EXAMINATION

29 April 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 statements best describes the duties of a company's board of directors?

A The directors should maximise shareholder wealth and ignore externalities.

B The directors should maximise shareholder wealth and respect regulatory constraints on the imposition of externalities.

C The directors should maximise shareholder wealth and seek the greatest possible social benefit.

D The directors should maximise social welfare.

[2]

2 Which of the following statements best describes why sellers are prepared to offer their customers trade credit?

A Business customers are unlikely to buy on cash terms.
B Credit sales provide a steady inflow of cash.
C It costs nothing to provide the customer with trade credit.
D Selling on credit simplifies the administration of the sales process.

[2]

3 In which of the following circumstances would it be inappropriate for a company to enter into an interest rate swap?

A The company has a comparative advantage in borrowing at a fixed rate of interest.

B The company has a comparative advantage in borrowing at a floating rate of interest.

C The company has a floating rate loan and wishes to protect itself against interest rate rises.

D The company wishes to create greater flexibility in the eventual settlement of its liabilities.

[2]

4 A company has consistently made losses for tax purposes for several years and it does not expect to make taxable profits for several years further. Which of the following statements best justifies borrowing rather than issuing further shares in order to raise funds for expansion and recovery?

A Existing shareholders have nothing to lose.
B Interest is an expense for tax purposes.
C Lenders cannot be affected by a company's failure.
D Potential shareholders are likely to be deterred by the ongoing losses.

[2]

5 A company has a substantial cash balance for which it has no immediate use. Which of the following would NOT be a valid reason for it to release this cash to shareholders by means of a repurchase rather than a dividend?

A potential tax advantages to the company
B potential tax advantages to the shareholders
C provision of an exit opportunity for a provider of startup equity
D the repurchase can be scheduled for any time of year

[2]

6 Historically, which of the following best explains why investments in equities have tended to outperform fixed interest investments in the very long term?

A Equity investors accept greater risks.
B Equity investors tend to overstate the returns from their investments.
C The returns on each type of investment are calculated in different ways.
D Returns from fixed interest investments ignore the effects of inflation.

[2]

7 Which of the following is responsible for ensuring that the financial statements published by a company give a true and fair view?

A the board of directors
B the chief accountant
C the external auditor
D the finance director

[2]

8 S is a holding company that has two subsidiaries, T and U. During the year, S made sales of £1.0m, including sales of £0.2m to T. T made sales of £2.0m, including sales of £0.3m to U. U made sales of £4.0m including sales of £0.6m to S.

Which of the following is the correct figure for group sales according to the consolidated income statement that will be prepared by S?

A £0.8m
B £1.0m
C £5.9m
D £7.0m

[2]

9 Which of the following would artificially understate stock (or inventory) turnover, expressed in days?

A Delay the replacement of inventory that would normally occur before the year end until just after.

B Introduce a new marketing strategy that increases sales during the year.

C Advance the replacement of inventory that would normally occur just after the year end until just before.

D Purchase goods for cash instead of on credit.

[2]

10 A company purchased an inventory item for £10.00 and sold it for £12.00. Due to rising prices, the inventory item cost £12.40 to replace.

Which of the following statements best describes the effects of the sale and replacement of this inventory item?

A The company will recognise a profit of £2.00 under historical cost accounting, but has made a real loss of £0.40.

B The company will recognise a profit of £2.00 under historical cost accounting, and it has made a real profit of £2.00.

C The company will recognise a profit of £0.40 under historical cost accounting, and it has made a real profit of £0.40.

D The company will recognise a profit of £0.40 under historical cost accounting, and it has made a real profit of £2.00.

[2]

11 Information asymmetry has been identified as a serious problem for shareholders.

(a) Explain what is meant by “information asymmetry” in the context of limited companies.

(b) Explain the role of financial reporting as a means of resolving information asymmetry for shareholders.

[5]

12 An individual investor is considering making an investment in an investment trust, but is deterred by the fact that many investment trusts trade at a discount to their underlying net assets.

(a) Explain why the discount exists.

(b) Explain why investment trusts may still be a sound investment for an individual shareholder.

[5]

13 An unquoted company wishes to raise a large loan in order to invest in a major new project. The finance director has proposed issuing bonds that have a significant number of warrants attached.

Describe the advantages and disadvantages to the company’s existing shareholders of attaching warrants to the bond issue. [5]

14 Describe the advantages of raising additional equity finance by means of a rights issue. [5]

15 A small company engaged a firm of consultants to evaluate a very complicated investment opportunity. The consultancy devised a Monte Carlo simulation and ran a very large number of iterations. They discovered that the project generated a positive net present value for 85% of the simulations. The directors of the company believe that this result is sufficient for them to justify investing in the project.

