INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

26 April 2012 (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 Why should an eligible bill of exchange be regarded as a very secure investment?

A The issuer is eligible to issue secure bills of exchange.
B The holder of the bill is eligible to claim repayment in full at any time.
C The bill has been guaranteed by a bank.
D The bill has been drafted by an eligible intermediary.

[2]

2 What aspect of a limited liability partnership (LLP) is "limited"?

A The liability of individual members is limited to £100,000.

B The liability of individual members is limited to their agreed share of the partnership's liabilities.

C No member can suffer loss due to the acts or omissions of another member.

D The LLP's creditors cannot normally seek payment from the members themselves.

[2]

3 A quoted company made a substantial rights issue. A shareholder who had a substantial shareholding did not wish to take up the right to buy shares and forgot to sell those rights.

Which of the following best describes the effects of this forgetful shareholder's actions?

A The forgetful shareholder was worse off because of the rights issue and the other shareholders were unaffected.

B The forgetful shareholder was worse off because of the rights issue and the other shareholders were better off.

C The forgetful shareholder was unaffected by the rights issue and the other shareholders were better off.

D The forgetful shareholder was unaffected by the rights issue and the other shareholders were worse off.

[2]

4 Which of the following best supports the assertion that the payment of a dividend signals confidence on the part of the directors?

A The dividend is paid out of past profits that have actually been earned.
B The directors are keen to receive dividends from their own shareholdings.
C The directors have to find the cash with which to pay the dividend.
D The shareholders will react badly to the non-payment of a dividend.

[2]

5 The net present value criterion is generally claimed to provide the most consistent and relevant basis for the selection of investment projects.

Which of the following situations creates the greatest threat to the validity of evaluating projects using net present value in practice?

A Net present value ignores risk.

B Shareholders may disagree with the results of a net present value calculation.

C The calculation of net present value can lead to two solutions.

D Managers may wish to undertake the project for selfish reasons and could manipulate the analysis.

[2]

6 A company's external auditor included an emphasis of matter in the audit report.

Which of the following statements best describes the meaning of an emphasis of matter?

A The auditor wishes to draw attention to an important matter that has been disclosed in the notes to the financial statements.

B The auditor wishes to draw attention to the limitations of the work undertaken during the audit.

C The audit report is being qualified.

D The auditor disagrees with the information in the financial statements.

[2]

7 Which of the following is most likely to arise as a consequence of the money measurement concept?

A Assets will be recorded at cost.
B Some valuable assets will be excluded from the financial statements altogether.
C Expenses will be accrued regardless of when the associated payment is made.
D Assets will not be written down to their break-up values.

[2]

8 Which of the following statements relating to current assets is correct?

A Current assets will be realised within one year.

B Current assets have short expected useful lives.

C Current assets comprise cash and items that will be converted into cash in the normal course of business.

D Current assets always comprise inventories, receivables, bank and cash.

[2]

9 Which of the following best explains why investment analysts often calculate Earnings before Interest, Taxation, Depreciation and Amortisation (EBITDA)?

A EBITDA is less prone to fluctuations and volatility than net profit.
B Depreciation and amortisation are not real costs to the business.
C Investment analysts are only interested in performance before tax.
D EBITDA is regarded as less prone to manipulation than net profit.

[2]

10 Net asset value per share is calculated by subtracting intangible assets from ordinary shareholders' equity and dividing the remainder by the number of shares in issue.

Which of the following best explains the relevance of net asset value per share?

A In the event that the entity is wound up the chances are that its intangible assets will not have any market value, but the shareholders will be certain to receive the value of the remaining net assets after disposal.

B In the event that the entity is wound up the net asset value per share is likely to represent the best possible outcome that the shareholders can expect.

C The shareholders should monitor the net asset value per share and should insist that the entity be wound up in the event that net asset value per share exceeds the market value of the company's shares.

D Net asset value per share is likely to correspond to the value that an unquoted company's shares would have on the open market.

[2]

11 Explain why, from a tax perspective, many individual shareholders prefer to earn a return from an increase in the share price rather than payment of a dividend. [5]

12 Martha is seeking funding for a company that she wishes to establish. Her plans involve too much risk for a conventional bank loan but a venture capital company has offered to invest in convertible loan stock.

Discuss the disadvantages to Martha of funding her company by issuing convertible loan stock to a third party. [5]

13 Outline the uses to which currency futures can be put. [5]

14 Four engineers have established a company to manufacture a new product that they have patented. Each of the directors owns 25% of the company's equity. They have employed a qualified accountant to manage the company's record-keeping and to engage with potential lenders on the company's behalf.

Describe the respective legal responsibilities of both the company's directors and its accountant in relation to record-keeping and lenders. [5]

15 Explain how a lessee can take on the risks and rewards of ownership of an asset, even though the leased asset remains the property of the lessor. [5]

16 Explain how there could be a conflict between the interests of directors and shareholders over the raising of additional finance, where the directors would prefer the company to issue equity and the shareholders would prefer the company to borrow. [5]

17 Explain why accounting information that is relevant may not be reliable and why accounting information that is reliable may not be relevant. [5]

18 Discuss the usefulness and limitations of a company's annual report to the company's lenders. [5]

19 Barton manufactures animal feed using machinery that is both very simple and very robust. The company has operated independently since it was founded.

