EXAMINATION

April 2007

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.

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Chairman of the Board of Examiners

June 2007

Comments

Generally the standard of answers was poorer than usual. Candidates did not appear to be well prepared for this exam. The standard of questions was similar to previous diets, however the answers were of a lower standard. The depth of many answers was poor. There were, as usual, some very good papers which is always heartening.

Further comments, where appropriate, are given in the solutions that follow.

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

Q1–10 were not answered as well as usual. Very few candidates achieved full marks. There was no one question that was poor. There were some extremely poor marks which is unusual.

Candidates need to be well prepared to sit the exam, more revision is required before the next sitting in September.

11 Stakeholders have conflicting interests due to the commercial realities of the business. For example, corporate social responsibility is good for the public but may be costly to the shareholders. Therefore, benefits accruing to one stakeholder group may impose costs on another. This may be particularly acute when the company has direct contact with both parties, as when improving employees' benefits may be expensive for the shareholders.

A related issue arises from the fact that the interests of different providers of finance may be in direct conflict. For example, the shareholders enjoy the upside from risky investments but the lenders do not. A risky investment could be good for the shareholders, but might undermine the security of the lenders. Similarly, taking on additional debt in order to finance growth may be in the shareholders' interests, but that could dilute the security enjoyed by lenders.

This question was answered well by many candidates.

12 Options give the right to buy or sell the underlying asset, whereas futures require completion of the transaction at the conclusion of the period. That makes each type of instrument suitable for dealing with a different type of risk. A future would be suitable for creating certainty as to the cost of a particular product in the future. For example, a farmer might use the futures markets to sell a crop for a fixed price at a specified date. That would mean that the selling price was fixed and the farmer would be unaffected by a drop in price. However, the farmer could not benefit from any subsequent increase in the price because delivery would still have to be completed. An option to sell the product would leave the farmer free to exercise the option if the price fell below the striking price, but it would also be possible to let the option lapse and sell at a higher market price. In a sense, the premium paid for an option might be thought of as an insurance policy to protect against a specific downside risk , whereas a future protects against all risks, good and bad.

This question was poorly answered. Many candidates talked about options in detail, which was not what was asked for. Read the questions carefully, it is worth spending a bit of time planning an answer rather than just rushing to answer it. Always try to answer exactly what is being asked.

13 Corporation tax reduces the profit available to pay the shareholders' dividend. Borrowing increases the interest charge, which is deductible as an expense for corporation tax purposes. Some forms of borrowing are very tax-efficient. For example, lease payments are tax-deductible and provide a more consistent tax benefit than the effects of raising finance to purchase assets outright and claiming capital allowances.

The alternative to borrowing is to raise finance from the shareholders. If the company makes a rights issue it may be difficult for the shareholders to obtain tax relief on any funds that they borrow in order to buy shares. The shareholders might prefer the company to borrow on their behalf because the tax benefit is much less likely to be lost.

This question was answered well by most candidates.

14

Operating profit	£500,000
Depreciation	150,000
Increase in inventories	-30,000
Decrease in trade receivables	10,000
Increase in trade payables	8,000
	£638,000

This question was poorly answered. Most candidates were unsure whether the increases and decreases in assets and liabilities were inflows or outflows of cash.

15 The company could have invested heavily in non-current assets.

The company could have repaid loan finance during the year.

The company could have paid a substantial dividend out of retained earnings or have conducted a share repurchase.

The company could have invested heavily in current assets, such as inventory or trade receivables.

The profit could be based partly on transactions that do not have a cash effect. For example, a long term contract could have led to the recognition of profit even though the related cash payment might not be until some time in the future.

This question was answered reasonably well.

16 Balance sheets reflect two aspects of the business: the assets controlled by it and the manner in which those assets have been acquired. This means that the assets are mirrored by capital and liabilities and this yields the balance sheet equation (assets = capital + liabilities). The accounting system keeps track of the various components of assets, liabilities and capital so that this relationship is maintained.
The dual aspect concept suggests that every transaction will affect two balances. Every entry in the books has a corresponding entry which has the effect of maintaining the balance between assets, liabilities and capital.
The balance sheet is part of the output of the double entry bookkeeping system. This records adjustments and transactions in such a way that any resulting balance sheet must balance. Every entry is recorded in two places, to reflect the fact that both sides of the balance sheet equation must hold true.

The balance sheet is also prepared on the basis of a series of accounting concepts which means that items are only recorded in response to an event such as a transaction or an adjustment. This means that the only assets that are listed have automatically been reflected in the capital and liabilities accounts.

This question was answered very poorly. Most candidates struggled to come up with more than two points. Very few candidates mentioned double entry bookkeeping or accounting concepts, which meant they were struggling to come up with any sensible answer. This is an area where candidates would benefit from some revision before the next attempt.

17 The going concern assumption effectively permits accountants to prepare financial statements that make no overt attempt to inform certain potential decisions. For example, non-current assets are recorded at a carrying value that may bear very little relevance to decisions such as whether the assets should be sold for their market values. This is because the going concern assumption takes it for granted that the assets cannot be sold because the business needs the assets in order to carry on. The assumption also means that potential errors in short to medium term forecasts and estimates can be tolerated because the figures will resolve themselves over time. For example, the inventory is valued on the basis of certain assumptions about its eventual selling price. Any error might affect the calculation of profit for the current year, but that will be reflected by a corresponding increase or decrease in the following year and that should not matter year on year.

In the absence of a going concern assumption, assets would have to be stated at reasonably current values. That would both complicate the preparation of the statements and would leave the preparers and auditors more open to challenge in the event that the values proved to be incorrect.

