REPORT OF THE BOARD OF EXAMINERS

April 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

3 June 2003

1 C

2 B

3 A

4 D

5 D

6 C

7 D

8 C

9 A

10 A

Questions 1-10 were generally answered well.

11 A formal proposal will require explicit consideration of the cash flows associated with the project. This will make it easier for management to decide on the overall impact on the company's future performance. Payback is also relatively easy to understand and to implement.

Unfortunately, payback is probably the least relevant investment criteria. It ignores the time value of money. It ignores cash flows occurring after the end of the payback period. It will also rank mutually exclusive projects in a manner that might be sub-optimal for the shareholders.

This question was answered well, candidates should however be careful in this type of question to discuss cash flow rather than profit.

12 Company law lays down a host of detailed procedures relating to the form and content of financial statements. These requirements include some prescriptions concerning accounting policies , such as a requirement that the current assets other than debtors should be valued at cost or net realisable value if lower . The Companies Acts also prescribe the basic accounting concepts such as accruals, consistency and so on .

The accountancy profession has published a series of detailed accounting standards . These generally focus on areas where there have been problems with accounting policies in the past . For example, there are accounting standards on detailed matters such as the valuation of closing stock and the calculation of depreciation .

Both company law and accounting standards require financial statements to give a "true and fair view" . This provides a further benchmark against which to measure the acceptability of accounting policies . Do the financial statements give a true and fair view ?

The directors can also consider the consistency of their policies with those of other similar companies . Readers of financial statements will expect similar businesses to follow broadly similar accounting practices .

Finally the directors can share the burden of ensuring the validity of their accounting policies with the auditors . The auditors will use similar criteria to those of the directors, but will provide an independent perspective in doing so.

Candidates should always be careful to answer the question rather than writing everything they know about the topic. A number of candidates confused accounting concepts and policies.

13 Insurance companies are taxed on their investment income and realised capital gains . These will have to be calculated in a manner that is acceptable to the Revenue .
The company can offset life business expenses and general annuity business expenses from their income. Only permissible expenses can be deducted . For example, entertaining and depreciation charges must be excluded from costs for tax purpose .
The income element of general annuity payments to policyholders may also be deducted.

The net income figure is the company's taxable profit. This is then multiplied by the appropriate tax rate , as set by the government, in order to arrive at the final liability.

Generally this question was well answered.

14 The company is quoted. The stock exchange requires existing shareholders to have the opportunity to purchase any new issues . Rights issues automatically grant this opportunity to the shareholders . Rights issues also involve slightly lower issue costs than other forms of selling new shares . The fact that the company is following this "common" approach will also reduce the risk of unsettling the stock market by trying something new.

The directors must decide on the most appropriate time for the issue . Ideally, it should be at a time when the markets are likely to be most favourably disposed to the company. For example, if the annual report will be due in a few months and if it is likely to impress the markets then it might be better to delay the announcement . If the next profit figure is likely to be slightly depressed then it might be better to move sooner .

The directors must also decide the issue price of the new shares . This must be less than the current market price, otherwise there ill be no point in exercising the rights . A large discount should not matter, at least in theory, because the shareholders can buy these reduced price shares and avoid diluting their equity . Alternatively, a large discount will increase the value of the rights themselves if the shareholders decide to sell rather than exercise them . Too large a discount could, however, unsettle the markets .

The directors must also decide how much information to release with respect to the underlying reasons for the issue . They are required to make some disclosures in the rights offer document , but they might decide to publish more detail in order to appear open and transparent and win the trust of the markets . Too much disclosure could, however, cost the company competitive advantage because competing businesses will make a point of obtaining a copy.

This question was really well answered most candidates were well prepared.

15 This company is likely to have large contracts that involve substantial payments at future dates. The company could use currency futures to "lock in" the exchange rate of receipts or payments that have been agreed for a future date and in a foreign currency . This will protect the company from the risk of liabilities appreciating in value or assets declining in value before they fall due to be settled.

The company can also sell its own specialised futures or options as an incentive to customers. It is common in this industry for airlines to take options on aircraft. These give the airline the right, but not the obligation, to purchase by a predetermined date but at a fixed price . This means that the airline is protected from any price increases . The company also benefits because it can retain the cost of the option, even if the customer decides not to buy.

