

EXAMINATIONS

12 April 2002 (pm)

Subject 108 — Finance and Financial Reporting

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 19 questions. From question 11 onwards begin each answer on a separate sheet.*

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 Actuarial Tables and your own electronic calculator.

For questions 1–10 indicate in your answer booklet which one of the answers A, B, C or D is correct.

- 1** Which of the following roles would NOT typically be played by a merchant bank?
- A acting as a trustee
 - B large scale lending to corporate borrowers
 - C issuing treasury bills
 - D providing advice on company mergers
- [2]
- 2** Which of the following bodies is primarily responsible for issuing accounting standards in the UK?
- A Financial Reporting Council
 - B Accounting Standards Board
 - C Accounting Standards Committee
 - D Urgent Issues Task Force
- [2]
- 3** Which of the following statements is NOT true of companies issuing commercial paper?
- A They must be listed on the London Stock Exchange.
 - B They must issue a statement that they comply with the requirements of the Stock Exchange.
 - C They must have a minimum level of net assets of £50m.
 - D They must have the commercial paper endorsed by a merchant bank.
- [2]
- 4** Which of the following best describes the manner in which individuals can claim tax relief for capital losses?
- A Capital losses can be offset against capital gains in the same year. Any unused capital loss may be carried forward to offset against capital gains in the next three years.
 - B Capital losses can be offset against capital gains in the same year. Any unused capital loss may be carried forward to offset against capital gains in any future year or years.
 - C Capital losses can be offset against capital gains in the same year. Any unused capital loss may be offset against taxable income in that year.
 - D Capital losses can be offset against capital gains in the same year. Any unused capital loss may be carried back to reclaim tax paid on capital gains during the previous three years.
- [2]

- 5** Which of the following is most likely to be true:
- A A company's cost of equity will be equal to its weighted average cost of capital.
 - B A company's cost of equity will be greater than its weighted average cost of capital.
 - C A company's cost of equity will be lower than its weighted average cost of capital.
 - D A company's cost of equity will fluctuate around its weighted average cost of capital. [2]
- 6** Which of the following types of company is most likely to employ a high proportion of equity financing?
- A supermarket
 - B property company
 - C IT developer
 - D bank [2]
- 7** Which of the following statements is NOT true of factoring.
- A A factoring service may be with recourse or without recourse.
 - B Factoring is the sale of debts to a factor at a discount.
 - C Factoring companies often provide their clients with bookkeeping services to save them from keeping their own records of debtor balances.
 - D The factor will make payment to the client as soon as the debt is collected. [2]
- 8** Which of the following statements is NOT true?
- A Companies can issue ordinary shares below the par value.
 - B The expected overall future return for ordinary shares ought to be higher than for most other classes of security.
 - C The Memorandum of Association will set out the total nominal value of authorised share capital.
 - D An appropriate way of valuing ordinary shares is to calculate the present value of the future dividend stream. [2]

- 9** In certain circumstances the Stock Exchange may grant a quotation for a company even though the company is not making any new shares or existing shares available to the market. This method of obtaining a quotation is known as:
- A a placing
 - B a prospectus issue
 - C a tender issue
 - D an introduction
- [2]
- 10** Which of the following changes in working capital will result in an outflow of cash?
- A decrease in creditors
 - B decrease in stock
 - C decrease in debtors
 - D increase in other current liabilities
- [2]
- 11** One of R plc's shareholders has written to the directors to complain that the company has reduced its dividend payment compared to last year. The shareholder is of the opinion that this action has reduced his wealth.
- Identify the matters that should be included in the directors' reply to their unhappy shareholder.
- [5]
- 12** Outline the key features of the taxation of a life insurance company.
- [6]
- 13** Explain how a holding company would construct a set of consolidated financial statements.
- [6]
- 14** Explain how you would price units in a unit trust, including a consideration of whether the fund is expanding or contracting.
- [5]
- 15** Trade credit and debt factoring are both used to provide business with short term finance. Outline the main features of each, stating the advantages and disadvantages of each.
- [6]
- 16** Accountants are guided by a series of accounting concepts when they prepare financial statements. Identify any three such concepts and explain how each affects the content of the financial statements.
- [6]

- 17** A company operates several successful restaurants. It is considering franchising its restaurant concept in a scheme whereby the company and the franchisee would invest equal amounts in setting up each new restaurant. The company would then receive a percentage of the turnover from each restaurant for the life of the agreement.

Outline how simulation might be used to estimate the cash flows from each proposed franchise site. [6]

- 18** The directors of Y plc are concerned that the company has a relatively low return on capital employed. They have asked you to help them to identify the areas where there is the greatest need for improvement. You have asked your assistant to obtain the financial statements of Y plc's most successful competitor and to compare these with those of Y plc. Your assistant has prepared the following table of ratios:

	<i>Y plc</i>	<i>Competitor</i>
(a) Return on capital employed	8%	15%
(b) Turnover / Fixed assets	4:1	6.5:1
(c) Current ratio	3:1	1.8:1
(d) Gross profit percentage*	27%	34%

* Both companies sell very similar product ranges. Their market is very competitive and their selling prices are almost identical.

- (i) Explain why each of the ratios (b) to (d) above help us to understand why Y plc's return on capital employed is relatively poor. [6]
- (ii) For each of the ratios (b) to (d) above, recommend courses of action to management which would improve Y plc's return on capital employed. [9]
- (iii) Explain why the limitations of financial reporting could mean that the comparison of Y plc's performance with its competitor might prove misleading. [5]

[Total 20]

- 19** W plc was established nine years ago. The company has grown steadily throughout that period and the directors are beginning to plan the next stage of expansion. The company requires to raise a substantial amount of finance in order to grow and the directors are considering the options that are open to them.

One possibility is to raise funds through borrowing. Another would be to raise further equity, although the directors are of the opinion that they might have to seek a stock exchange quotation in order to do so.

- (i) Describe the tax implications of selecting a source of finance from the point of view of the company and the provider of the finance. [5]
- (ii) Explain why it might not always be appropriate for management to choose the least expensive form of capital whenever new finance is required. [5]
- (iii) Explain the advantages and disadvantages of seeking a stock exchange listing. [6]
- (iv) All of W plc's shares are held by the directors, all of whom are actively involved in the running of the company. Describe one advantage and one disadvantage of having a "tight" shareholding. [4]

[Total 20]