INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

26 September 2014 (pm)

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 new page.*

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 When considering the maximisation of shareholder wealth, how is shareholder wealth expressed?

A directors' estimates
B share price
C share price and dividends
D surveys of shareholders

[2]

2 A company has issued £0.25 shares at a premium of £0.20 per share. The shareholders have each paid £0.22 for each share that they hold. What is the maximum liability that each shareholder might bear with respect to each share in the event that the company cannot pay its liabilities?

A £0.03
B £0.20
C £0.23
D £0.25

[2]

3 A UK taxpayer has disposed of four assets during the year. Which of the following gains could be subject to Capital Gains Tax?

A The taxpayer purchased a large sum of Euros for use on holiday, which were not spent and were worth more than had been paid for them when converted back to Sterling.

B The taxpayer had invested in shares issued by his employer and sold them at a gain.

C The taxpayer purchased a rare model of sports car, but sold it soon afterwards at a profit because he found it difficult to drive.

D The taxpayer sold his family home, realising a profit, in order to move to a smaller property.

[2]

4 A UK taxpayer has earned income in Australia and has paid tax to the Australian tax authorities equivalent to £10,000. Under UK tax law the income would have been subject to tax of £8,000. Which of the following is most likely to apply?

A The taxpayer can reclaim the whole of the tax paid in Australia.

B The taxpayer can offset the £10,000 paid in Australia against the total tax liability arising in the UK.

C The taxpayer can offset £8,000 against the total tax liability arising in the UK.

D The taxpayer does not have to declare the income earned in Australia to the UK tax authorities.

[2]

5 What is the most logical explanation for the requirement that investment income often has tax deducted at source?

A To discourage companies from paying dividends.

B To ensure that taxpayers who have insufficient income to pay tax are required to pay tax on their investment income.

C To enable governments to tax investment income at a higher rate than earned income.

D To simplify the collection of tax.

[2]

6 A project that has been under review for some time has been modified so that the cash receipts will remain the same, but their timing will be brought forward throughout the length of the project. How will this affect the project's internal rate of return and net present value (using a positive risk discount rate)?

A The internal rate of return and net present value will both decrease.
B The internal rate of return and net present value will both increase.
C The internal rate of return will increase and the net present value will decrease.
D The internal rate of return will decrease and the net present value will increase.

[2]

7 Which of the following is NOT a potentially correct interpretation of a high gross profit percentage?

A The entity has negotiated high selling prices.
B The entity has negotiated low cost prices.
C The entity is overcharging its customers.
D The entity is undercharging its customers.

[2]

8 A company's earnings before interest and tax is £400,000. It has one million £1 shares in issue, fully paid, and retained earnings of £800,000. Long term liabilities are £500,000. What is the entity's return on capital employed?

A 17.4%
B 22.2%
C 26.7%
D 30.8%

[2]

9 How will the components of the return on capital employed ratio be affected if a company charges depreciation too slowly?

A Return will be understated and capital employed will be overstated.
B Return will be overstated and capital employed will be overstated.
C Return will be overstated and capital employed will be understated.
D Return will be understated and capital employed will be understated.

[2]

10 Which of the following best explains why liquidity ratios based on a company's published accounts are unlikely to be useful for credit control purposes?

A The figures are likely to be based on historical costs.
B The figures are likely to be inaccurate.
C The figures are likely to be manipulated by creative accounting.
D The figures are likely to be out of date.

[2]

11 Explain why the market prices of shares are generally regarded as unbiased reflections of the shares' "true" value. [5]

12 Discuss the circumstances in which non-recourse factoring might be an appropriate means of obtaining finance. [5]

13 A company has five years left to run on a variable rate loan which it has issued. It has been suggested that it would be possible to enter into a swap in order to achieve the effect of converting this to a fixed rate loan. The directors are concerned that the counterparty might not honour the terms of the swap arrangement and leave the company's liabilities unpaid.

Discuss the directors' fears with respect to the risks arising from the potential default by the counterparty. [5]

14 A quoted company's shares have a nominal value of £0.25 per share. The shares have been trading at prices between £0.40 and £0.43 per share for almost two years. The shareholders are concerned that the share price is not growing. The directors wish to raise further equity by means of a rights issue in order to invest in new projects, but informal discussions with shareholders suggest that a rights issue would be unpopular. One of the directors has suggested a scrip issue in order to boost shareholder confidence in the hope that a rights issue would then be more likely to succeed.

Set out the advantages and disadvantages of the director's suggestion. [5]

15 A company requires all proposals for investment projects to be supported by a net present value calculation. One of the directors has suggested that proposals should also indicate opportunity costs.

Discuss the advantages and disadvantages of the director's suggestion. [5]

16 Discuss the potential advantages and disadvantages of using probability trees for the evaluation of long term projects. [5]

17 Discuss the ways in which the external auditor adds credibility to a company's published financial statements. [5]

18 Discuss the potential risks and benefits associated with having very rapid receivables and inventory turnover ratios. [5]

19 Trevor and Simone have taken early retirement. Their retirement package has left each of them with a lump sum that is substantial, but they have decided to start a business together in the hope of accumulating significant wealth before reaching normal retirement age in eight to ten years.

They have identified an opportunity to import consumer electronics from the Far East. They have established that there is a substantial niche market in the UK for products such as mobile phones and tablet computers that are produced for the Chinese market and which are rarely exported.

Trevor and Simone have negotiated the exclusive UK rights to import a new line of products that is presently in the final development stage. They have a few months to establish their company and to ensure that all of their distribution lines are in place. Their retirement payments will only provide approximately 60% of their funding requirements. They are unsure whether to raise additional funds by inviting investors to become minority shareholders in this venture, or to seek a bank loan, or a combination of the two.

(i) Discuss the relative merits of the bank loan or additional equity from minority shareholders for Trevor and Simone's company. [10]

(ii) Discuss the difficulties associated with determining the optimal gearing level for Trevor and Simone's company. [10]

[Total 20]

20 Victor Ltd manufactures office equipment.

Prepare the following financial statements for the year ended 31 August 2014:

- an income statement
- a statement of financial position
- a statement of changes in equity

The following trial balance has been extracted from Victor Ltd's bookkeeping records:

Trial Balance as at 31 August 2014

	£000	*£000*
Administrative expenses	4,500	
Audit fee	3,780	
Bank	11,340	
Debenture loan (8%)		43,470
Debenture loan interest	1,740	
Dividend paid	3,240	
Factory – cost	100,440	
Factory – depreciation		19,008
Inventory at 1 September 2013	2,160	
Manufacturing equipment – cost	90,504	
Manufacturing equipment – depreciation		25,920
Manufacturing overheads	3,606	
Purchases	27,000	
Retained earnings		23,760
Revenue		108,000
Share capital		60,480
Trade payables		2,844
Trade receivables	9,072	
Wages – administration	1,944	
Wages – manufacturing	11,772	
Wages – sales	12,384	
	283,482	283,482

1. Closing inventory was counted on 31 August 2014 and was valued at £675,000.

2. The debentures were issued in 2011 and are repayable in 2022. The interest for the period from 1 March 2014 to 31 August 2014 was paid in September 2014.

3. Depreciation has still to be charged as follows:

   - factory – 2% of cost
   - manufacturing equipment – 25% reducing balance

4. The following expenses have to be accrued:

   - wages (split equally between administration, manufacturing and sales) £9,000
   - administrative expenses £40,000

   Manufacturing overheads includes insurance that has been prepaid by £10,000.

5. A tax expense of £4,190,000 has to be provided for.

[20]

END OF PAPER