Faculty of Actuaries | Institute of Actuaries

EXAMINATIONS

September 2000

Subject 108 — Finance and Financial Reporting

EXAMINERS' REPORT

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

Comment on Questions 1 to 10

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

11 The shareholder value approach to project evaluation considers the net present value of the project from the shareholder's perspective.

In theory, investing in a positive NPV project will increase shareholders' wealth by the amount of that NPV. In practice, this change will only occur if the market is aware of the investment and agrees with management's estimates of the potential risks and rewards. It may be that the share price will not move in line with expectations because the market is not convinced that the risk is justified or even because the directors have withheld important information for the sake of commercial sensitivity.

The directors would essentially attempt to apply the same valuation models used by outside analysts and advisers in an attempt to determine how the information that they intend to publish will impact the share price.

Comment on Question 11

Many candidates had clearly not understood that the shareholder value approach is a clearly defined technique for project evaluation. A large number of answers were clearly based on a sensible guess as to what the technique might comprise.

12 The directors should consider the current level of gearing. If the company is already heavily financed by debt then it will be difficult for the directors to justify borrowing more.

The use of one form of finance can have implications for the risks, and therefore costs, associated with the other. Issuing fresh debt will expose the existing shareholders to a greater risk of losing their investment if the company is forced to default on its loans. This will mean that the cost of equity might increase. Issuing fresh equity creates a broader "buffer" between assets and liabilities for providing lenders with collateral and that might reduce the cost of debt.

Debt finance is usually cheaper than equity and so the company should consider using it wherever possible. The lower cost is partly because the debt holders are taking much less of a risk when they purchase debt stock and are, therefore, willing to accept a lower rate of return.

The cost of debt is further reduced because interest is allowable as an expense for tax purposes, whereas dividends on shares is not.

It might be difficult to sell £500,000 of share capital without incurring disproportionate issue costs. Raising debt can be rather more flexible. The company could, however, get round this by issuing rather more than £500,000 and using the additional sum raised to repay some of its existing debt.

Comment on Question 12

This question was generally answered well.

13 A body called the Financial Reporting Council (FRC) is responsible for the standard setting process. The FRC concentrates on the management of the process and delegates the real work of developing standards to the Accounting Standards Board (ASB). The FRC's contribution to the process is largely restricted to raising finance for the ASB and appointing its members.

The ASB develops documents called Financial Reporting Standards (FRSs). FRSs are intended to reduce the number of acceptable treatments for specific items in the financial statements. One example of this is FRS 2 which deals with group accounts. This standard defines the relationship between holding companies and their subsidiaries and establishes a standard approach to their incorporation into consolidated financial statements.

A typical standard would be set in the following manner:

- ASB establishes a working party.
- Working party drafts an exposure draft (ED).
- ED published and comments invited.
- Interested parties may 'lobby' in defence of their interests.
- There may be one or more rounds of revision to the ED.
- FRS issued.

This process involves considerable openness, but it also creates the risk of the standards being influenced by the actions of lobbyists.

This system is necessary because there have been many controversies over the correct preparation of financial statements. These have led to problems with the credibility of the profession. Standards also reduce processing and interpretation costs for users because they can become more familiar with the specific treatments adopted by all companies for particular items.

Comment on Question 13

Many candidates appeared to be writing everything that they knew about accounting in the hope that this related to the question. The most common error was to write a detailed explanation of the concepts underlying financial accounting, with no reference whatsoever to the regulatory framework referred to in the question.

14 Life insurance companies are major institutional investors and, collectively, are amongst the very largest institutions.

The companies collect cash from policy holders and invest this in the long term. Policy holders will normally be offered the expectation of a future bonus based on the profits of the company. This has the effect of requiring insurance companies to seek out investment opportunities which both offer the prospect of maintaining the real purchasing power of their deposits and also a realistic expectation of capital growth.

Insurance companies are also subject to a number of regulatory constraints on the nature of their investments. These are partly attributable to the need to maintain solvency margins in accordance with DTI regulations.

Comment on Question 14

This question was generally answered well.

15 Franked investment income (FII) is the grossed-up value of dividends paid by UK companies. The cash value of the dividend received is grossed up by the addition of a tax credit which is currently 10%.

The tax credit is a reflection of the fact that the dividend has been paid out of profits which have already been subject to corporation tax. Individuals who are basic rate taxpayers will not normally pay any further tax on their FII. The FII is added to their taxable income, but the tax credit will cancel the additional tax that this would involve. Non taxpayers cannot, however, recover the tax credit which has been notionally withheld by the company. Higher rate taxpayers may have to pay some additional tax in order to satisfy their obligation to pay tax at the higher rate.

Companies must also include their FII in their tax computation and will be liable to tax on it. This income will, however, be taxed at a flat rate of 20% regardless of the rate of corporation tax to which the company is subject.

Comment on Question 15

This question was generally answered well.

16 Eurobonds are bonds which are issued outside of the company's domicile. There is a thriving market in such arrangements. The fact that the stocks are traded in a country in which the host government has no particular interest can mean that they are not subject to any legal or tax regulations. This lack of regulation can reduce issuing costs and the possibility of freedom from taxes can even reduce the coupon rates of debts. Eurobonds tend to be traded through banks rather than recognised stock exchanges.

Eurobonds can be issued in almost any currency. They are redeemed at par with coupon payments throughout the term of the bond. Almost all Eurobonds are unsecured. Eurobonds are bearer documents.