Explain how the directors should go about interpreting the results of this simulation before making a final decision on the project. [5]

16 Describe the purpose of a cash flow statement. [5]

17 A company has entered into an unusual transaction that is not covered by any specific accounting standard. As a consequence, the directors are unsure how to account for this in the annual report and are tempted to choose the treatment that gives the highest reported profit.

Explain how the directors should go about selecting an appropriate accounting policy for this transaction. [5]

18 The directors of a limited company receive an annual bonus that is linked to reported profit. Explain how unscrupulous directors could go about overstating the reported profit without risking the legal and other penalties that would be imposed if they falsified the financial statements. [5]

19 The following information was extracted from the draft financial statements of Gander plc:

Draft balance sheet as at 31 March 2010

ASSETS	
Non-current assets	
	£m
Property, plant & equipment	200
Current assets	21
Total assets	221
EQUITY AND LIABILITIES	
Share capital	100
Other reserves	–
Retained earnings	61
Total equity	161
Non-current liabilities	
Long-term borrowings	50
Current liabilities	10
Total liabilities	60
Total equity and liabilities	221

Property, plant and equipment includes land and buildings that have a book value of £150 million. The directors commissioned an independent valuation of the land and buildings and have been advised that they were worth £240 million on 31 March 2010.

Gander plc's long-term borrowings have a covenant in place that requires that the directors must seek permission from the lender before taking out any further loans that would have the effect of increasing gearing (measured as long term liabilities as a percentage of equity plus long term liabilities) to more than 25%. The directors wish to borrow a further £30 million and are concerned that they will not be able to obtain the necessary permission from their existing lender. It has been suggested that they might show the land and buildings at their revised valuation in order to reduce the risk of being in default of this covenant.

(i) Identify the figures that would be affected in Gander plc's draft balance sheet if the directors decide to incorporate the revaluation of the land and buildings and recalculate the affected figures. [4]

(ii) Calculate the company's gearing ratio using both the draft balance sheet provided above and the revised figures according to the answer produced in (i), and assuming that the company borrowed the further £30m early in the new financial year. [4]

(iii) Explain whether revaluing the company's land and buildings is an appropriate response to the problem created by the covenant in the existing loan agreement. [6]

(iv) Discuss the advantages and disadvantages of revaluing non-current assets in the balance sheet. [6]

[Total 20]

20 The directors of Merchant plc are considering a five year project that has been proposed by the company's sales director. A customer is about to sell a very specialised milling machine that has become surplus to requirements. This type of machine would cost tens of millions of pounds to buy new. Used machines are rarely sold on the open market. The machine has an expected remaining useful life of five years and has been checked and certified by an independent engineer.

The sales director proposes buying the used machine for £4 million and using it to manufacture a new product for which Merchant plc owns some patent rights and which cannot be manufactured in an economic manner without such equipment. The sales director proposes taking out a five year lease on a factory building and using an employment agency to provide labour for the five year period. The sales director estimates that it would be necessary to invest a further £1 million at the start of the first year in addition to buying the machine: a returnable deposit of £100,000 on the factory, £200,000 for the first year's lease, £400,000 for the opening inventory of raw materials and £300,000 for the initial payment for labour.

The sales director has drafted the following budgeted annual income statement for the project:

	£m
Revenue	2.6
Raw materials	(0.4)
Factory lease	(0.2)
Labour	(0.3)
Depreciation of machine	(0.8)
Other running costs	(0.5)
Profit	0.4

It is anticipated that materials, recurring lease payments and labour will be paid for annually at the start of each year. Other running costs comprise the cost of electricity and other operating costs and they will be paid for annually at the end of each year. Revenues will be received at the end of the year in which they are earned.

At the conclusion of the project, the sales director anticipates that it will cost £300,000 to dismantle the equipment and at that time it will be possible to reclaim 100% of the deposit paid to the factory owner.

The sales director has shown this proposal to a potential lender, who has agreed to lend Merchant plc £5 million at an interest rate of 7% p.a. This loan will be secured on Merchant plc's existing assets because the milling machine is deemed to be too specialised to be a suitable form of security.

The sales director proposes that the project should be evaluated at a required rate of return of 7% p.a. because it will be financed by means of a self-contained loan package upon which that rate will be charged. The finance director believes that the project should be evaluated at a much higher rate than 7% p.a., but cannot state the specific rate that should be charged without conducting a further analysis.

The finance director is also concerned that the sales director has ignored tax when preparing the budgeted income statement.

(i) Calculate the net present value of the project using a discount rate of 7% p.a. and ignoring tax. [8]

(ii) Explain why the required rate of return might be higher than the 7% rate charged by the bank on the funding for the project. [6]

(iii) Explain how adjusting for tax will affect the analysis of this project. You are not required to calculate the effects of tax. [6]

[Total 20]

END OF PAPER