This question was also very poorly answered. Very few candidates knew what this concept meant. Most candidates just talked about solvency and the business continuing into the future. While this was relevant there was rarely enough detail to give candidates many marks. The area of accounting concepts is one where candidates would benefit from revision.

18 There is no agreed definition of the term true and fair. It is absolutely mandatory that financial statements have this quality, but the lack of a definition means that it cannot be measured. The various rules and regulations that deal with specific figures and adjustments provide some guidance, but compliance may not be sufficient in itself. Indeed, there could be circumstances in which compliance with a specific rule would be misleading and the preparers would be required to set this aside in the interests of giving a true and fair view.

The lack of a clear benchmark means that the truth and fairness of the set of statements may be challenged. Accounts that have been prepared in good faith may be portrayed as misleading by a decision-maker who feels that s/he has been misled into making a loss.

This question was answered reasonably, however more depth would have improved the answers.

19 (i) A company's market capitalisation is a function of the future expected cash flows, discounted to take account of the time value of money and risk. Entering into a positive NPV project has the effect of creating the expectation of additional future cash flows and these have already been adjusted for the cost of capital.

The stock market might be viewed as a system that has an incentive to process information about future cash flows as effectively and as quickly as possible. Market participants who can spot future gains before their competitors can buy before the market price catches up with any new disclosures. When it does the share price will rise and they will have a capital gain. Any bias or error on the part of speculators will prove expensive because they will suffer losses if the share price falls after they buy or if any increase is too small to cover the transaction costs.

The NPV decision rule effectively requires management to consider proposals on the basis of their effect on shareholder wealth. If management make correct decisions then shareholders' wealth will increase, as reflected in market capitalisation.

(ii) It is highly unlikely that the directors' disclosures would enable the stock market to calculate the NPV accurately. Apart from anything else, this would lead to the publication of commercially sensitive information.

Market participants do not actually value shares on the basis of formal NPV calculations. Share prices are set by a process of supply and demand, with most participants taking note of the buying and selling decisions of other participants. The relationship between future cash flows and share prices is sound, but it is more of a long-term benchmark for prices than a measure that can be reported and valued on a day to day basis. The markets might even take the view that companies will invest in positive NPV projects as a matter of course and so share prices might reflect the possibility of such announcements, even though they have yet to be made.

The markets may not wholly agree with the directors' opinion of a project. The directors might be deemed to have an incentive to claim optimism that is subsequently shown to be unfounded.

(iii) Agency theory suggests that agency costs will eventually be passed on to the directors in the form of lower salaries or a deflated share price. Information asymmetry (the fact that directors know more about the running of the business) is one factor in creating agency costs. Publishing information enables the directors to signal that their stewardship of the company is sound and that the shareholders should not be concerned.

Companies are often keen to keep shareholders informed in order to distinguish themselves from less efficient businesses. Without information, shareholders have no way of distinguishing well run companies with poor prospects from those that are better. Voluntary disclosures should enhance the share price and reduce the risk of a takeover bid motivated by the possibility that the shares are undervalued.

This question was very poorly answered. This topic has been examined in a similar fashion for several years now, it is difficult to know why it was badly done on this occasion. All sections of the question were poor. The answers lacked any depth.

Again this topic should be revised in detail before the next attempt.

20 (i) Gearing = $\dfrac{1{,}200+300}{1{,}400+1{,}200}$ = 58%

Current ratio = $\dfrac{350}{120+100+30}$ = 1.4:1

Quick ratio = $\dfrac{350-200}{120+100+30}$ = 0.6:1

(ii) Cash Ltd's gearing is much higher than the industry average. That means that the total risks are much higher. The most obvious reason for this is that the company must meet the interest payments and loan repayments every year. If the company has a problem with its cash flows then it will struggle to pay its debts when they fall due. The fixed interest and preference dividend commitments will also make the earnings per share more volatile. That means that the ordinary shareholders will suffer a riskier pattern of dividends.

The liquidity ratios are lower than the industry average. That is a further reason for the risk to be higher. If the company's current assets are insufficient in comparison to current liabilities then the company may struggle to pay its debts when they fall due. That could lead to the company operating inefficiently and therefore with greater chance of errors and could make the business more volatile.

The composition of the assets and liabilities complicates this analysis further. The company's bank account is overdrawn. That means that the liquidity ratio is further cause for concern because the bank might suddenly stop the company from writing cheques. The overdraft makes it more difficult to manage the weak liquidity position. On the other hand, a significant current liability is in the form of a tax liability. The company has several months to pay this from the balance sheet date. That is a partial source of comfort because the directors can treat dealing with that payment as a separate exercise for which they have time to plan and prepare.

(iii) The bank does not wish to risk the company going into default on any loans. Even if the bank loan is secured on assets or the bank has a floating charge it is undesirable to have the loan default and have to pay the costs associated with foreclosing. This will also create adverse publicity for the bank.

The bank might not have security and could rank alongside other creditors in the event of default. The loan covenant will ensure that the bank's claim to the company's assets is not unduly affected by a disproportionate claim from other lenders.
The covenant will also give the bank some protection in the event that the company starts to decline. If there are large losses or asset write-offs then the covenant might be breached and the bank will be able to claim its money back before the company's cash flows give it the right to demand immediate repayment

This question was very poorly answered. Ratio questions appear frequently in this paper so candidates who were well prepared should have had little difficulty with this question. It calls for understanding of the figures and interpretation of a set of financial statements. Part 3 was poor, this was a straightforward question, very few candidates discussed the loan covenant, which was surprising. As this topic tends to be examined frequently some revision is recommended.

END OF EXAMINERS' REPORT