Most Eurobonds offer a fixed coupon rate, although some offer a variable coupon rate.

Comment on Question 16

This question was generally answered well.

17

	T plc			*Y plc*		
ROCE	246	28	%	371	46	%
	871			815		
Gross profit %	360	60	%	490	70	%
	600			700		
Selling / sales	54	9	%	84	12	%
	600			700		
Admin / sales	60	10	%	35	5	%
	600			700		
Current ratio	200	2.2	:1	153	1.3	:1
	89			118		
Acid test ratio	152	1.7	:1	127	1.1	:1
	89			118		

Y plc is the more profitable company because it has a higher return on capital employed. It appears to have achieved a higher return by virtue of three factors:

- It can generate a higher gross profit from every £ of sales. Either it is selling at a higher margin or it can obtain goods at a lower cost price.

- Its sales appear to be supported by a higher spend on advertising. This has enabled it to achieve higher sales despite having higher selling prices.

- It manages to spend less on administration.

Y plc also appears to have better managed working capital. At first glance, T plc has a "textbook" current ratio of 2:1. The company has a very high acid test ratio, which appears to be due to very slow turnover of debtors. This means that the company has a great deal of finance tied up in non-productive assets. These are not necessarily available to meet short-term commitments.

Comment on Question 17

This question was generally answered well.

18 (i) Share capital is the most flexible form of finance. The payment of dividend is entirely at the discretion of the directors. If the dividends are withheld for any reason then the shareholders have no direct sanctions against the company, other than the right to sell their shares on the open market.

Issuing fresh share capital also makes it easier to raise further finance by borrowing. This is because lenders are usually keen to see the company maintain a sensible relationship between debt and equity. If the company fails then the lenders must be repaid in full before the shareholders receive anything. If the shareholders have financed a large proportion of the share capital then this protects the lenders from the loss of their principal.

Share capital tends to be a rather expensive form of finance. This is because shareholders bear a much higher risk than lenders. They have to be rewarded with a substantial return in order to motivate them to accept this level of risk. In addition, the company does not receive any tax relief on dividends whereas loan interest is tax deductible.

Issuing additional share capital will also tend to dilute the sense of ownership and control enjoyed by the present shareholders. They might be willing to forego the opportunity to expand if doing so would make them accountable to outside shareholders.

(ii) A stock exchange quotation would provide a ready market for the sale of shares. This would make it easier for the company to sell fresh shares on the open market. It would also offer existing and future shareholders a means of disposing of their shares.

The fact that an investment in the company could be liquidated more easily would make it a more attractive prospect, thereby reducing the cost of finance.

The availability of a ready market means that market forces will determine an objective share price. This can be a useful piece of information for shareholders and directors alike. There can be tax problems associated with the gift of shares that cannot be easily valued. Knowing the share price makes it easier to calculate the cost of capital.

The stock exchange imposes strict regulations on the behaviour of quoted companies. The fact that a company is willing to accept this discipline provides further confidence for both shareholders and lenders and so should have the effect of further reducing finance costs.

There are, of course, substantial transaction costs associated with obtaining a listing. Apart from professional fees and other direct costs, a great deal of management time will be taken up.

The fact that the company's shareholders can sell their shares easily on the market might encourage them to take a short-term outlook. This could make the company vulnerable to take-over bids.

(iii) The company ought to consider an offer for sale. This would involve selling new shares to the general public at a fixed price which was determined by the directors. The advantage of this is that it raises additional capital at the same time as introducing the company to the stock exchange.

There is relatively little risk of this type of transaction going wrong because the company would sell the shares via an issuing house. The issuing house would act as an intermediary between the company and the public. In the first instance, the issuing house would purchase the shares from the company and then resell them to the public. This means that the company knows in advance how much the issue will generate because the issuing house is responsible for any lack of demand and will be left holding any unsold shares.

The use of an issuing house also provides the company with a source of experience and advice in the selection of other professionals and in the coordination of their various efforts.

Well before the offer for sale, the company will engage an issuing house. The issuing house will try to generate interest in the launch, e.g. by publicising positive news that might be picked up by the financial press.

In the weeks before the launch, the issuing house will advise on the price that should be set. This will normally be a reasonably conservative figure, if only because a higher issue price would involve a greater risk for the issuing house and that might result in higher fees and premia.

The company is required to publish a prospectus, which is a formal document required by the stock exchange. This is a detailed document containing a wealth of historical and forecast information, both financial and non-financial. This information will also be supported by a number of assurances from the company's external auditors. The prospectus will also state the offer price for the shares.

The prospectus will be reproduced in at least one national newspaper and may be distributed in other ways.

Anyone wishing to purchase shares can do so during the period immediately after the publication of the prospectus. Hopefully, the offer price was set at a level that would encourage investment and the issue will be over-subscribed. This means that the issuing house will have to decide on the most appropriate basis for the allocation of shares.

Finally, the successful applicants will receive letters of acceptance. Official trading on the stock exchange can take place on the day after the acceptance letters are posted.

Comment on Question 18

This question tended to be answered well in some parts, but not others. Parts (i) and (ii) were generally answered well, although there was very little attempt to relate answers to the facts of the scenario. Part (iii) tended to generate a checklist of mechanisms for issuing shares instead of recommending one particular technique, as required by the question.