

EXAMINATIONS

13 April 2000 (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 19 questions, beginning your answer to each question 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.

<p><i>In addition to this paper you should have available Actuarial Tables and an electronic calculator.</i></p>
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For questions 1–5 indicate in your answer booklet which one of the answers A, B, C or D is correct.

- 1** In certain circumstances the Stock Exchange may grant a quotation for a company even though the company is not making any new shares or existing shares available to the market.

This method of obtaining a quotation is known as:

- A A placing
 - B A tender issue
 - C An introduction
 - D A prospectus issue
- [2]

- 2** The following information relates to the ordinary shares of F plc:

Earnings per share	50p
Dividend cover	2.5 times
Published dividend yield	3.2%

The price of F plc's ordinary shares implied by the above data is:

- A 78p
 - B 625p
 - C 1563p
 - D 3906p
- [2]

The following information relates to questions 3 and 4.

X Ltd's Balance sheet as at 31 December 1999 included the following items:

	£
Total assets less current liabilities	125,000
9% Debentures (repayable 2004)	20,000
	<u>105,000</u>
Ordinary shares of 50p each	50,000
10% Preference shares of £1 each	20,000
Reserves	35,000
	<u>105,000</u>

- 3** X Ltd's profit before interest and taxation for the year to 31 December 1999 was £40,000.

X Ltd's company's Return on Capital employed for the year ended 31 December 1999 is:

- A 32%
- B 38%
- C 44%
- D 47%

[2]

- 4** X Ltd's interest cover is:

- A 6.6 times
- B 10.5 times
- C 13.9 times
- D 22.2 times

[2]

- 5** A company's ordinary shares have a current market price of £2. The company is making a 2 for 5 rights issue at a price of £1.50.

What is the ex-rights price?

- A £1.50
 - B £1.74
 - C £1.86
 - D £2.60
- [2]

In questions 6–10 one or more of the options may be correct. Answer in your booklet by selecting according to the following code:

- A if I and II only are correct*
- B if II and III only are correct*
- C if I only is correct*
- D if III only is correct*

- 6** Which of the following assets are not intangible fixed assets?

- I Research costs
 - II Trade marks
 - III Development costs
- [2]

- 7** Which of the following is true:

- I Depreciation adjustments are attempts to reflect the value of fixed assets in the balance sheet.
 - II Depreciation is an application of the matching concept.
 - III Depreciation is a measure of the wearing out or consumption of a fixed asset over time.
- [2]

- 8** Which of the following statements about preference shares is correct?

- I Preference shares carry fixed dividend rights.
 - II Preference dividends can be suspended if the directors decide that the company cannot afford to pay them.
 - III Preference shareholders never have any voting rights.
- [2]

- 9** An ordinary share may have a high dividend yield because:

- I Dividend cover is high.
 - II It is cheap.
 - III Dividend growth prospects are poor.
- [2]

- 10** Chargeable gains on the disposal of the following assets are not subject to capital gains tax:
- I Any residential properties.
 - II Private motor cars.
 - III British government securities. [2]
- 11** The directors of Sawburn plc have decided to investigate ways in which they might improve their management of short and medium term finance. The company's business involves irregular inflows and outflows of cash. The directors have tended not to rely on bank overdraft in order to deal with cash shortages, preferring to use short fixed term loans instead. They are now considering a change to this policy because of the greater flexibility of overdraft finance. They have decided that this might reduce finance costs because interest is only paid on overdrafts on the amount by which the account is actually overdrawn.
- Describe the factors that the directors should take into account in making this change of policy and explain whether overdraft is likely to be the most suitable form of short term finance in these circumstances. Your answer should make appropriate references to the alternatives to overdrafts. [8]
- 12** The directors of a company are planning to undertake a rights issue. Describe the factors that should be taken into account in deciding whether to have this issue underwritten. [6]
- 13** Explain what is meant by the term "associate company" and explain how associates are treated on consolidation. [4]
- 14** Discuss the proposition that ratio analysis is considered to be a useful method of interpreting financial statements, although it has some limitations. [6]
- 15** A company intends to acquire a factory and £600,000 of plant and machinery. Explain the taxation implications of leasing these assets rather than purchasing them outright. [6]
- 16** Describe the main features of merchant banks and discuss their influence on the financial markets. [6]

17 Explain how the Bank of England provides liquidity in the money markets. [4]

18 The following information has been extracted from the accounting records of Tyler plc:

Trial Balance at 31 March 2000

	£000
Administration costs	800
Bank overdraft	700
Debtors	1,300
Factory — cost	23,300
Factory — depreciation	1,800
Factory running costs	1,200
Loan interest	1,680
Long term loans	12,000
Machinery — cost	15,000
Machinery — depreciation	8,000
Manufacturing wages	1,300
Materials — consumed	1,600
Profit and loss account	380
Sales	13,000
Sales salaries	1,600
Share capital	12,000
Stock at 31 March 2000	700
Trade creditors	600

Notes:

- (a) The corporation tax charge for the year has been estimated at £1,290,000.
- (b) The directors have proposed a dividend of £1,400,000.
- (c) At the year end the directors had the factory professionally revalued. The valuer's report estimates the value of the property at £25,000,000. This value is to be incorporated into the balance sheet.
- (d) During the year the company charged depreciation of £460,000 on the factory and £2,000,000 on the machinery. The company purchased new machinery at a cost of £2,700,000. There were no other transactions involving fixed assets. All of these adjustments and transactions have been incorporated into the above figures.

Prepare Tyler plc's profit and loss account for the year ended 31 March 2000 and the balance sheet as at that date. These should be in a form suitable for publication. You should provide a note in respect of tangible fixed assets, but you are not otherwise required to provide notes to the accounts. You should, however, clearly show your workings. [20]

- 19** The directors of Holt plc have introduced a formal system of investment appraisal. Projects must have a positive net present value when discounted at a cost of capital determined in relation to their systematic risk. The board is presently considering two unrelated projects. One is for an investment in a speculative research project. This is fraught with potential problems because it is dependent on the successful application of a recent theoretical discovery reported in the physics literature. Even if the technical problems can be overcome, there is a serious risk that another company will offer the principal scientists — who are the leading specialists in their field — more lucrative contracts. The other project is a rather more predictable expansion of the production facilities for an existing product line which has a well established market.

The beta coefficient for the research project is 0.6 while that of the new production facilities is 1.3. The risk free rate is 3% and the risk premium is 8%.

- (a) Calculate the required rate of return for each of the projects. [4]
- (b) Explain why it might be possible that an apparently risky project could have a lower required rate of return than that for a less volatile project. [6]
- (c) Explain whether company directors are likely to accept the logic underlying the capital asset pricing model (CAPM) in practice when they are making investment decisions. [5]
- (d) Outline alternative ways in which one might estimate the beta coefficient of a project. [5]

[Total 20]