EXAMINATION

27 September 2007 (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 A company has a low current ratio. Which of the following would best explain why this is not a matter for concern?

A Shareholders are only ever interested in profit.
B The current ratio has been high in previous years.
C The company has a good credit rating.
D The company's current ratio has always been low.

[2]

2 Which of the following would explain the need to publish a figure for diluted earnings per share?

A There is an active market in traded options on the company's shares.
B The company has convertible loan stock in issue.
C The company's profit is declining.
D The company made a rights issue during the year.

[2]

3 A company's operating profit was £2.5m. Interest paid was £0.3m. Tax was £0.6m. Dividends paid were £1.4m. The company is financed by £10.0m of ordinary shares, £12.4m of reserves and £5.0m of long term loans. To calculate return on capital employed using £27.4m as the figure for capital employed, what figure would be used for return?

A £0.8m
B £2.2m
C £2.5m
D £2.8m

[2]

4 Which of the following best explains the need to depreciate buildings, even though their market value may be rising year on year?

A Depreciation is an accounting concept.
B Buildings have finite useful lives.
C Historically, buildings have always been depreciated.
D The depreciation charge is part of the cost structure.

[2]

5 Which of the following explains why insurance companies' financial statements are normally produced in a conservative way?

A Insurance companies are naturally conservative institutions.
B The underlying liabilities are generally both long term and difficult to predict.
C The asset base is composed largely of long term investments.
D The tax liability is reduced if profit is depressed.

[2]

6 A holding company has a 60% shareholding in a subsidiary. If the subsidiary fails, which of the following would be a valid reason for the holding company to pay the subsidiary's creditors the amounts owed to them?

A Action by the subsidiary's minority shareholders.
B Avoid adverse publicity for the group.
C The holding company is legally obliged to pay.
D Holding companies routinely guarantee all their subsidiaries' debts.

[2]

7 A company has a very high gross profit margin. Which of the following is the only statement which is definitely true?

A The company has a low cost-base.
B The company is over-pricing its sales.
C The company is highly profitable.
D The company makes a large percentage profit from a typical sale.

[2]

8 A shareholder owns 5,000 ordinary shares of 25p, of which 20p per share has been paid. The shares were originally issued at a premium of 15p per share. The company has just gone into liquidation. What is the maximum amount the shareholder would have to pay towards the company's liabilities?

A £250
B £1,000
C £1,250
D £2,000

[2]

9 Investment analysts often base their analysis of profitability on earnings before interest, taxation, depreciation and amortisation (EBITDA). Which of the following is NOT a valid reason for using EBITDA in preference to net profit?

A It gives an insight into cash generated from operations.
B It is more objective than net profit.
C It gives a clearer insight into future net profit.
D It is more difficult to manipulate than net profit.

[2]

10 A trade creditor is owed £6,000 by a company that is in the process of being liquidated. The company was financed by £1m of ordinary shares, £2m of preference shares, £2.5m of retained earnings, £0.6m of secured debentures and £3.7m of other loans, including the trade creditor's balance.

The creditor hopes to recover 20% of the amount owed. How much would the company's assets have to realise in order for this to happen?

A £0.86m
B £1.34m
C £3.34m
D £4.34m

[2]

11 Explain the difference between systematic and specific risk from the perspective of an investor who has a portfolio of investments. [5]

12 A company wishes to rely heavily on retained earnings in order to finance a long-term planned expansion.

Describe the problems that such a proposal might create. [5]

13 Explain why strict adherence to historical cost accounting might produce misleading figures in financial statements. [5]

14 Gamma plc is in the process of making a rights issue. The company presently has 2m shares in issue. The current market price is £3.00 per share. The terms of the issue give each shareholder the right to buy one new share for every five previously held. Each new share will cost £2.40.

(a) Calculate the theoretical price after the rights issue; and
(b) Explain why the actual price might vary from that calculated in (a).

[5]

15 (a) Explain why relatively new companies occasionally give warrants as an incentive to buy shares; and

(b) Describe the main problems associated with issuing warrants.

