EXAMINATIONS

4 April 2003 (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.

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 best describes a company's "authorised capital"?

A The amount of share capital it has issued.
B The amount of share capital for which payment has been received.
C The total amount of share capital it is allowed to issue.
D The total amount of loan capital it has issued. [2]

2 Which of the following is NOT a disadvantage of using the internal rate of return (IRR) method of capital budgeting?

A Projects can have multiple IRRs.
B IRR ignores the time value of money.
C IRR does not provide a clear basis for deciding about an individual project.
D It is difficult to determine an "average" IRR for a range of scenarios. [2]

3 Which of the following would not normally be included in the calculation of gearing?

A bank overdraft
B debentures
C ordinary shares
D preference shares [2]

4 Laura has just been admitted to a long established business partnership. She has purchased 20% of the partnership equity, although she has not paid for this yet. She will be entitled to 15% of the partnership profit. If the firm incurs any liability, what proportion of that liability will be Laura's legal responsibility?

A 0%
B 15%
C 20%
D 100% [2]

5 X plc has issued both ordinary and preference shares. The directors have suspended payment of the preference dividend. Which of the following is UNLIKELY to be true?

A The company will be unable to pay an ordinary dividend.

B The preference shareholders will be entitled to vote at the annual general meeting.

C The market value of the preference shares will decrease.

D The preference shareholders will be entitled to sue the company for non-payment of preference dividend. [2]

6 Beta plc is a quoted company. Which of the following is a specific risk that can be diversified away by shareholders?

A Beta plc is highly geared and it is exposed to increases in interest rates.

B Beta plc has a great deal of foreign competition and so changes in exchange rates can affect its competitive position.

C Beta plc's main product line requires a steady supply of a rare mineral that is only found in a region that is politically unstable.

D Beta plc produces luxury goods, demand for which is highly vulnerable to changes in the economic climate. [2]

7 When a firm announces a two-for-one stock split (in the absence of other new information), investors should expect that:

A earnings per share will fall but stock price will remain the same
B stock price will fall but earnings per share will remain the same
C both earnings per share and stock price will remain the same
D both earnings per share and stock price will fall

[2]

8 Bidder plc acquired all of the shares of Target Ltd for £4.5m. At the date of acquisition Target Ltd's premises had a fair value of £1m, although their written down value according to its balance sheet was £0.6m. Other fixed assets were worth £0.8m. Net current assets were worth £0.1m. Long term liabilities were worth £1.3m. The goodwill on acquisition was:

A £2.6m
B £3.0m
C £3.9m
D £4.3m [2]

9 If a company has stock of £20,000, debtors of £30,000, bank deposits of £5,000, creditors of £22,000, and an overdraft of £11,000, then the quick ratio is:

A 1.1:1
B 1.6:1
C 1.7:1
D 2.5:1 [2]

10 Which of the following is NOT true of investment trusts?

A They are owned by management companies.
B They are companies which may be listed on the stock exchange.
C They raise equity and debt capital.
D They are run by a board of directors. [2]

11 T plc has never had a formal system of investment appraisal. The directors have decided that, in future, managers must submit a formal proposal in respect of all investment projects and each project must have a payback period of five years or less. Describe the advantages and disadvantages of this new policy. [6]

12 Outline how the directors of a company can decide whether the accounting policies that they wish to adopt in their company's annual report are acceptable. Your answer should refer to both legal and professional pronouncements. [8]

13 Explain how the tax liability of the life business and general annuity business of a life insurance company is determined. [6]

14 The board of F plc, a major quoted company, intends to raise additional equity. The directors have been advised to do so by means of a rights issue. State the advantages of a rights issue as a method of issuing shares and explain the decisions that the directors have to make in the process of making this issue. [10]

15 Explain how the main types of derivative instrument might be used by a multinational manufacturing company in the aerospace industry. [10]

16 R plc is a quoted company. Its directors are reviewing the company's long term financial strategy. The company has been criticised for being financed largely by equity. It has no significant long term borrowings. The board has asked for some calculations to enable them to decide whether the company should consider borrowing in the future. The next phase of expansion will require the company to raise £200m and will involve a general expansion of the existing lines of business.

The following information has been obtained:

Current risk free rate	4%
Equity risk premium	5%
Current corporation tax rate	30%
Equity capital	£1,000m
R plc's Beta	1.4
Probable gross interest rate on debt	7%

(i) Calculate R plc's expected weighted average cost of capital (WACC). [3]

(ii) Calculate R plc's expected WACC AFTER the new finance has been raised assuming that the finance is raised by borrowing. [6]

(iii) Explain the relevance of the WACC figure to the decision to use equity or debt for the new finance. [6]

(iv) It has been suggested that company directors are often motivated by a desire to act in their own best interests rather than those of the shareholders. Explain why directors might be reluctant to use the capital asset pricing model (CAPM) as a decision making criterion for financial planning. [5]

[Total 20]

17 The following balances have been extracted from the books of JK plc, as at 31 March 2003:

	£000
Administrative expenses	150
Advertising	70
Cash at bank	10
Creditors	45
Debtors	115
Directors' remuneration	75
Interest on long term loans	4
Investment income	18
Investments (short term)	350
Long term loans	200
Ordinary dividend paid	30
Ordinary share capital, issued and fully paid	700
Plant and machinery — cost	210
Plant and machinery — depreciation at 31 March 2002	95
Premises — cost	950
Premises — depreciation at 31 March 2002	20
Profit and loss at 31 March 2002	236
Purchases	600
Sales	1,760
Share premium account	50
Stock at 31 March 2002	130
Wages and salaries — administrative staff	160
Wages and salaries — manufacturing staff	190
Wages and salaries — sales staff	80

Additional information:

1. Stock at 31 March 2003 was valued at £185,000.
2. Provision is to be made for administrative expenses owing at 31 March 2003 amounting to £12,000.
3. Premises are to be depreciated at the rate of 2% on cost, and plant and machinery at 25% reducing balance.
4. Advertising paid in advance at the end of the year amounted to £9,000.
5. Corporation tax based on the year's profit is estimated at £15,000.
6. The company's ordinary share capital is 700,000 £1 ordinary shares, fully paid.
7. A final ordinary dividend of 5p per share is proposed.

Required

Prepare JK plc's profit and loss account for the year to 31 March 2003, and a balance sheet at that date. These should comply with Companies Act presentation requirements. [20]