EXAMINATIONS

September 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.

M Flaherty
Chairman of the Board of Examiners

23 November 2004

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

The objective test questions were generally answered well, with no particular problems arising.

11 Projects are often too complex or too uncertain to analyse using conventional means. Cash flows might be subject to a host of different assumptions. Discount rates or beta coefficients might also be subject to some uncertainty. Simulation provides a means of sensitivity analysis to enable management to see whether altering key variables is likely to have a profound effect on the outcome of the project. In an ideal world, the simulation will indicate that the expected outcome of the project is robust even when several aspects of the decision vary.

Simulation makes it possible to model the effects of changing estimates and assumptions. A model can be built that allows for relationships between these (e.g. links between exchange rates and interest rates). A probability distribution can be modelled for the remaining independent variables and a series of outcomes can be generated using a range of inputs — possibly biased towards the most likely or the most pessimistic depending on the nature of the decision and its importance to the company.

This question was looking for an understanding of the role of simulation. Generally answers were correct in factual terms, but often failed to make the link to investment.

12 Individual shareholders might not have the necessary wealth to enable them to diversify their investment portfolios. Investment trusts enable them to make a single investment in one company and to have that investment spread across a range of shares. Investment in an investment trust may also entail the purchase of the underlying assets at a discount to their net asset value. The investment trust managers will also be expert investors. Investing in an investment trust might be a cheaper means of obtaining such expertise than would be offered by an investment adviser.

Individual investment trusts have different investment policies, offering a choice between different profiles of risk and return. Investors should be able to find a fund that balances their need for stability against their desire for higher gains. Some investment trusts are geared to providing capital growth, whereas others focus on income, so investors can choose accordingly depending on their circumstances and their tax position.

Investors might want to invest in particular niche areas, such as specific industries or markets. Even larger investors might not have the necessary expertise to invest in, say, the Japanese market. Some investment trusts specialise in very focussed areas and so it should be possible to find a trust that can plug a gap in a portfolio.

Investment trusts are not ideal investments for everybody. Some investors will have both the means and the expertise to manage their own portfolios. Investing through an investment trust will involve management charges that could be avoided. Some investors will have very specific needs for flexibility and access to their funds. Investment trust investments will generally be suitable for those who intend to buy and hold for a considerable period.

This question was looking for knowledge of the particular institutional issues raised. Answers were surprisingly weak, with relatively few full answers.

13 Large companies, including quoted companies, are often organised as groups. Consolidated financial statements reflect the economic reality of the group structure. Groups have no specific legal identity. Technically, they comprise independent companies operating under the common control of a holding company. Groups do, however, have an economic identity. Almost by definition, the directors of the holding company can control the affairs and manage the assets of each of the group members. Consolidated financial statements present the economic reality of this group arrangement by combining the figures of the individual group members in such a way as to eliminate internal balances and combine the remaining figures as if they were under one common management.

If there were no consolidated financial statements then investors in holding companies would have no convenient means of understanding how their investments were being managed by their directors. The process of consolidation enables shareholders to see how their investments are being managed in terms of real, economic activities.

This question was looking for an appreciation of the nature of consolidated financial statements. Answers were generally sound, although many candidates did not attempt the question.

14 The stock market is likely to interpret any change in the dividend policy as a very clear message about the directors' confidence in the company's future. The decrease will almost certainly create doubts and uncertainties and the directors should take the greatest possible care to minimise these. The company should give the markets as much warning as possible about the decrease. That announcement should be supported by the clearest possible indication that this is a temporary measure intended to get the company through a period of change. The directors will have to take care that this information is distributed in a manner acceptable to the stock exchange because it is clearly price-sensitive. It would be advisable to brief analysts and other key investors in greater detail so that they are less likely to undermine public confidence in the company's recovery.

There is no doubt that the share price will fall as soon as the announcement is made. This is partly because the markets will regard the reduction in dividend as a more reliable signal than the directors' assurances. Some shareholders will choose to sell because the suspension of the dividend will affect their personal liquidity. The laws of supply and demand will push down prices. In the medium to long term the price will rise again and, hopefully, return to its previous level. The share price will always be a function of the market's expectation of future earnings and dividends. Once the markets see that the directors' promises about the future are genuine then the uncertainty that depressed the share price will be eliminated.

This question brings together issues about dividend policy and the behaviour of capital markets. It tended to polarise candidates, with some very full and thorough answers and others that were either thin or had missed the point.

15 Investment income from equities normally takes the form of franked investment income. That is the amount of any net dividend received plus an associated tax credit. The tax credit is then deducted from the resulting tax liability in order to reflect the fact that the company has already paid corporation tax on the profits that provided the means to pay the dividend. Basic rate taxpayers will not pay any additional tax as a result of the receipt of franked investment income, but higher rate taxpayers will be required to pay additional tax.

