EXAMINATIONS

April 2004

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

22 June 2004

1 C
2 C
3 C
4 A
5 B
6 B
7 C
8 C
9 D
10 B

All questions in this section were answered well apart from a common error in question 3. The only potentially correct answer is C because preference shares should be treated as debt in the gearing ratio. Borderline candidates who missed this point were reviewed and given some credit for question 3 where this made a difference.

11 Both methods would give the use of the asset for its useful life. Both have the effect of increasing borrowing in the company's balance sheet. The cost of each is likely to be of broadly equal size. The concept of borrowing is rather simpler than the concept of leasing. That can make the bookkeeping arrangements for a loan rather simpler. Leasing an asset does not lead to transfer of legal ownership. Borrowing offers scope for negotiating the form of the loan. For example, the borrower might opt for a variable rate or the right to repay early. Leasing is unlikely to be as flexible.

This question was answered well by most candidates.

12 The calculation of profit involves a number of adjustments that do not involve any cash flows. Depreciation, gains or losses on disposal of fixed assets, accrued income and expenses affect profits but not cash flows. Conversely, there are many different transactions that can affect cash flows without any impact on the profit and loss account. For example, receipts and payments of loans, acquisitions and disposals of fixed assets, issue of shares all affect bank but not profit.

In the very long term total profit and net cash flow should be roughly the same . Over time, the cost of fixed assets and the total depreciation charged will come into line with one another . That does, however, require a very long term outlook.

If the business is growing then it is possible for increased profits to be associated with a decline in cash. The growth is often associated with additional investment in stock and debtors and that can lead to an outflow of cash. Furthermore, the fact that the company has done well might encourage an excessive dividend payment, more than the company can afford in cash terms.

An alternative reason for differences may be fraud or error in the business accounting system.

This question produced some very weak answers. Many candidates were not capable of explaining the difference between profit and cash flows in the "common sense" manner implied by the question.

13 The first issue is whether the country that Q Ltd will be operating in has a DTR treaty with the UK. Many countries do, but not all .

If a treaty is in place then Q Ltd will be able to offset tax paid overseas against the liability to UK tax on that income. The maximum offset is the rate of tax that would have been payable in the UK.

Q Ltd can only claim DTR in respect of income-based tax. No relief is available for tax of a capital nature .

This question was well answered. Most candidates were aware of the nature of double taxation relief.

14 The business will require some initial funding in order to provide drawings for the owners' living costs while they become established and also to provide for basic requirements of office equipment, stationery, etc. . Initially there are three main sources: owners' capital , a bank loan and a bank overdraft .

Owners' capital has the advantage of being flexible . It is a matter for Terry and Julie to decide how much each should contribute. Thereafter they are only accountable to each other . Arguably, the two of them will have greater confidence in the business than outside investors and so this might be the easiest way to raise money . This does, however, leave them exposed to any problems with the business. If it fails then they will have spent their savings and will have nothing to fall back on .

A bank loan has the advantage of providing an agreed source of finance right from the beginning of the business . The bank might, however, demand personal guarantees from Terry and Julie and so the exposure might be almost as great as for personal investment . The business will also have to generate sufficient cash right from the start to service the loan and so that will put them under some pressure .

An overdraft is a flexible form of finance, most suited to meeting day to day requirements . One advantage is that interest is paid only on the amount outstanding . A major disadvantage is that the bank can demand the repayment of the overdraft at any time, without any particular reason . An overdraft is also likely to have higher interest charges than a loan .

Most candidates applied their understanding of the material in the core reading to this simple scenario.

15 A self-administered pension fund aims to provide pensions for employees when they retire . Almost all are funded by contributions from both employers and employees throughout the working lives of members . The funds are normally established by employers who make contributions of a sum determined by an actuary or as set out in the fund rules . The employer will also collect contributions as deductions from employees' salaries and will pay those into the fund on the employees' behalf .

The trustees of a self-administered pension fund are responsible for its investment strategy . Trustees must act in accordance with the trust deeds and rules, and in the best interests of the beneficiaries .

The funds' liabilities are long-term, relatively open-ended and are automatically adjusted for inflation when pensions are linked to final salary . This means that they need to invest in real assets that are likely to maintain their values in times of rising values . Historically, most funds invested heavily in equities, but now more funds are investing in a wider range of activities .

Some assets are in the form of very secure investments such as stocks and bonds in order to obtain some return from working capital . The long term nature of the liabilities is likely to mean that any investment in bonds is likely to be an investment in long dated bonds.

This question tested knowledge of self-administered pension funds. It caused no particular difficulty for most candidates.

