EXAMINERS' REPORT

April 2010 Examinations

Subject CT2 — Finance and Financial Reporting Core Technical

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.

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Chairman of the Board of Examiners

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Comments

These are given in italics at the end of each question.

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

Questions 1–10 were answered well by most candidates.

11 (a) Information asymmetry arises because the directors know more about the management of the company than its shareholders. The directors can also have greater confidence in the figures at their disposal because they can check the underlying data and the manner in which the information has been prepared.

(b) Financial reporting is a vital part of assuring the shareholders that the company is being managed properly and in their best interests. The directors will normally be keen to signal that the figures have been prepared accurately and in accordance with acknowledged accounting standards. Publishing credible financial statements will simplify the process of dealing with shareholders.

The external financial statements are likely to be subject to an independent external audit to further enhance the credibility of the accounts.

Part (a) was answered poorly with many candidates not showing any understanding of the term at all, however part (b) was answered very well with most candidates scoring high marks.

12 (a) The discount arises because the investment trust will charge an annual management fee. The net present value of that should be deducted from the underlying assets held by the trust in order to establish the investment trust's true value to the shareholder. It is also possible that the investment trust will be slightly less marketable than the large quoted companies in which it has invested and so the discount will be increased still further. Other reasons may include natural sellers, aging population, illiquidity and a proliferation of similar investments.

(b) The discount should not deter investors. If they buy existing shares in an established investment trust then their initial investment will take advantage of the discount. Even if they buy directly from the company it will be more practical for an investment trust to spread the risk and diversify than it would be for many individual investors. Furthermore, the investment trust will provide management expertise that will either reduce the risk of a costly mistake or will offset the cost of paying for advice. Other reasons include lower total expense ratios, audited accounts requirements, a wider range of investment specialisms and gearing

This question was answered well by many candidates.

13 Warrants provide lenders with an opportunity to enjoy future increases in the share price. That is a valuable benefit that can be added to the interest earned from the loan stock, so the interest rate charged can be reduced. That will save cash and provide the company with a better cash inflow in order to finance growth. The benefit will be enhanced by the fact that the downside risk is restricted to the relatively small value that will be attached to the warrant. The lender's principal will almost certainly be secured and so outright loss is highly unlikely.

The main problem faced by the shareholders is that the warrants will dilute their equity in the event that the lenders exercise their rights to buy shares. If the project is successful then the lenders will share in the gain and so the shareholders will earn less from taking the ultimate risk.

Some candidates appeared not to know what warrants were while others gave a very complete answer.

14 A rights issue is targeted at shareholders who have already demonstrated their willingness to invest in the company. That reduces the cost of promoting the issue and identifying suitable investors.

If the shareholders do not wish to take up their rights then the rights themselves have a value and the shareholders have an incentive to sell them. The buyers are likely to take up the right to subscribe to the offer, which reduces the need to underwrite the issue.

The fact that the rights issue automatically compensates the shareholders for the effects of the discount means that it is generally an equitable and acceptable method of generating fresh equity. That makes rights issues more acceptable to the stock market than other methods for an established company to issues further shares.

This question was answered very well by most candidates.

15 The basis on which the simulation has been prepared and tested should be studied closely. The apparent success rate could be due to an error in the specification of the model.

The results in the 15% of the time that the project returned a negative net present value must be studied closely. Is there a significant downside risk that should be considered? A project that carries a realistic probability of the company being forced into liquidation might be best avoided even if it has a significant probability of success.

The anticipated income from the project should also be taken into account. If the likely NPV is a small positive then that might not be sufficient to justify the possibility of a loss.

Ultimately, the directors should consider the distribution of likely outcomes rather than simply look at the most likely.

This question was answered very well by most candidates.

16 The cash flow statement indicates how the company has managed inflows and outflows of cash during the year. A comparison of the opening and closing balance sheets will indicate whether the company has more or less cash at the end of the year than at the beginning, but that comparison does not indicate what has happened in order to bring about that increase or decrease. The cash flow statement shows how the company has both generated cash receipts and made payments.

The cash flow statement also indicates an important performance measure. Arguably, it is more important to generate profit than to earn cash, but profits are not sufficient to keep a business afloat unless they are backed by net cash receipts. A profit can be recognised long before the company has any cash to show for it and the company will have to meet its commitments in the period before the cash is actually received.

This question was answered poorly by some candidates. Candidates appeared not to have learnt the format of the cash flow statement.

17 There is a general requirement that the financial statements give a true and fair view. Amongst other things, that any treatment gives a realistic and representative treatment of the transaction. It cannot be accounted for in a flattering way just because it is not the subject of a specific regulation.

In the UK, FRS 18 gives some guidance as to how the policy should be selected. For example, the objectives of relevance, reliability, comparability and understandability should be applied.

