REPORT OF THE BOARD OF EXAMINERS

September 2003

Subject 108 — Finance and Financial Reporting

EXAMINERS' REPORT

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.

J Curtis
Chairman of the Board of Examiners

11 November 2003

EXAMINATIONS

September 2003

Subject 108 — Finance and Financial Reporting

EXAMINERS' REPORT

1 B

2 D

3 B

4 C

5 A

6 D

7 C

8 B

9 C

10 C

In Questions 1-10 there were no particular problems with the objective test questions, with most candidates scoring a reasonable mark.

11 Shareholder value reflects the impact of any investment decision on the wealth of the shareholders. This is important because it is generally accepted that the directors are responsible for maximising the shareholders' wealth. The focus is on the needs and interests of the shareholders, rather than that of the directors or the company itself. The criterion looks at more than the quantitative analysis of the project itself. Instead, it takes into account the market's perception of whether the company is improving as a result of the investment.

The biggest problem to be overcome in applying this approach is in predicting how the market will perceive a project. If the company enters into a project without releasing any information then the immediate impact on the market perception could be zero. News will only start to affect the share price as it unfolds and as the markets become confident in its authenticity. Thus, the markets might react badly to the announcement of a new project if they discount some of the claims made by management as over-confident or self-serving. This could mean rejecting positive NPV projects because they might harm the company's standing in the eyes of the investment community. The company will have to decide on the time frame to be considered. In the longer term, market confidence should be restored as the project develops and matures and the shareholders can see profits and cash flows coming from it.

The company will also have to decide how much information it is planning to make available to the markets and when this will be released. Keeping the market abreast of developments will see the information about new projects incorporated into share prices sooner, but could also provide competitors with valuable information.

This question was answered quite badly. In many cases this appeared to be due to candidates either being unaware of the shareholder value approach or providing a "prefabricated" answer on the net present value criterion.

12 Corporation tax is charged on the annual accounting profit. This figure is, however, adjusted to take account of a variety of adjustments. These adjustments include the replacement of depreciation with capital allowances, the exclusion of disallowed expenses such as entertaining and the exclusion of franked investment income from profit.

Some companies are also entitled to exclude profits earned overseas because of double tax relief provisions. These profits will be taxable in the jurisdiction where they are earned, but not in the home country.

The tax rate is announced by the government, usually on an annual basis.

Corporation tax is normally paid nine months after the year end. Large companies are, however, required to pay their tax on a quarterly basis.

This question was answered well, demonstrating awareness of the basic principles of UK corporation tax.

13 The return on a security is largely related to the risk that is borne by an investor. This return is determined on the basis that the investor takes all reasonable steps to minimise those risks. In particular, investors are expected to diversify, so that certain risks are cancelled out. Companies face both "systematic" and "unsystematic" risks . The latter are specific to the company (e.g. some companies are exposed to a strong US Dollar and others to a weak Dollar) . Investing in a portfolio combines companies that thrive in, say, a weak Dollar with those that do better when the Dollar is strong. This means that movements in the Dollar have very little effect on the portfolio . Systematic risks cannot be diversified away because they affect all companies . For example, high interest rates tend to affect all companies .

Investing in a single company will mean that the relative is being rewarded for the systematic risks associated with the security, but not the unsystematic . That means that the return will not adequately compensate for the risks undertaken .

Common sense also dictates that the investor runs the risk of losing everything from investing in a single company if that company fails . The fact that this person also works for that company could mean the loss of both his job and his savings if the company collapses .

Most candidates provided sensible answers to this question. Better answers highlighted the practical implications of the CAPM for investors without becoming bogged down in technical detail.

14 Traditionally, the Bank of England used discount houses as a buffer between itself and the clearing banks . The discount houses acted as money-market intermediaries, channelling excess short term cash to institutional borrowers, and borrowing from the clearing banks on a very short term basis . The traditional money market has been replaced and widened over the last two decades, since the Bank of England has allowed other institutions to participate in maintaining the liquidity of the money-markets .

The Bank of England still acts in a supporting role for the various institutions that are active in the short-term money markets. Banks and other institutions can lend money to, or borrow money from, the Bank of England . The Bank is always willing to act as lender of last resort, otherwise the banks could run short of money and a financial panic could occur .

If the money markets are short of cash, Treasury bills, local authority bills and bills of exchange can be sold to the Bank of England in return for cash . Similarly, if there has been a large cash inflow into the money markets institutions can use up their spare cash by buying existing bills from the Bank of England .

The Bank of England also provides cash to the market by lending cash against bills deposited on security , and by purchasing bills with a simultaneous agreement to sell at a later date (known as "repo" arrangements) .