[5]

16 An actuary has his own actuarial consultancy. He is considering taking on a business partner.

Explain the potential advantages and disadvantages to the actuary of admitting a partner to his business.

[5]

17 It has been suggested that quoted companies are subject to the “discipline” of financial markets and that company managers may be penalised if they do not maintain the markets’ support.

Explain how these disciplinary processes might operate in practice. [5]

18 An individual taxpayer, subject to UK tax law, has complained to you that she is effectively being taxed several times on the same earnings. Her only assets are investments in shares and also a pension scheme. These assets were purchased out of her earned income, on which she has paid income tax. Now she feels that she is being taxed for a second time on the returns from her investments.

Explain whether this taxpayer’s concerns are justified. [5]

19 A firm of actuaries is considering a major international expansion. They are considering investing heavily in a feasibility study in order to determine whether to open a major new office in a new country. There are many factors that would determine the success or otherwise of this. For example:

- It may prove difficult to recruit suitable actuaries and support staff for the office without offering very substantial salaries.

- It is difficult to predict how competing firms who are already established in that country will respond to the competition.

- The new host country's currency is very volatile compared with the firm's home currency and all profits from the new office would be earned in that host currency.

The feasibility study is a very costly undertaking in itself and so the firm is considering the respective merits of three options:

- Conduct a feasibility study, prior to making a decision as to whether to proceed.
- Proceed with the expansion without first undertaking a feasibility study.
- Abandon the whole idea of the expansion.

One of the directors of the firm has prepared a probability tree using the following assumptions:

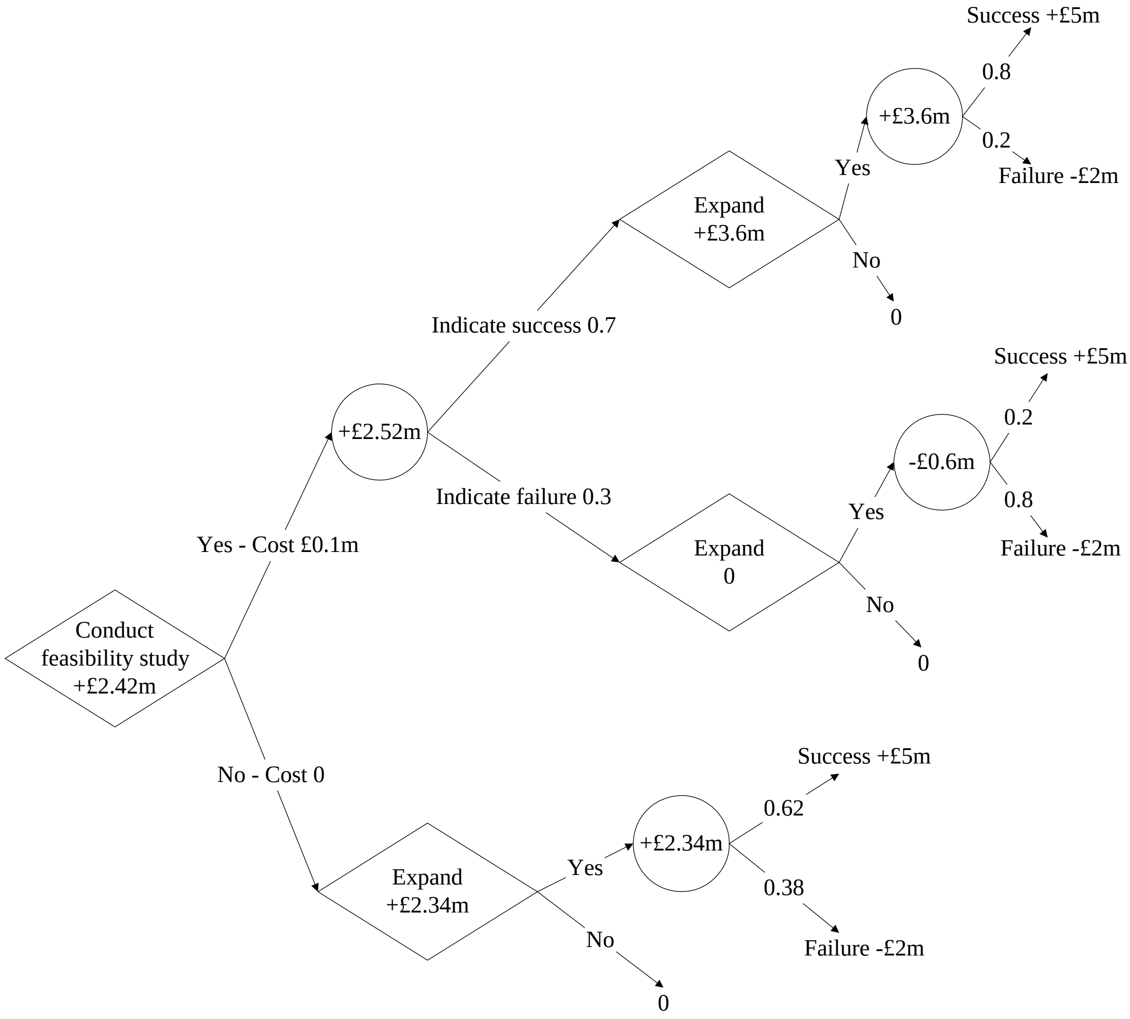
- If the expansion goes ahead it will yield either of the following outcomes: Success [with a positive net present value (NPV) of £5m] and Failure [with a negative NPV of £1m].

