EXAMINATION

September 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.

M A Stocker
Chairman of the Board of Examiners

December 2007

Comments

Comments are given after each of the solutions that follow.

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

Questions 1–10 were generally done well by most candidates.

11 Specific risk is the risk that is directly related to the investment itself . For example, the company might have to recall a product and incur substantial costs as a result. Systematic risks are those that are shared to a greater or lesser extent by all companies. For example, global economic cycles means that all companies are subject to occasional slumps. Investors need not be concerned with specific risk because those risks can be cancelled through diversification. Provided the investors have a diversified portfolio, their risk is related to the systematic risks of the individual investments.

This question was done very well by most candidates.

12 There is no guarantee that the necessary surpluses will be generated in time to meet the company's needs. This could interfere with the efficient implementation of the investment programme. A series of losses could even restrict the very expansion that is necessary to return the company to profit.

The use of retained profits could interfere with the company's ability to pay dividends. Shareholders tend to have particular preferences for either dividends or capital gains. Suspending a dividend to fund growth could lead to the sale of shares and the reduction of the share price.

Retained earnings have the same cost as ordinary shares. That makes this an expensive form of finance in comparison with debt.

It was really good to see so many excellent answers to this question. Well done!

13 The figures in the balance sheet can be a combination of historical £ amounts from different dates when the purchasing powers were all different. The total might not be particularly meaningful if the assets are relatively old.

The figures in the income statement relate current selling prices to historical costs of inventory and depreciation. This can have the effect of overstating profits when prices are rising.

The historical cost of an asset is unlikely to be directly relevant to any decision, unless it happens to be a reasonable approximation for another value. For example, it is useful to know how much a piece of inventory would cost to replace before deciding a selling price. Its historical cost might give a rough approximation, but not necessarily

This question was also answered well. However some candidates went on to discuss depreciation methods in detail which was not required.

14 Price after issue = $\dfrac{(2m \times 3.00) + (\frac{2m}{5} \times 2.40)}{2m + \frac{2m}{5}}$ = £2.90

The actual price will depend on the market's expectations concerning the use to which the investment will be put. If the market feels that the directors have been unduly optimistic then the theoretical price might not be realised. The theoretical price also does not take into account the associated costs of the issue

This question was extremely well done by most candidates.

15 Warrants are financial instruments that give the holder the right to buy additional shares at a fixed price by some future date. The holder of a warrant can participate in any subsequent growth in the share price, particularly if the warrant has a long lead time and gives the company the opportunity to raise further funds and grow over time.

The terms of the warrant can give additional shares to the original buyer (or even be restricted to shareholders who hold their original share allocations). That gives shareholders an incentive to stay with the company.

Warrants can be a relatively inexpensive means of offering an incentive to potential investors, particularly in the case of an established business that is trying to raise fresh finance without giving up too much control.

The main problem with warrants is that they can lead to the dilution of shareholders' rights if they are exercised in the future. That might deter some shareholders from investing in the company once it is well established. Certainly the threat of dilution will reduce the price at which new shares can be issued .

This question was answered reasonably by many candidates but very poorly by others. Some revision of this topic is required.

16 Admitting a partner may require the introduction of further long-term finance into the business. That could either fund expansion or give the owner the opportunity to realise some of his investment

A partner will have an incentive to make the business a success. A new employee could be just as talented, but will have less to gain from the success of the business .

The owner will have to surrender outright control of the business to give the partner some say in its management.

The owner will be jointly and severally liable for the liabilities of the partnership. Anything that the new partner commits the partnership to will be the personal responsibility of both partners

This question was answered extremely well by many candidates.

17 Stock markets exist to process information as effectively and with as little bias as possible. Share prices must reflect the market's expectations of future cash flows or the shares will be mispriced and investors who realise that will be able to buy or sell at advantageous prices. This creates a situation where the directors must work towards running things so that they create as much wealth as possible on behalf of their shareholders. If they do not then the share price will fall and that could lead to them being threatened with a takeover bid. In that case the directors may be replaced by a new board appointed by the victors.

Markets also operate in the provision of debt. A great deal of effort goes into forming an opinion on corporate credit ratings. Companies which have poor ratings will have to pay more for their debt, with consequences for profit and share price .

This question was answered very well.

18 Firstly, income from certain investments such as Personal Equity Plans (PEPs) or Individual Savings Accounts (ISAs) is tax free .

Dividends from companies are effectively paid net of basic rate tax. This is not immediately obvious from an individual's tax return because the gross income has to be declared, but the resulting tax is offset by the deduction. This "tax credit" is designed to compensate for the fact that the company has paid corporation tax on the profits from which the dividend is paid. It could, however, be insufficient to cover any additional tax due because the taxpayer is subject to higher rates of income tax .

