlying threat of some penalty for failure or poor performance.
The annual report is often viewed as a means of the agents (directors) demonstrating their stewardship of the principals' (shareholders') investment.

16 Return on capital employed is normally regarded as the most reliable measure of profitability.
Given a certain level of investment, it is always better for the business to generate the highest possible return on that capital.
Other ratios might give an insight into profitability, but they can be difficult to interpret in isolation.
For example, the higher gross profit % in P plc implies that it makes more profit from every £1 of sales.
That does not necessarily mean that the company is better managed because it could be overpricing its sales in order to achieve that result.
Similarly, the net profit % figures suggest that P plc is spending less on non-trading operating expenses than D plc,
but that could be a false economy. D plc might be making a conscious investment in better administrative systems and in promotion and advertising and that might be a further explanation for the higher returns that it is enjoying.

17 Employees are generally regarded as stakeholders,
as is government.

Employees are interested in the company's ability to offer them satisfactory terms and conditions of employment and in their job security.
The shareholders are usually more interested in making a profit and might be keen to see the company outsource some tasks or even move them offshore.

The government is interested in the company's social and economic contribution and also its ability to pay taxes.
Again, the shareholders might prefer to have the company relocate to an easier tax regime or to claim substantial grants and other support in order to obtain higher profits and dividends.

Credit was also awarded for discussion of other stakeholders (e.g. directors, creditors, debtors).

18 Debentures are normally secured against assets and so there is very little risk of default.
This security might be a fixed charge against specific assets or a floating charge over the assets generally.
Regardless of this, the debenture holders normally rank ahead of most other creditors in the event of a default.

The debenture will normally give the holder the right to a fixed annual or six-monthly interest payment.
If this is not paid then there are normally clear agreements to enable the holder to force the company to make payment.

Debentures are not totally risk free investments, though. Their value arises from providing a highly predictable series of cash flows. The value of that series will fluctuate in accordance with the risk-free rates offered on the markets.
If interest rates rise then the cash flows from the debenture will have to be discounted at a higher rate and a capital loss will ensue.

19 (i) The most likely explanation is that the directors do not have sufficient positive NPV projects to invest in.
Retaining the cash in the company without putting it to good use will undermine their return on capital employed.
That would lead to dissatisfaction from the shareholders
and could even lead to an attempted takeover.

The distribution might also demonstrate the integrity of the board.
They are clearly good stewards if they prefer to act in the shareholders' best interests rather than hoard cash for their own sake.

(ii) (a) The stock market reaction will depend on the interpretation of the facts. Presumably the fact that the company had substantial cash reserves was known.
The market would have had some expectations that this cash would be put to some use.
If the market believed that the funds would be invested in highly profitable projects then the announcement that they will be returned as a cash distribution will depress the market price.
If the market had lacked confidence in management's ability to invest these funds successfully then the share price might rise.
For example, the market might have anticipated that this cash would be used to fund some expansion through takeover. This usually involves considerable expense and takeovers are rarely wholly successful.

In the short term, the stock market might take some time to adjust to this announcement. It is an unusual step and it might be regarded as a lack of self-confidence on the part of management.

(b) The share price will fall just after the payment because the company will be buying the shares back at a small premium.
By the time of the repurchase the shares will have value partly because of the repurchase
and partly because of the future cash flows to be generated from the remainder of the company.

(iii) If the company paid a major dividend then the shareholders would have to pay income tax on the whole amount.
The repurchase will constitute a partial disposal, and any profit will be subject to capital gains tax.
That is often less onerous, particularly for individual tax payers. Depending on the original cost of the shares, some shareholders might even make a capital loss on this "disposal" and so there will be no tax liability.

The directors might also wish to ensure that this is viewed as a highly abnormal event.
The use of an unusual form of distribution might help to signal that the company will not be making any similar disbursements in the foreseeable future.

(iv) The advance warning will avoid any panic-stricken reactions.
The time scale makes it clear that there will be ample opportunity for consultation and discussion,
including at least one annual general meeting.

The period of warning will also enable investors to make their own arrangements in the meantime. Those wishing to avoid recognising a capital gain in 18 months' time will have the option of selling their holding now and possibly spreading the capital gain. They will also be able to start planning how best to invest or manage the cash that will be released.

20 (a)

JK plc
Profit and Loss Account
for the year ended 31 August 2005

	£000	*£000*
Sales		2,200
Cost of sales		(1,284)
Gross profit		916
Administration	(395)	
Distribution	(145)	
		(540)
Operating profit		376
Income from investments		20
Interest		(9)
Net profit before taxation		387
Taxation		(25)
		362
Dividend		(60)
		302
Balance brought forward		374
		676

JK plc
Balance Sheet
as at 31 August 2005

	£000	*£000*
Fixed Assets		
Tangible		1,281
Investments		450
		1,731
Current Assets		
Stock	180	
Debtors	134	
Bank	8	
	322	
Creditors: amounts due within one year		
Taxation	(25)	
Creditors	(52)	
	(77)	
Net current liabilities		245
		1,976
Loan		(400)
		1,576
Share capital		900
Profit and loss account		676
		1,576

Note — Fixed Assets

	Cost	*Aggregate depreciation*	*Net book value*
	£000	*£000*	*£000*
Land and buildings	1,200	(39)	1,161
Machinery	250	(130)	120
	1,450	(169)	1,281

Workings

Cost of sales	
Opening stock	210
Materials	800
Closing stock	(180)
	830
Depreciation (30 + 24)	54
Wages	400
	1,284
Admin	
Directors' salaries	85
Head office running costs	200
Wages	110
	395
Distribution	
Advertising	90
Wages	55
	145

(b) Companies are liable to corporation tax on their taxable profits. Taxable profits include both income (less expenses) and capital gains.

The starting point for a company's tax assessment is profit on ordinary activities before taxation. This figure then needs to be adjusted.

The main adjustments are:

- add back any business expenses shown in the accounts which are not allowable for tax
- add back any charge for depreciation, and instead subtract the allowable capital allowance

- deduct gross franked investment income

Franked investment income is income paid by UK companies as a distribution of their post-tax profits together with an attaching tax credit. The company paying the dividend has already paid corporation tax on the profits from which the dividend is paid. The purpose of the tax credit is to reflect the fact that the dividend is paid from post tax profits.

END OF EXAMINERS' REPORT