EXAMINATIONS

September 2001

Subject 108 — Finance and Financial Reporting

EXAMINERS' REPORT

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Examiner's Comments

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

Question 11
The only recurring problem with this question was a slight failure to answer the question. Many candidates described the shortcomings of various methods without explaining whether they had been dealt with by net present value.

Question 12

This question was generally answered well.

Question 13

Many candidates wrote very general essays about gearing and its calculation rather than discussions of how gearing might affect share price.

Question 14

This question was generally answered well.

Question 15

Again, marks were lost because of a failure to answer the question as set. Most candidates managed to discuss the information needs of various users groups, but many either ignored the further requirement to explain how those information needs might conflict or discussed the different business strategies and policies that each group might prefer to see the company adopt.

Question 16

This question was answered reasonably well, although a significant minority of candidates focussed on capital gains and indexation allowance rather than addressing the whole question.

Question 17

Most candidates scored well on this question, although many answers tended to describe depreciation and identified the points required by the question almost by chance.

Question 18

This question was generally answered well, although many candidates seemed to be unaware that shareholders could sell their rights rather than letting them lapse unexercised. Others appeared to expect the share price to stabilise on the theoretical price without any consideration for the possibility that market expectations concerning the use of the funds raised might have a role to play.

Question 19

Most candidates managed to produce reasonable accounting statements and scored well. Most candidates also spotted that the company had a relatively optimistic dividend policy relative to its profitability.

1 D

2 C

3 D

4 D

5 C

6 A

7 A

8 A

9 C

10 C

11 Net present value takes account of the time value of money. This gives it an immediate advantage over several other methods such as payback and accounting rate of return. These do not take into account the effects of interest rates and also ignore some cash flows.

Net present value gives a direct link to the effect of the project on the shareholders' wealth. Other methods, such as IRR, can indicate whether a project would increase their wealth, but would not indicate by how much.

Net present value is the only criterion that reliably ranks mutually exclusive projects.

12 The Bank licences gilt-edged market makers and imposes certain requirements on them in return for which they receive certain privileges.

Market makers can buy, sell or borrow gilts direct from the bank and they get favourable tax treatment.

The bank is responsible for keeping the main register of owners of gilts.

The bank buys and sells gilts. It uses various methods of selling gilts: offers for subscription, auctions, tenders, tap stocks and taplets. The bank buys gilts in the market weeks and months before maturity so it does not have to find billions of pounds on one day.

The bank's activities have the effect of providing liquidity throughout the markets and thereby enable government to influence liquidity and thereby short term interest rates.

13 Capital structure, or gearing, can affect the profits available to the shareholders. Debt is a relatively cheap source of finance. If the company borrows rather than issuing further share capital then a larger proportion of the returns from the resulting investments will be available to the shareholders. The company can also claim tax relief on the interest and that will further decrease the cost of debt.

Debt can also affect the volatility of returns to shareholders. Interest and capital repayments must be paid regardless of whether the company has had a good year or not. The fact that this fixed commitment must be met means that the company may have very little profit left for the shareholders in leaner years. Conversely, the fixed return offered to the lenders will mean that any upturn in revenues will lead to all of the excess being passed on to the shareholders. This means that borrowing will accentuate any fluctuations in the operating profit.

14 Building societies take deposits and invest mainly in mortgages for house purchase. They do, however, find themselves with surplus cash and will invest this in short dated gilts and local authority bonds and in other banks and building societies.

This means that building societies have some, but not much, influence in the markets for short dated gilts and local authority bonds.

Building societies also raise funds by issuing long term debt capital. This is in the form of index-linked bonds and so they have considerable influence in this market.

15 Equity investors make investment decisions and require information about profits and cash flows. Analysts are constantly preparing and updating forecasts of performance. The annual report provides an opportunity to "fine tune" these forecasts. Existing shareholders also require information about the transactions authorised by the directors for stewardship purposes.

Loan creditors make lending decisions involving the measurement of the risk of default. A lender wants to know whether a business can generate sufficient cash to repay any loan. The lender will also wish to ensure that the business has an adequate asset base to meet its obligations in the event of failure. To this end, loan agreements often contain restrictive covenants which are based on accounting numbers.

Employees are interested in the enterprise's ability to pay salaries and also to offer job security. Accounting information is, however, of limited value for such decisions.

Business contacts are interested in continuity of sales (to customers) and of materials and services (from the suppliers). Their interest is, therefore, similar to that of the shareholders. They may also use accounting information to try to gain some insight into the company's pricing and trading policies.

These groups have different needs and it may be that better serving the needs of one will conflict with the others. For example, investors require the most realistic impression possible of the company's performance. Lenders will prefer a more conservative treatment so that they can better manage the risk of default.

16 Companies are liable to corporation tax on their taxable profits. Taxable profits include income less expenses and capital gains. The tax year runs for 12 months to 31st March regardless of the company's financial year.

Corporation tax is paid 9 months after the end of the accounting period except for "large" companies who pay tax on a current year basis by quarterly instalments.