The taxpayer would have received some tax relief on the contributions paid into the pension scheme. That means that the subsequent taxation of benefits paid is actually the first time that the taxpayer has been taxed on that .

This question was done well by most candidates.

19 (i) The expected gain is higher from the branch for the feasibility study because the probability tree makes it clear that the project should be abandoned if the feasibility study suggests failure. This suggests that the additional information about the risks associated with proceeding outweigh the cost of the study. If the company would carry on with the investment even if the feasibility study indicated otherwise then it would be better not to conduct it because that would be a waste of money, unless the study was likely to yield information that would somehow enhance the probability of the project's success.

(ii) Probability trees are useful for resolving projects which involve sequential decisions where the outcome can be changed once the project is under way. This enables the decision maker to allow for different contingencies at the planning stage. For example, in this example the company must decide whether or not to conduct a feasibility study. Once the study has been undertaken the company must decide whether to proceed with the expansion . Probability trees are best suited to circumstances where probabilities can be estimated for different eventualities. This means that the method is best suited to relatively simple chains of decisions.

(iii) A simulation exercise can be much richer than a probability tree. It is possible to incorporate far more variables into a simulation than to a probability tree. It may also be possible to deal with distributions that might not be open to an analytical solution. The simulation could allow for far more complex probability distribution functions. It would also be possible to have more realistic ranges of outcomes than the present "success" or "failure" dichotomy.

A simulation will also provide an insight into the range of possible outcome from different choices. The results can be presented as a distribution of outcomes from each major choice open to the directors .

(iv) The project must be capable of being modelled. For example, it would have to be possible to model the likelihood of the company recruiting suitable local employees. The effects of each possibility will also have to be built into the model so that, for example, the effects of the jobs market variables are consistent with the salary variables. This might involve assuming that managers behave rationally, but in practice human decision makers might not take the most appropriate decisions when faced with, say, a run of bad luck .

(v) All of the decision tools for appraising capital projects require highly subjective decisions and estimates from the decision makers. The results of the appraisal exercise can be predetermined by biasing assumptions. Furthermore, some decision aids have an inbuilt bias of their own (e.g. payback favours early cash flows). This means that the choice of decision model can be just as important as the decisions. It may not be a bad thing that these factors exist. Arguably an instinctive assessment of a project's viability can be as valid as a slightly distorted impression from a supposedly objective model.

This question was answered poorly by many candidates. Most just wrote everything they knew about simulations and probability trees.

The marks for this question were very poor compared to the rest of the paper. Some revision of this topic is required by many candidates.

The main problem was that candidates simply did not answer the question.

20 (i)

CKL plc
Income statement
for the year ended 31 August 2007

	£000	*£000*
Sales		4,400
Cost of sales		(2,535)
Gross profit		1,865
Administration	(390)	
Distribution	(510)	
		(900)
Operating profit		965
Investment income	40	
Interest	(18)	
Net profit before tax		22
		987
Tax		(50)
Net profit after tax		937

CKL plc
Statement of changes in equity
for the year ended 31 August 2007

	Retained profit £000
Opening balance	748
Net profit for year	937
Dividend	(300)
Closing balance	1,385

CKL plc
Balance Sheet as at 31 August 2007

	£000	*£000*
Non-current Assets		
Tangible		2,555
Investments		900
		3,455
Current Assets		
Inventory	420	
Trade receivables	258	
Bank	16	
		694
		4,149

EQUITY AND LIABILITIES		
Equity		
Share capital		1,800
Retained earnings		1,385
		3,185
Long term loans		800
Current liabilities		
Trade payables	114	
Tax payable	50	
		164
		4,149

Formats

Non-current assets

	Cost	*Aggregate depreciation*	*Net book value*
	£000	*£000*	*£000*
Premises	2,400	77	2,323
Machinery	500	268	232
	2,900	345	2,555

Workings

Cost of sales	
Materials	1,420
Repairs	190
Wages	800
Depreciation on premises	48
Depreciation on machinery	77
	2,535
Admin	
Directors salaries	170
Wages	220
	390
Distribution	
Advertising	400
Wages	110
	510

(ii) A fixed asset is something that will be held by the business and will be used to generate income over more than one period. Any expenditure on a fixed asset that increases its capacity to generate income should be classified as an addition to fixed assets. For example, an extension or a modification to a production line should be treated as a fixed asset. Repairs are essentially running costs of the business. A repair would have the effect of ensuring that an asset would continue to run and generate an income. For example, the routine servicing and lubrication of a machine would be a repair.

On the whole the first part of the question was well answered, the only really common error was confusing the stock in the Income Statement and therefore getting an incorrect Cost of sales figure. Some compounded this error by changing the Balance Sheet to make it balance which then made an additional figure incorrect. The formats were generally poor. Many students omitted part b or gave a very brief answer – few scored highly here.

END OF EXAMINERS' REPORT