EXAMINATIONS

29 April 2004 (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 17 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.

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

1 Which of the following is not explicitly required by the UK Companies Act?

A Directors' report
B Auditor's report
C Chairman's report
D Notes to the accounts

[2]

2 Kate is an employee of an insurance company in the UK.

Kate receives additional benefits such as free medical insurance cover. What effect will these benefits have on her income tax liability?

A The benefits are not subject to tax because they are not in the form of cash.

B She will be taxed on the benefit at a lower rate than the rate of tax applied to her salary.

C She will be taxed on the benefit to her of receiving these benefits.

D She will be taxed only on the benefits that are not provided in the normal course of the company's business.

[2]

3 A company's long term finance comprises: ordinary shares £10m, share premium £8m, preference shares £3m, debentures £6m and long terms loans £5m. What is the company's gearing ratio?

A 19%
B 34%
C 44%
D 69%

[2]

4 Sam owns 1,000 £1.00 ordinary shares in T Ltd. These shares were purchased from the company for £1.25 each. Sam has paid £0.80 per share to date and the shares are deemed £0.45 paid up. What would be the maximum that Sam could be made to pay to T Ltd's creditors if the company fails and leaves unpaid liabilities?

A £550
B £800
C £1,000
D £1,250

[2]

5 Frank submitted a tender to buy 2,000 £1.00 shares in X plc. He offered £3.00 per share. Tenders received varied from £1.50 to £3.60. The striking price was set at £2.40. How much will Frank have to pay for his allocation of 2,000 shares?

A £2,000
B £4,800
C £6,000
D £7,200

[2]

6 Grow plc owns sugar cane plantations in the Caribbean. In April 2004 it buys an option to give it the right to purchase refined sugar at a predetermined price at some time in the future. Which of the following is the LEAST likely explanation for Grow plc's purchase?

A Grow plc is concerned that this year's crop will fail.

B Grow plc wishes to hedge against price changes on the commodity markets for sugar.

C Grow plc's knowledge of the industry leads it to believe that it can make money from speculating.

D Grow plc is attempting to drive up the cost of refined sugar.

[2]

7 Preference share capital has been more popular in recent years. Which of the following is the most likely explanation for this?

A Preference dividends are more tax efficient than ordinary dividends.
B Preference shares are always redeemable.
C Preference shares can be structured so as to improve the issuer's gearing ratio.
D Preference shares impose no risks on the ordinary shareholders.

[2]

8 Owner plc owns 60% of the ordinary share capital of M Ltd and classifies M Ltd as a subsidiary. Owner plc owns 25% of the ordinary share capital of O Ltd and classifies O Ltd as an associate company. Each of the three companies have tangible fixed assets worth £1m. What total will appear under tangible fixed assets in the consolidated financial statements published by the Owner Group?

A £1.6m
B £1.85m
C £2.0m
D £3.0m

[2]

9 Which of the following is the best reason for NOT referring to the working capital section of a company's latest balance sheet when deciding whether that company is a good risk for purposes of granting trade credit?

A A company's liquidity says nothing about its ability to pay debts.
B It is reckless to base such decisions on information provided by the customer.
C The figure for working capital is likely to be distorted.
D The information will almost certainly be out of date.

[2]

10 Which of the following is true of unit trusts?

A Unit trusts are quoted on the Stock Exchange.
B Unit trusts are not companies.
C Unit trusts are allowed to have gearing.
D Unit trusts have no initial charge.

[2]

11 Compare a finance lease with a medium-term loan as a means of acquiring a fixed asset. [6]

12 Peter and Susan cannot understand why their business is short of cash as it made profits of over £100,000 last year. Explain why there can be differences between profits or losses generated, and cash received.

[8]

13 Q Ltd is a general trading company that is domiciled for tax purposes in the UK. The directors are considering setting up an overseas subsidiary but are concerned that they might end up paying tax twice on the subsidiary's profits, once in the host country and a second time when the profits are remitted back to the UK. Describe the principles of double taxation relief (DTR) as they would apply to Q Ltd. [6]

14 Terry and Julie have decided to establish their own actuarial consultancy. They have identified a gap in the consultancy market for their services and are keen to start trading as a partnership soon. First they have to go through the process of creating and financing their business.

Identify the financing needs of this business and explain how these might best be met from the various alternatives available. [10]

15 Describe the operation of self-administered pension funds in the UK and explain how the factors that govern their operation influence their choice of investment.

[10]

16 G plc is a quoted company in the telecommunications industry. The government has offered a licence for the use of a new broadcast technology that could revolutionise the sector in which G plc operates. This would initially operate in parallel with existing communications media, but has the potential to become the standard technology within the next ten years. The directors believe that they would have to bid £800m in order to secure this licence in competition with the other companies in the industry.

G plc's market capitalisation is £4,000m. If it decides to bid for the licence and is successful then it will have to raise most of the cost through the combination of a rights issue and a loan from a consortium of commercial banks.

G plc's directors are unsure whether to proceed with the bid. One aspect of their decision is the question of whether the potential returns from this project are adequate to compensate for the risks involved. They have obtained the following information:

Current risk free rate	5%
Equity risk premium	7%
G plc's Beta	1.8

(i) Calculate the required rate of return from this investment, using G plc's Beta coefficient as a proxy for the project Beta. [3]

(ii) Explain why G plc's Beta is likely to be an appropriate approximation for the project Beta and explain how a more appropriate project Beta might be determined. [6]

(iii) Explain the limitations of the capital asset pricing model (CAPM) in making a decision about a project of this size and nature. [6]

(iv) Assuming that the directors of G plc make a successful bid for this project, explain how the stock market is likely to react to the news and explain how that reaction might best be managed by the company. [5]

[Total 20]

17 The Insurance Group has recently published an annual report. This contains the following summarised balance sheet:

Insurance Group
Consolidated balance sheet as at 31 March 2004

Assets	£m
Intangible assets	
Goodwill on acquisition of subsidiary	4
Investments	278
Reinsurers' share of technical provisions	
Claims outstanding	110
Debtors	80
Other assets	
Tangible assets	6
Cash at bank and in hand	35
	41
Prepayments and accrued income	14
Total assets	527
Liabilities	
Capital and reserves	
Called up share capital	50
Share premium account	22
Profit and loss account	9
Shareholders' funds attributable to equity interest	81
Technical provisions	
Claims outstanding	386
Creditors	60
Total liabilities	527

Required

The following questions have been posted to an internet chat site devoted to the Insurance Group. Outline your response to each question, taking account of the specific interests of each person asking a question.

(i) "Insurance (Accident) Ltd, a wholly owned subsidiary of the Insurance Group, owes me substantial compensation which will be paid in six months' time. Insurance (Accident) Ltd has massive liabilities and almost no assets. When I wrote and asked for some assurance that they were capable of paying my settlement they sent me the group balance sheet and stated that they were part of a large and solvent group of companies. **Explain whether I should accept this reassurance"**. [5]

(ii) I am a shareholder in Insurance (Holdings) plc, the holding company of the Insurance Group. I have the following questions:

(a) Every year the financial statements show that a proportion of the goodwill on the acquisition of a subsidiary has been written off. **Why is this adjustment necessary and what does it mean for the value of my investment?** [5]

(b) The notes to the financial statements explain that the company has estimated the amount payable in respect of claims from policyholders and also the amount recoverable from reinsurers. **Why should the financial statements contain such estimates when their value must be the subject of some doubt?** [5]

(c) **How can I be certain that these financial statements have not been falsified by dishonest directors?** [5]

[Total 20]

END OF PAPER