The quality of answers to this question varied considerably. Weaker answers were generally short of detail and gave the impression of a lack of familiarity with the subject matter. While the examination is designed to avoid testing recall of facts, candidates should attempt to understand the role and behaviour of institutions and the frameworks in which they operate. That should develop sufficient familiarity with the basic facts to deal with questions such as this.

15 The scrip issue does not require many formalities. It does, however, involve some administrative effort and therefore cost . The company will have to write to shareholders and inform them that the issue is taking place . This will also have to be announced publicly to prevent anyone being misled and buying or selling at a time when the rights to scrip shares are lost . The shareholders themselves will also suffer an element of irritation because they will have to keep detailed records of the change in their holdings for tax purposes .

The company will also have to update its share registers and will have to issue the shares themselves .

It is unlikely that the issue itself will make the company a better investment . It could, however, be interpreted as a signal of confidence on the part of the directors . For example, scrip issues can reduce the scope for a future rights issue. Carrying on with the issue might signal that the directors believe that future share price strength will outweigh these concerns . Scrip issues can also be associated with a slight increase in future dividends .

This answer was answered well, with candidates demonstrating understanding of both the mechanics of scrip issues and their role in signalling confidence to the markets.

16 One of the advantages of Eurobonds is that they are issued outside of the tax and legal framework of the country of the issuing company . It is possible to arrange for loan capital to be issued without it coming under the legal or tax jurisdiction of any country . Additionally, Eurobonds can be issued in any currency .

Eurobonds normally have fixed coupon rates, although floating rate bonds can be issued . Bonds are normally unsecured .

Eurobonds are bearer bonds . The company does not keep a register of owners; instead holders must claim coupon payments using coupons cut out of the certificates . A possible disadvantage for the company is that it may have very little real idea of the identity of the holders of its bonds .

The nature of these instruments means that the company must have a strong reputation, otherwise the general absence of regulation may mean that the lenders will be deterred from buying the issue .

Eurobonds cannot be issued for small amounts, but must be issued in large blocks . Issues are generally for $75m or more .

Answers to this question were very variable, with weaker candidates struggling to demonstrate any real understanding of the Eurobond markets.

17 (i) Trevor and Simone are effectively faced with two alternatives. If they invest in this company then they will suffer all of the risks associated with running it . They may also lose their homes if the business fails or does not provide them with sufficient return to service the mortgages that they will have to take out . On the other hand, they will enjoy the benefits if the company grows and succeeds . If the company is a major success then they will either be able to share 25% each of the profits or they will be able to sell out at a substantial capital gain .

If they do not buy this company then it appears that their employers will make them redundant . This means that, by buying the company, they will suffer the opportunity cost of the redundancy pay that they would have received if the company was closed down .

Given the importance of the future prosperity of the company, it is worth considering the motives of the holding company . It appears committed to either selling or liquidating its subsidiary . This suggests that it can obtain either better service or keener prices from other suppliers . They may have decided that it would be cheaper to sell the company as a going concern rather than incur the redundancy costs associated with closing it down .

(ii) Make Ltd might find it difficult to borrow in order to expand because it is a small company that does not have the backing of a larger entity . The shareholders are unlikely to be able to provide much fresh finance or to guarantee loans for the company because they will be stretched by the cost of buying out the existing owners .

Leasing would be a suitable means of acquiring specialised plant because it would provide the lessor with security in the form of legal ownership of the new assets . Make Ltd could specify the precise items of equipment that they want and the lessor would then buy these and make them available to the company . Make Ltd would enjoy all of the benefits associated with outright ownership for as long as they met the lease payments .

Hire purchase would be a similar form of finance to leasing in the sense that the asset would provide its own security for the duration of the loan period .

The third possibility would be a term loan to enable the company to buy the equipment outright . This might require Trevor and Simone to provide personal guarantees to the lender . Even though the guarantees might not provide sufficient financial backing to compensate the lender they would, at least, provide the lender with the reassurance that the directors had an incentive to see the loan repaid .

(iii) The most important source of short term finance is trade credit . This is effectively a “free” source of finance since its cost is built into the cost price of the goods, but this is unlikely to be discounted for immediate cash payment . It is also a very flexible source of finance, that expands and contracts in line with the company's requirements .
The creditors are under no obligation to continue to support Make Ltd after the change of ownership . They might be concerned that the company no longer has the strength of a large group behind it . They might also be concerned that any attempts to expand could create cash flow problems that might threaten the company's ability to meet its short term debts .

As a matter of priority, Trevor and Simone should meet with their principal suppliers and attempt to negotiate a continuation of existing credit arrangements . If they have any immediate plans to expand then they should discuss their needs with each supplier in turn and attempt to negotiate an adequate credit facility .