- The feasibility study will cost £100,000 and will have an 80% probability of correctly predicting the outcome of the expansion.

- There is a 70% probability that the feasibility study will indicate that the expansion will succeed and a 30% probability that it will indicate failure.

- If the expansion proceeds without the feasibility study then it has a 62% probability of success and a 38% probability of failure.

These assumptions yielded the following probability tree:



The director who prepared this diagram claims that it indicates that the expansion is likely to prove successful, but that the firm should undertake the feasibility study nevertheless.

Another director has prepared a simulation of the investment and has simulated the outcome of proceeding for 10,000 cycles. This suggests that the expected net present value of the expansion is negative, whether the feasibility study is conducted or not.

(i) Explain why the probability tree suggests that the firm should conduct the feasibility study, even though the expansion is likely to be a success. [3]

(ii) Explain when it might be appropriate to use a probability tree in the evaluation of a capital investment project. [4]

(iii) Explain why the other director's simulation exercise may be more reliable than the probability tree. [5]

(iv) Describe the prerequisites of a "successful" simulation of a capital investment project. [4]

(v) It has been suggested that managers often use capital investment appraisal techniques in order to justify decisions that they have already taken.

State, with reasons, whether or not you agree with this suggestion. [4]

[Total 20]

20 The following balances have been extracted from the books of CKL plc, as at 31 August 2007:

	£000
Advertising	400
Cash at bank	16
Directors' remuneration	170
Dividend paid	300
Interest on long term loans	18
Inventory at 31 August 2007	420
Investment income	40
Investments (long term)	900
Long term loans	800
Materials and other manufacturing costs	1,420
Ordinary share capital, issued and fully paid	1,800
Plant and machinery – cost	500
Plant and machinery – depreciation at 31 August 2006	190
Premises – cost	2,400
Premises – depreciation at 31 August 2006	30
Repairs to manufacturing equipment	190
Retained earnings at 31 August 2006	748
Sales	4,400
Trade payables	114
Trade receivables	258
Wages and salaries – administrative staff	220
Wages and salaries – manufacturing staff	800
Wages and salaries – sales staff	110

Additional information:

1. Premises are to be depreciated at the rate of 2% per annum on cost and plant and machinery at 25% per annum reducing balance.

2. Corporation tax based on the year's profit is estimated at £50,000.

(i) Prepare CKL plc's income statement and statement of changes in equity for the year to 31 August 2007, and a balance sheet at that date. These should comply with Companies Act presentation requirements. [15]

(ii) The directors are concerned that some of the large amount spent on repairs to manufacturing machinery might have been classified incorrectly. They have asked whether some of that amount should have been treated as expenditure on fixed assets.

Explain how the cost of expenditure on repairs might be distinguished from money spent on fixed assets. [5]
[Total 20]

END OF PAPER