16 (i) Rate = 5% + (1.8 × 7%) = 17.6%

(ii) This model is only appropriate where the project is subject to the same systematic risks as the company as a whole . This might be the case here because the investment is fundamentally in the same industry as G plc . On the other hand, a new form of telecommunication (e.g. a new form of digital television or the latest mobile phone) might be regarded as more of a luxury item . That could make adoption far more dependent on the state of the economy than the flow of revenue from existing technologies .

The company should consider the fundamental nature of the project in order to understand its underlying sensitivity to movements in the market . The beta of existing telecommunications companies is an appropriate starting point. If this product is a "must have" then it might not be sensitive to factors such as interest rates or exchange rates . That would suggest a lower beta . If it is a luxury then it might be more appropriate to compare it to other forms of consumer spending such as designer clothing . Risks associated with the technology itself or the detail of the market can be diversified away and can be ignored.

(iii) CAPM is ideal if the directors are primarily interested in the needs of the shareholders. The shareholders can diversify away the unsystematic risks associated with the large project. There could, however, be a problem if the project is so large as to affect the company's beta . That might alter the balance of the shareholders' investment portfolios and leave them open to more risk than they would wish to accept.

CAPM might create a conflict between the interests of the directors and their shareholders. The shareholders can diversify, but each of the directors is likely to have only one major appointment and only one reputation. The directors are more exposed to the total risk of the project and might not pursue investments that are in the shareholders' interests.

(iv) The stock market may view this investment as a risk and the share price might drop once the company's successful bid is announced. Alternatively the share price might rise once the successful bid is announced if the market views this as a good investment. If the market is unsure of whether this is good or bad news the uncertainty is likely to result in a fall in the share price. That will be a temporary reaction to the uncertainty created by the project and the price will stabilise once the market has worked through whether this is a good investment or not.

The best way to minimise this uncertainty is to keep the markets as fully informed as possible. That might be difficult given the need for commercial sensitivity. Ideally, the directors should brief the major investors prior to the result of the bid being announced. The markets will then factor in an amount (but not the full announcement of bid result amount) for the possibility that the company's bid is successful.

The performance in this question was disappointing given results in similar questions in previous diets. Candidates should ensure that they understand the logic behind this topic.

17 (i) The compensation is a liability of Insurance (Accident) Ltd. Its holding company has no specific duty to make good any default by any member company. There is no legal advantage in being owed money by a company that happens to be part of a large group. It would be possible to ask for a formal guarantee from the holding company. That would create a contract that would be binding in the event of default. There is also the commercial reality that the holding company would suffer adverse publicity if it permitted a group member to collapse leaving unpaid creditors. It is very possible that the group would make good any failure by Insurance (Accident) Ltd as a goodwill gesture. You should not accept this reassurance without obtaining legal advice.

(ii) (a) The goodwill on acquisition is very much a technical accounting adjustment that reflects differences between the amount paid for a subsidiary and its balance sheet valuation according to accounting standards. As an asset it has no separate existence outside of the group accounts and even its initial valuation might not reflect the true value of the investment in the subsidiary (e.g. it could have been purchased at a low price because of sound bargaining). The asset cannot remain a permanent entry in the consolidated financial statements because the factors that led to its initial recognition will change rapidly, rendering its value out of date. It is written off in order to eliminate it from the bookkeeping records, but that does not imply any lack of commitment to maintaining its value. The alternative to writing it off would be to revalue each and every group member on an annual basis and restate goodwill to reflect the underlying worth of the businesses. Such a treatment would be impractical because of the difficulties of valuing companies in any kind of objective manner. There is no direct implication for the value of your investment.

(b) Many of the figures in the financial statements require some estimates or assumptions in order to determine them. Failure to include such figures would leave substantial gaps in the accounts. Very few figures, other than bank or cash, are strictly accurate. Most readers are aware of this and take it into account when reading the annual report.

In general, the estimates and assumptions are likely to fall within realistic ranges and so there is little scope for massive manipulation or error. For example, an insurance company will have substantial experience of determining the likely outcome of pending claims. Those involved in the reporting process will take care to ensure that this expertise and experience is put to good use.

(c) The directors are subject to the provisions of the accounting standards published by the accountancy profession , the relevant rules and regulations contained in legislation and possibly other rules such as those laid down by the stock exchange. The directors are legally responsible for ensuring compliance with these requirements and would suffer public criticism if they were later found to have manipulated them. The financial statements also carry an auditor's report. The auditor is responsible for expressing an opinion on the truth and fairness of the accounts and is subject to various professional and statutory duties to ensure that this responsibility is discharged correctly.

Performance in this question was notably weak. This was largely due to a failure to read the question's requirements. The case material provided was intended to support candidates, but many appeared to have been confused by it. This was essentially a straightforward question that tested an understanding of the key accounting statements.

END OF EXAMINERS' REPORT