Investors have no discretion about the timing of the receipt of their dividend income and are taxed in the year in which the income is received.

Capital gains are taxed separately from dividend income. Individuals have a separate annual allowance for capital gains. The gains themselves are not taxed in the year in which the gain arises but in the year in which it is recognised. Thus, an investor could delay the timing of a disposal in order to delay a gain until a more suitable tax period. The gains themselves are subject to a tapering allowance which counters the effects of rising prices.

Higher rate taxpayers will often find that capital gains are taxed in a less onerous manner than income.

This question was generally answered well, with most candidates being aware of the broad differences in the tax treatments of income and capital gains.

16 (i) The company cannot be listed unless a significant proportion of the shares are in public hands. This means that the family will have to make significant sacrifices in terms of control over their business.

Decision making will be far more formal and complex because it is no longer a matter for family discussion. Outside shareholders will probably want a significant change in the composition of the board to ensure that the family's interests do not drive the direction of the company.

There will be substantial costs associated with the flotation and these will effectively be borne by the family. There are also ongoing reporting costs and compliance costs associated with listing.

Outside shareholders will not have the same long-term commitment to the company as members of a family.

The flotation would open up the prospect of significant external equity. That might make it possible for the company to expand rapidly. However, the company may also become more open to an unwelcome takeover.

There will be an objective market price for the shares and this will make it far easier to value any shares that are sold or given to a family member.

Any member of the family who is not happy will be able to leave and liquidate his/her shareholding.

(ii) The directors will have to decide on the timing of the flotation. Ideally, this will be at a time when the business is likely to be viewed as successful.

There are different levels of quotation. A quote on the main exchange will be more expensive, but will carry more prestige. A quote on one of the alternative markets will be simpler, but might not offer as many advantages. The directors may wish to consider whether London is the most appropriate stock exchange for the company, or whether a better alternative would be found overseas.

The method of introducing the shares will have to be considered. For example, the company could sell additional shares on the open market (and dilute existing shareholdings) or it could sell existing shares on behalf of the family members.

The asking price will have to be decided. Too high a price will make the sale flop while too low a price will dilute the family's wealth.

The company will have to select professional advisers to manage this process.

Depending on the manner in which the shares are to be made available to the market, the directors will have to decide on whether to underwrite the transaction. Doing so will reduce risk, but will also incur substantial fees.

Again, this question was answered well, with most candidates being aware of the implications of a flotation.

17 (i)

	P Ltd		*Q Ltd*	
Gearing	$\dfrac{900+200}{3,247+200}$	32%	$\dfrac{400}{585+400}$	41%
Interest cover	$\dfrac{870}{16+72}$	9.9 times	$\dfrac{340}{44}$	7.7 times

Current ratio	$\frac{283}{286}$	1.0:1	$\frac{211}{166}$	1.3:1

(ii) Q Ltd appears to be at greater risk in terms of gearing and interest cover. This means that Q Ltd is more vulnerable to any fluctuation in operating profits. Q Ltd's fixed outgoings are proportionately higher than P Ltd's. Any decrease in turnover will put the company at greater risk of failing to meet an interest payment or loan repayment.

The above comparison actually overstates P Ltd's vulnerability relative to Q Ltd's. Much of P Ltd's fixed interest capital is in the form of preference shares. In the event of a downturn in business, it should be possible for P Ltd to suspend dividend payments to the preference shareholders. It is also unlikely that the preference shareholders will be entitled to the repayment of their investment or that they can force P Ltd into liquidation in the event that any scheduled repayment is delayed.

Q Ltd's gearing is also understated in the sense that the company rents its premises. The nature of the rental agreement does not appear to require disclosure as a finance lease, but the need to pay rent on this factory or a replacement creates a very similar commitment. If Q Ltd's factory rent was treated as a finance charge then earnings before interest and tax would increase to £540,000 and interest to £244,000. That would reduce Q Ltd's interest cover to 2.2 times.

The fact that P Ltd owns property will also make it easier for the company to secure a loan in order to weather any temporary cash crisis.

P Ltd has a poorer current ratio. That increases the risk of the company running out of cash in the short term. That is, however, a less serious threat than that created by Q Ltd's high gearing because P Ltd could borrow more easily to obtain long term working capital. It would also be relatively easy for H plc to make a small payment in advance to P Ltd in order to resolve any short-term difficulties.

(iii) The current ratio measures a company's ability to meet its immediate liabilities. The tax liability is not an immediate liability because it does not have to be paid until several months after the year end. There is no need to worry whether the company has sufficient cash to meet this liability as at the year end provided it has the capacity to raise funds before the due date.

Answers to this question were disappointing, with too many answers consisting of little more than a computation of ratios. Also, the question had some quite specific requirements about the issues that were to be raised in the analysis. Many candidates wasted time on the provision of ratios that were irrelevant to the question.

END OF EXAMINERS' REPORT