EXAMINATIONS

5 April 2001 (pm)

Subject 108 — Finance and Financial Reporting

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Write your surname in full, the initials of your other names and your Candidate's Number on the front of the answer booklet.*

2. *Mark allocations are shown in brackets.*

3. *Attempt all 18 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 and this question paper.

In addition to this paper you should have available Actuarial Tables and an electronic calculator.

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

1 C plc is to make a 3 for 5 rights issue at 120p. If the price of the shares on the day the allotment letters were posted was 140p, what price would you expect for the shares ex-rights when dealings commence?

A 127.5p
B 130p
C 132.5p
D 140p [2]

2 A key difference between the net present value technique and the internal rate of return technique for capital budgeting is:

A that the net present value is easier to calculate
B that they use different cash flows
C that they have different reinvestment rate assumptions
D that they are relevant to the shareholders [2]

3 Which of the following would **NOT** be included in a firm's capital structure?

A retained earnings
B dividends
C capital surplus
D convertible debentures [2]

4 Which of the following is **NOT** a current asset?

A stock
B creditors
C debtors
D cash [2]

5 Which of the following is **NOT** a method of short term borrowing?

A commercial paper
B bill of exchange
C factoring
D leasing [2]

6 Which of the following are limited companies **NOT** required to produce as a result of the Companies Act?

A chairman's report
B directors' report
C balance sheet
D auditor's report [2]

7 Which of the following is **NOT** a method of bringing a security to listing?

A an offer for sale
B a scrip issue
C an offer for subscription
D an introduction [2]

8 A manufacturing company's cash balances have run low. Which of the following would increase cash in the short term?

A press debtors for prompter payment
B pay creditors more quickly
C encourage sales staff to sell more
D delay the acquisition of a piece of manufacturing equipment [2]

9 Which of the following statements is **NOT** true of self-administered pension funds?

A a typical fund invests mainly in index linked gilts
B most existing schemes are defined benefit schemes
C all the schemes are responsible for their own investment strategy
D almost all private sector schemes are funded [2]

10 Which of the following is **NOT** an intangible asset?

A development costs
B patents
C investments
D goodwill [2]

11 Explain the differences between an investment trust and a unit trust. [8]

12 Explain why a company would seek a Stock Exchange quotation. [8]

13 Describe the different reports the external auditor can give when it is impossible to express an unqualified opinion. [6]

14 Ordinary shares are the most important form of financial instrument used by UK companies.

(i) Describe the main characteristics of ordinary shares. [6]

(ii) Explain why ordinary shares are more marketable than loan capital. [2]
[Total 8]

15 Explain why pension funds have special regulations governing the form and content of their financial statements. [4]

16 Explain why a company might issue convertible securities instead of straightforward debt or equity. [6]

17 PQR plc is a pharmaceutical company. The company's research department has identified a compound that can cure the common cold without any side effects. Unfortunately, the manufacture of this compound requires the company to invest heavily in a high technology factory which will use a number of new techniques, some of which are unproven. The company will also need to recruit and retain the services of a number of eminent scientists, each of whom is both vital to the project and would be irreplaceable.

Financing this project will require the company to borrow heavily. The company is unlikely to survive as an independent entity if it invests in this project and it fails. The directors have been advised that there is at least a 50% chance of a catastrophic failure.

The project has a beta of 0.5. The risk free rate is 3% and the equity risk premium is 8%. The project offers an estimated return of 24%.

REQUIRED:

(a) Calculate the required rate of return for the project. [2]

(b) Explain how investing in this project would affect the wealth of PQR plc's shareholders. [5]

(c) Explain how an apparently risky project can have a relatively low required rate of return. [7]

(d) Explain whether you believe that the directors of PQR plc will invest in the project. [6]
[Total 20]

18 MNO plc has a number of different business interests. The directors of MNO are interested in identifying managers for promotion to senior positions. As part of this process, they are comparing the performance of two autonomous divisions, both of which purchase goods in bulk for resale to small retailers. Each division is responsible for a different part of the country, but is otherwise engaged in the same line of business. The directors have prepared the following summary financial statements from the company's bookkeeping records:

	Eastern division	*Western division*
Profit statements (year ended 31 December 2000)	*£000*	*£000*
Sales	800	1,400
Cost of sales	320	490
Gross profit	480	910
Advertising and distribution	80	196
Administration	64	56
Operating profit	336	658
Interest	24	11
Net profit	312	647
Balance sheets (as at 31 December 2000)	*£000*	*£000*
Fixed assets	1,000	1,200
Current assets		
Stock	51	57
Debtors	80	222
Bank	10	7
	141	286
Current liabilities		
Creditors	48	53
Working capital	93	233
Long term loans	200	100
	893	1,333
Capital	893	1,333

(a) Compare the performance of the two divisions in terms of their profitability, liquidity and management of stock, debtors and creditors. Your answer should be supported by relevant ratios, although these should form only part of your analysis. [14]

(b) Describe the limitations of your analysis in (a), explaining why the directors should seek additional information before making a final decision about the suitability of either divisional management team for promotion. [6]

[Total 20]