The company is likely to have operations around the world. It might be able to make use of currency swaps in order to reduce its total cost of borrowing. For example, it might have a comparative advantage in borrowing in the main currency of it base country . It might enter into a reciprocal agreement with a borrower in a host country who has a corresponding comparative advantage . The two parties can exchange a series of payments so that each has access to finance in their desired country and currency, but payable on terms that have been negotiated with their counterpart .

The company might also be able to use interest rate swaps in a similar way if it has a similar form of advantage (say in borrowing at a fixed rate) that can be shared with another company with a corresponding advantage (say in borrowing at a variable rate).

This question was poorly answered with many candidates giving a general answer on all types of derivatives. Candidates should always try to be as specific as possible.

16 (a) WACC = cost of equity

Cost of equity = 4% + (1.4 x 5%) = 11% [2]

(b) Gearing = 200:1,000 = 0.2

Geared beta = 1.4 x (1+(0.2 x (1-0.3)) = 1.596 [2]

Cost of equity = 4% + (1.596 x 5%) = 11.98%

Net cost of debt = 7% x (1-.3) = 4.9%

WACC = (11.98% x 1,000 / 1,200) + (4.9% x 200 / 1,200) = 10.8%

(c) The company should, ideally, minimise its WACC. In theory, doing so will maximise the expected cash flows that it will generate and so increase its market capitalisation . If it raises the additional finance from shares then it will have 100% equity and so its WACC will be 11% . It would, therefore, be slightly cheaper to borrow the £200,000 .

The problem is that this comparison is not quite valid because of the risks associated with borrowing . If the company borrows then it will run the risk of being unable to make interest payments when they fall due . Earnings available to the shareholders will also be more volatile because of gearing . This could mean that the shareholders will actually feel that the company is a poorer investment, even though it is benefiting from the cheaper debt finance and its associated tax advantages .

It should also be noted that R plc's ungeared beta is relatively high at 1.4 . This means that the company's shares are already a slightly risky proposition when taken on their own. Adding the additional risks associated with gearing might make things even worse .

(d) CAPM assumes that investors have a portfolio of assets . A company director's principal asset will be his or her job . CAPM assumes that any and all unsystematic risks can be diversified away . The directors are, however, exposed to both systematic and unsystematic risks . Companies sometimes reduce this problem slightly by rewarding directors with stock options, thereby providing an incentive to introduce some volatility into the company's share price performance , but these are unlikely to be a sufficient incentive to invest in highly risky investments. The directors might also be concerned that the shareholders will not view any investments from a CAPM perspective. CAPM is not especially intuitive and so the directors might be concerned that the merits of their decisions will not be understood .

This question was very well answered by most candidates

17

JK plc

Profit and loss account for the year ended 31 March 2003

	£000	£000
Turnover		1,760
Cost of sales		(783)
Gross profit		977
Selling and distribution costs	(141)	
Administrative expenses	(397)	
		(538)
Operating profit		439
Interest paid	(4)	
Investment income	18	
		14
Profit before taxation		453
Taxation		(15)
Profit on ordinary activities after taxation		438
Dividends		(65)
Retained profit for the year		373
Balance brought forward		236
Retained profits carried forward		609

JK plc

Balance sheet at 31 March 2003

	£000	£000
Fixed assets		997
Current assets		
Stock	185	
Debtors	115	
Investments	350	
Prepaid expense	9	
Bank	10	
	669	
Creditors: amounts falling due within one year		
Creditors	(45)	
Accrued charge	(12)	
Corporation tax	(15)	
Proposed dividends	(35)	
	(107)	
Net current assets		562
		1,559
Creditors: amounts falling due after more than one year		
Long term loan		(200)
		1,359
Share capital and reserves		
Ordinary share capital		700
Share premium		50
Profit and loss account		609
		1,359

Workings

	£000
Cost of sales	
Opening stock	130
Purchases	600
Closing stock	(185)
Depreciation - premises	19
Depreciation - plant and machine	29
Wages and salaries	190
	783

	£000
Selling and distribution	
Advertising	70
Less - prepaid	(9)
wages and salaries	80
	141

	£000
Administrative expenses	
Administrative expenses	150
Add - accrual	12
Directors' remuneration	75
Wages and salaries	160
	397

	£000
Dividends	
Paid	30
Proposed	35
	65

Fixed assets

	Cost	Aggregate depreciation	Net book value
Premises	950	39	911
Plant and machinery	210	124	86
	1,160	163	997

This question was designed to test the candidates' ability to prepare a profit and loss account and balance sheet. Most candidates could calculate the correct figures but many lost marks for incorrect formats.