The accounting profit is adjusted to arrive at the taxable profit. The main adjustments are: add back any business expenses shown in the accounts which are not allowable, add back any depreciation and deduct gross franked investment income and subtract capital allowances.

17 The depreciation charge is affected by the estimated useful life of the asset, taking account of the possibility that it might be replaced before it reaches the end of its physical capacity. It will also be affected by the estimated residual value of the asset when it reaches the end of its useful life. These require subjective decisions, particularly with respect to useful life because this is the most important single factor in determining the charge in any one year.

The other factor that can affect depreciation is the allocation of the loss of value to the different accounting periods. Depreciation can be written off in equal instalments (straight line) or on other bases (e.g. reducing balance). The choice of method can also have a significant effect on the charge in any one year.

18 (a) Before the rights issue, four shares would have been worth $4 \times$ £4.50 = £18.00. In theory, after the issue, this would leave five shares worth £18.00 + £3.50 = £21.50.

Thus, the shares would be worth £4.30 each.

(b) There is no reason why the shareholder should either have to buy new shares or suffer any loss in wealth. He must, however, either take up his rights or sell them for their market value. Provided he takes one of these steps, the issue should have no effect on his wealth. The larger the discount, the more valuable the rights to subscribe.

It would be worth pointing out that the discount is necessary to avoid the company having to pay substantial underwriting fees. If the rights price was close to market value then the share price could increase so that it was cheaper to buy shares on the open market than to take up the rights. The discount actually helps to ensure that the issue proceeds smoothly and without undue expense. It is, therefore, in the shareholders' interests, whether they choose to take up their rights or sell them.

(c) It is impossible to tell what the share price will actually be after the issue. Everything depends on the market's perception of the company's future. If the markets are aware of the detailed purpose of the issue and if it is confident that management has a viable project then the share price could be far higher than the theoretical ex-rights price. If the market is unsure about the company s prospects then the share price could actually fall much further than our prediction.

(d) Loan stock is a cheaper form of finance than equity.

Issuing loan stock will involve substantial costs.

The fresh loan stock will increase gearing, reducing the company's borrowing future capacity and increasing the risks associated with existing debt and equity.

The loan stock holders will rank alongside the existing lenders for payment and may require a higher rate of interest to compensate for this.

It may be difficult to organise an issue quickly in order to get the extension work under way.

(e) The mortgage will be even cheaper than the loan stock because the loan will be secured against the new property.

It should be possible to organise the mortgage reasonably quickly.
Even though the loan is secured against a specific asset that will be bought out of the proceeds of the loan it will still reduce the company's future borrowing capacity.
The costs of negotiating and organising the mortgage will be lower than for the issue of loan stock.

The mortgage holder might insist on restrictive covenants which will reduce the company's freedom to enter into contracts in the future.

19 (a)

Z plc
Profit and Loss Account
for the year ended 30 June 2001

	£000	*£000*
Sales		1,200.0
Cost of sales		–743.7
Gross profit		456.3
Administration	–69.0	
Distribution	–230.0	
		–299.0
Operating profit		157.3
Interest		–120.0
Net profit before taxation		37.3
Taxation		–22.0
		15.3
Dividend		–80.0
		–64.7
Balance brought forward		180.0
		115.3

Z plc
Balance Sheet
as at 30 June 2001

		£000	*£000*
Fixed Assets			
			1,218.3
Current Assets			
	Stock	19.0	
	Debtors	140.0	
		159.0	
Current liabilities			
	Bank	–6.0	
	Proposed dividend	–80.0	
	Taxation	–22.0	
	Creditors	–54.0	
		–162.0	
Net current liabilities			–3.0
			1,215.3
Loan			–600.0
			615.3
Capital and reserves			
	Share capital		200.0
	Share premium		300.0
	Profit and loss account		115.3
			615.3

Note — Fixed Assets

	Cost	*Aggregate depreciation*	*Net book value*
	£	£	£
Factory	983.0	–64.7	918.3
Machinery	550.0	–250.0	300.0
	1,533.0	–314.7	1,218.3

Workings

Cost of sales	
Opening stock	18.0
Purchases	450.0
Closing stock	–19.0
Factory — depn	
	19.7
Machinery — depn	100.0
Manufacturing overhead	35.0
Manufacturing wages	140.0
	743.7

Admin	
expenses	25.0
Admin wages	44.0
	69.0

Distribution	
Advertising	200.0
Wages	30.0
	230.0

(b) The company's dividend exceeds its profit for the year. This means that the dividend has been financed by drawing on retained profits from previous years. That is perfectly legal, although it does tend to suggest that Z plc is determined to maintain its dividends regardless of whether it has had a good year or not.

It is also noticeable that the company has a bank overdraft and has very little in the way of working capital. This means that the company will have to borrow, perhaps substantially, in order to meet the commitment represented by the dividend payment.

It may be that the company's shareholders have put the directors under some pressure to maintain their dividend. It may be that the directors do not have sufficient confidence in the shareholders' judgement to risk paying a more realistic dividend relative to the profit for the year.