The second important source of short term finance is the company's bank overdraft facility . This gives the company the right to borrow up to its overdraft limit as and when required and without seeking specific permission from the bank . Overdraft rates are relatively high, but the company will only have to pay interest on the amounts actually borrowed at any given time . This can mean that the overdraft is a relatively cheap means of covering short term commitments .

Trevor and Simone should seek a meeting with their bank manager to negotiate an adequate overdraft facility . This might prove difficult because overdrafts are not normally secured . The bank might be nervous about supporting this new venture .

This question was intended to test a basic understanding of business risks. Answers tended to be either very good or very bad. The former achieved success by applying some common sense to dealing with the business issues described. The latter often appeared to be trying to list facts from the core reading without any real attempt to relate them to the circumstances of the case.

18 (i) The following ratios are relevant:

Profitability	*PJ plc*		*Pricecut*		*Bigstore*	
Return on capital employed	$\frac{2,150}{5,018}$	43%	$\frac{960}{1,320}$	73%	$\frac{5,060}{8,017}$	63%
Gross profit percentage	$\frac{5,000-1,500}{5,000}$	70%	$\frac{4,000-2,000}{4,000}$	50%	$\frac{11,000-2,750}{11,000}$	75%
Advertising / sales	$\frac{400}{5,000}$	8%	$\frac{480}{4,000}$	12%	$\frac{880}{11,000}$	8%
Sales compensation / sales	$\frac{350}{5,000}$	7%	$\frac{400}{4,000}$	10%	$\frac{880}{11,000}$	8%
Fixed asset turnover (times)	$\frac{5,000}{5,000}$	1.0	$\frac{4,000}{1,300}$	3.1	$\frac{11,000}{8,000}$	1.4
Activity						
Stock turnover (days)	$\frac{123}{1,500}\times 365$	30	$\frac{99}{2,000}\times 365$	18	$\frac{286}{2,750}\times 365$	38
Creditors turnover (days)	$\frac{115}{1,500}\times 365$	28	$\frac{82}{2,000}\times 365$	15	$\frac{286}{2,750}\times 365$	38

Pricecut appears to have a much smaller markup than PJ plc on its selling prices. Assuming that it is selling the same ranges as PJ plc, this suggests that it is competing on the basis of price . It also spends a higher proportion of its turnover on advertising and on rewarding its sales staff . Pricecut appears to have a more aggressive selling policy, as indicated by the fact that it has a more rapid stock turnover .

Pricecut also has a greater fixed asset turnover. This suggests that it has consciously minimised its investments in fixed assets in order to maximise return on capital employed .

Finally, Pricecut pays its suppliers very quickly, suggesting that it buys a proportion of its goods for cash or that it is keen to maintain supplier support .

Overall, Pricecut appears to be a low cost, low status supplier, possibly selling in the cheaper end of the market . This approach generates a higher return on capital employed than PJ plc and so might be worth considering . It could, however, be risky to adopt this policy because it would provoke direct price competition with an established competitor .
Bigstore has a higher margin than PJ plc on its sales . It has managed to achieve higher sales and so it manages to spend a much greater absolute

amount on advertising, even though it does not spend more as a percentage of turnover . That means that it might be able to afford more effective methods (e.g. television or large press adverts) .

Bigstore has a slower stock turnover than PJ plc, suggesting that it carries a wider range of stocks or that it sells more expensive brands or ranges .

Bigstore appears to be a high status, high cost supplier concentrating on the luxury end of the market . PJ plc might also consider this approach because it also yields a higher return on capital employed . Doing so would, however, require a great deal of time to develop a reputation to rival Bigstore and to grow to the necessary size to make some of these practices viable .

(ii) The financial statements could be based on different accounting policies. Many of the differences identified in (i) above could be due to the manner in which the figures have been prepared .

Some companies will disclose as little as possible about their business strategies in order to avoid giving useful information to competitors .

Comparisons could be misleading because of the effects of inflation or specific price changes . It may be that Pricecut does not have a smaller store or less equipment — its investment could be just as great in real terms, but the valuations could be markedly different .

There might not be sufficient detail to make some of the comparisons provided above. For example, the statements might not disclose the amounts paid to sales staff .

The working capital sections of the balance sheets could be affected by window dressing or other factors . For example, one of the companies could have had a sale just before the year end so that the stock figures were artificially low .

Part (i) tended to be answered well by candidates who understood the technique of ratio analysis. Good answers provided a range of relevant ratios and made use of these in providing a considered analysis of the companies. Weak answers often provided more ratios than was necessary and failed to draw any form of reasoned conclusions in their analysis.

Part (ii) tended to be answered well, with many candidates demonstrating some understanding of the problems affecting the preparation of financial statements.