The directors might consider looking at the treatment laid down by standards for similar balances, even though those standards might not be strictly applicable. That would ensure that the logic underlying the chosen treatment was consistent with good accounting practice.

18 Preparing financial statements involves making estimates and assumptions. For example, inventory is valued at the lower of cost and net realisable value. The directors can bias such assumptions towards maximising profit without doing so to the extent that any dishonesty can be proven.

The selection of accounting policies is subject to accounting standards, but there are often cases where the transactions or balances are not directly governed by any specific standard. For example, the recognition of revenue can be quite a difficult area of accounting. The board could start to recognise profits at a time that can be justified without that necessarily being the most appropriate in terms of good accounting practice.

This question was answered poorly.

The accounting policies are a common question. Generally the more theoretical questions were not answered as well as questions involving calculations.

19 (i) The book value of property, plant and equipment would increase, as would the revaluation reserve.

Property, plant and equipment would be increased to £200m+90m = £290m. The revaluation reserve would be £90m.

(ii) Gearing (original figures) = (£50m+30m)/(161m+50m+30m) = 33%

Gearing (with revaluation) = (£50m+30m)/(161m+90m+50m+30m) = 24%

(iii) The revaluation means that the company would be in technical compliance with the covenant. However, the purpose of the covenant is to ensure that the company's borrowings are manageable and that the interests of the lenders are not prejudiced. The revaluation has the effect of altering the figures from which gearing has been calculated, but that does not generate any additional cash from which to meet the company's commitments.

Borrowing heavily, using the revaluation of assets as a basis for doing so, will threaten the equity invested by the shareholders. The more heavily that the company borrows the greater the risk that the company will be unable to meet its commitments. If the company goes out of business then the assets that have been revalued may have to be sold under duress and that might mean that the revalued sum will be impossible to realise.

It would be more satisfactory for the directors to decide that the company is already heavily geared and seek some way to generate additional funds from equity.

(iv) The revaluation of assets gives shareholders a more realistic impression of the resources that they have placed at the disposal of the directors. That gives them a clearer impression of the performance of their board in generating wealth from the company's assets.

Revaluation should also give a clearer indication of the assets that will actually be available in the event that the company runs into difficulty. Keeping the assets at their valuation may be helpful to potential lenders when evaluating the assets that have been pledged as security.

Valuation increases the subjectivity in the financial statements. Any valuation is only ever an opinion as to how much the assets are actually worth, but the validity of that assumption can only be tested by selling the asset and seeing whether it can be sold for that amount.

Valuing assets also introduces some volatility into the balance sheet because the valuations must be kept up to date. The asset may have to be written down if market prices fall.

In general the larger questions were answered poorly compared to the shorter questions.

Part (iii) was answered well by many candidates. Part (iv) was answered very badly with some candidates not doing this part of the question.

20 (i)

Time	0	1	2	3	4	5
Revenue		2.6	2.6	2.6	2.6	2.6
Machine	(4.0)					
Factory deposit	(0.1)					0.1
Lease payment	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	
Inventory	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	
Labour	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	
Running costs		(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Dismantling						(0.3)
Cash flow	(5.0)	1.2	1.2	1.2	1.2	1.9
Discount factor	1.000	0.935	0.873	0.816	0.763	0.713
Discounted cash flow	(5.0)	1.1	1.0	1.0	0.9	1.4

Net present value = total = £0.4m
Cash flows
Discounted cash flow
NPV

(ii) The cash flows should be assessed in terms of the risk attached to the project. The risks borne by the company and its shareholders are not mirrored by those borne by the lender. The risks to the company are based on the possibility that the project will not generate a satisfactory return in line with expectations, which has nothing to do with the risk that the bank will not be repaid on time or in full. The bank will secure its advance against the company's other assets, which will increase risks to the existing providers of finance. The loan will push up the cost of equity and so the real cost of the finance to the company will be higher than 7%.

(iii) Tax will reduce the net cash inflow from the project.

The timing of payments will also be affected because tax is often paid for in arrears, which means that the tax bill for year 5's profits will probably be paid in year 6. That might mitigate the effect of the additional outflows arising from the tax on profits from the project.

Tax calculations will complicate the analysis and increase the risk associated with the figures. There is a possibility that the tax authorities will not agree with the tax calculations prepared by the company and that some expenses will not be permitted. The time spent negotiating the tax bill will create additional outflows for professional fees and may also prove to be a distraction from other projects.

Allowing for tax may affect the cost of capital because tax relief will be obtained on the loan.

This question was answered badly by many candidates. The main difficulty was part (i) where candidates did not understand what a cash flow was or what should go into it.

It should only have items that involve the movement of money.

Parts (ii) and (iii) were answered a little better but were still poor.

END OF EXAMINERS' REPORT