EXAMINATION

11 October 2010 (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 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 Which of the following best describes the role of the stock market in motivating company directors to make sound decisions?

A A badly managed company can be identified by comparison to other quoted companies.

B A badly managed company may have its stock market quotation suspended.

C A badly managed company will have a low share price and it may be possible to buy a controlling interest and replace the board.

D A badly managed company will report poor profits and the shareholders will complain.

[2]

2 Which of the following statements best explains why a company's shareholders are prepared to tolerate the risks associated with raising additional funds through borrowing?

A If the company fails then the lenders will bear the burden of loss.

B Shareholders are capable of creating their own gearing if they so wish.

C Tax relief on interest reduces the cost of borrowing, which offsets the effects of the additional risk associated with borrowing.

D The shareholders do not bear the risks directly because they are borne through the company itself.

[2]

3 Which of the following might be classified as a systematic risk?

A A major customer could switch to a different supplier.
B A major product could be deemed to be unsafe.
C Interest rates might decrease.
D The chief finance officer could be fraudulent.

[2]

4 A company has had a long-established policy of reinvesting profits in order to finance expansion, but has reached a stage of maturity where it does not need to retain equity and so it has announced that it will pay substantial dividends. Which of the following describes the most likely response of the capital markets to such a change?

A The share price will decrease in the short term, but will return to previous levels as the market becomes accustomed to the new dividend policy.

B The share price will increase in the short term, but will return to previous levels as the market becomes accustomed to the new dividend policy.

C The share price will decrease in the short term and the decrease will persist.

D The share price will increase and that increase will persist.

[2]

5 Which of the following accounting concepts can be used to justify carrying a non-current asset at its historical cost less depreciation even though this is not a particularly relevant figure for most decisions?

A accruals
B going concern
C prudence
D realisation

[2]

6 Which of the following best describes depreciation?

A An annual accounting adjustment that has no real purpose.
B A process of correcting the balance sheet to make valuations more relevant.
C A process of reflecting market values for depreciating assets.
D A process of writing the cost of an asset off over its useful life.

[2]

7 Which of the following could cause the earnings per share figure to be diluted?

A a decline in revenues
B a loss on the revaluation of an asset
C the correction of an accounting estimate
D the issue of a convertible bond

[2]

8 Which of the following best describes the purpose of a cash flow statement?

A to forecast future inflows and outflows of cash
B to show historical inflows and outflows of cash
C to show the company's financial position
D to show the company's profitability

[2]

9 A company has to choose between two competing projects. Which of the following decision criteria will definitely maximise shareholder wealth?

A Choose the project that has the lower risk.
B Choose the project with the higher internal rate of return.
C Choose the project with the higher net present value.
D Choose the project with the shorter payback period.

[2]

10 Which of the following best explains the use of maximisation of shareholder wealth as the basis for finance theory?

A All shareholders are greedy.

B It provides a single, clear criterion against which success or failure can be measured.

C The shareholders require a return for investing.

D The shareholders require protection from the directors' ambitions.

[2]

11 Explain why a small business should take great care in managing its overdraft. [5]

12 National tax systems often have the objectives that the tax burden is fair and reasonable. Explain how these objectives are achieved. [5]

13 Explain why Eurobonds tend to offer investors a higher rate of return than traditional loan stock. [5]

14 Explain why a company's gearing ratio calculated from the company's annual accounts might not be sufficient on its own to provide an interested party with an understanding of its capital structure. [5]

15 A company's directors are considering the implications of two downside risks that might affect a project. One of the risks has a 20% probability of occurrence and will reduce the net present value of the project by £1m if it does. The other risk has a 1% probability of occurrence and will reduce the net present value of the project by £20m. The company's market capitalisation is presently £100m.

Explain why it would not be acceptable to treat these risks as being equivalent to one another because each has an expected value of £200,000.