Barton's primary product cannot be manufactured using modern technology and Barton faces very little competition within its market niche. The product is popular with horseracing stables and other horse owners who wish to promote the health and stamina of their animals.

Barton's owner is planning to retire and has offered to sell the company to Nufeed, an animal feed business that manufactures animal feed using heavily industrialised processes. Nufeed is interested in acquiring Barton because it will complement its existing product range and will demonstrate Nufeed's commitment to manufacturing traditional products using traditional methods.

Barton's owner proposes that the company's selling price should be set by multiplying the most recent profit figure by a multiple that has yet to be agreed. Nufeed's chief financial officer is reviewing Barton's financial statements in order to establish whether that is a realistic suggestion.

Barton's property, plant and equipment figures are as follows:

	Property	*Plant and equipment*	*Total*
	£000	£000	£000
Cost			
As at 31 March 2011	800	250	1,050
Additions	50	9	59
As at 31 March 2012	850	259	1,109
Aggregate depreciation			
As at 31 March 2011	272	170	442
Charge for year	16	10	26
As at 31 March 2012	288	180	468
Net book value			
As at 31 March 2012	562	79	641
As at 31 March 2011	528	80	608

All of Barton's property, plant and equipment is shown at cost less depreciation. Property is depreciated at a rate of 2% of cost every year and plant and equipment at a rate of 4% of cost.

Property comprises a large factory building located in the countryside, close to several large farms that provide the company's raw materials.

Plant and equipment comprises heavy milling and mixing equipment that was built to Barton's specifications when the company was established. The equipment is maintained to a very high standard by Barton's head of production, who has worked for the company for almost 20 years.

Nufeed commissioned a report on the plant and equipment. The report stated that it would cost at least £1.2 million to replace the production machinery. With the correct maintenance, this type of equipment can have a very long useful life, but very few engineers have the skills to repair ongoing wear and tear. In the absence of such a skilled maintenance team, the bearings would wear out after approximately ten years, resulting in the scrapping of the equipment.

The equipment has almost no resale value because it is too large and heavy to be dismantled and removed.

Nufeed's chief financial officer has asked Barton's owner to restate the depreciation charge to deal with the effects of inflation. Barton's owner has refused on the basis that it could be argued that depreciation ought to be zero because the plant and equipment has no market value. Furthermore, he has not asked Nufeed to pay anything for Barton's good name and loyal customer base because neither of those assets is recognised in the company's statement of financial position (balance sheet).

(i) Explain why it appears that Barton's depreciation charge may have been understated. [5]

(ii) Calculate an alternative more relevant depreciation charge for Barton's plant and equipment that would better reflect the use of these resources. [3]

(iii) Explain the logic underlying your depreciation calculation. [3]

(iv) Outline the logic behind Barton's owner's claim that the depreciation charge should be zero. [3]

(v) Discuss the validity of the claim made by Barton's owner that he has not charged Nufeed anything for the company's reputation and customer base. [6]

[Total 20]

20 Manor is a quoted property company that specialises in the development and resale of commercial office buildings. The company frequently invests in large projects that run for between three and five years, with that being the typical timescale from the acquisition of a new property to its resale after redevelopment.

Manor evaluates potential investments using the net present value (NPV) criterion. The NPVs of all proposals are calculated using a discount rate of 8% p.a. The criterion has been in place for at least the past ten years. The finance director is unhappy that the company's principal investment criterion has been in place for so long that none of the present senior executives were in post when it was introduced. As a result, nobody knows the reasons for its selection. That has become an issue in recent years because the property market has been depressed and most of the investment opportunities have offered a negative NPV when discounted at 8% p.a. The shareholders are beginning to become anxious that the company is not putting its assets to good use because the proceeds of selling developed properties are being banked instead of being reinvested in fresh projects.

The chief executive has asked the finance director to consider the following possibilities:

- Calculate the NPV using a discount rate of 5% p.a., at least until the property market improves and creates the possibility of higher returns.

- Continue to discount investment opportunities at 8% p.a., but take a more optimistic view of future cash flows from projects under consideration. Most projects have a range of possible outcomes and many become desirable when evaluated using the "best possible" outcome for costs and revenues rather than the "most likely".

(i) Discuss the validity of Manor's policy of using an 8% p.a. discount rate when calculating the NPV of investment opportunities. [8]

(ii) Discuss the logic behind reducing the discount rate for evaluating projects to 5% p.a. until the property market improves. Your discussion should cover both the validity of the proposed reduction in the discount rate and the likely impact on Manor's share price. [8]

(iii) Discuss the validity of evaluating projects using the "best possible" forecast outcomes instead of the "most likely". [4]

[Total 20]

END OF PAPER