[5]

16 (a) Explain the implications for the weighted average cost of capital if a company's ordinary share price decreases.

(b) Explain how this will affect the company's strategy for investing in capital projects.

[5]

17 Explain the likely implications that will arise from a company preparing financial statements which do not comply with relevant accounting standards and the external auditor reporting that failure to comply in the audit report. [5]

18 Alpha is a quoted company. The company's directors consistently choose optimistic accounting policies in the belief that doing so increases their share price.

Explain why it is unlikely that the share price will be overstated by this practice. [5]

19 The directors of Real plc are considering an investment in a project that has a positive net present value. This will involve borrowing £4m on 1 October 2010 and investing £3m in a new piece of machinery on that date and spending the remaining £1m on raw materials during the two months before the year end of 31 December 2010. There will be no production from the machine in 2010.

The new equipment is expected to have an estimated useful life of five years with no residual value. Real plc depreciates equipment using the straight line method, with a full year's depreciation charged in the year of acquisition.

Interest will be charged on the loan at a rate of 8% per annum, with the first interest payment due on 30 September 2011.

Entering into this series of transactions will have no effect on the tax charge for the year ended 31 December 2010.

Before the directors became aware of this investment opportunity they prepared the following forecast financial statements:

Real PLC
Forecast Income statement for the year ended 31 December 2010

	£000
Revenue	20,000
Cost of sales	(12,000)
Gross profit	8,000
Distribution costs	(1,200)
Administrative expenses	(400)
Operating profit	6,400
Finance costs	(632)
Net profit before tax	5,768
Tax expense	(1,500)
Profit for the year	4,268

Real PLC
Forecast balance sheet as at 31 December 2010

	£000
ASSETS	
Non-current assets	
Property	10,000
Plant and equipment	11,000
Total non-current assets	21,000
Current assets	
Inventories	500
Trade receivables	1,667
Bank	10
	2,177
Total assets	23,177

EQUITY AND LIABILITIES	
Equity	
Share capital	10,000
Retained earnings	4,677
Total equity	14,677
Non-current liabilities	
Long-term borrowings	6,000
Current liabilities	
Trade payables	1,000
Current tax payable	1,500
	2,500
Total liabilities	8,500
Total equity and liabilities	23,177

(i) Restate the forecast financial statements to incorporate the effects of the investment on the company's income statement and balance sheet. [5]

(ii) Compare and contrast, using ratio analysis, the figures according to the original financial statements with those prepared in your answer to (i) above. Your analysis should cover the areas of profitability, liquidity and efficiency. [9]

(iii) Use your answer to (ii) above to explain why the need to publish annual financial statements might discourage company directors from investing in positive net present value projects. [6]

[Total 20]

20 Koolclean plc was founded several years ago by the inventor of an innovative consumer product. The product has been very successful in the UK and the inventor has decided to seek a quote on the Alternative Investment Market (AIM). At present 60% of Koolclean plc's shares are held by the inventor and the remaining 40% are held by a venture capitalist who is keen for the company to list in this way so that his block of shares can be sold.

The company has been managed by the inventor herself, assisted by a part-time director appointed by the venture capitalist. The part-time director will step down when the venture capitalist's block of shares is sold.

The inventor is keen to appoint an experienced management team and has decided to offer a remuneration package that comprises a fairly large number of share options and a relatively small salary in order to attract a particular type of manager.

Koolclean plc has published audited financial statements every year since it was incorporated. The inventor has decided to replace the company's audit firm with one that is larger and more experienced in auditing the financial statements of quoted companies.

(i) Explain the advantages and disadvantages of seeking the initial funding for a new business in the form of equity from a venture capitalist rather than borrowing. [6]

(ii) Explain the agency issues that are likely to arise from paying the new directors with share options rather than salaries. [8]

(iii) Describe the external auditor's role in protecting Koolclean plc's shareholders' interests after it obtains its quotation. [6]

[Total 20]

END OF PAPER