EXAMINATIONS

14 September 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 18 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.

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

For questions 1–4 indicate in your answer booklet which one of the answers A, B, C or D is correct.

1 Which of the following statements is incorrect:

A Companies can issue ordinary shares below the par value.

B Ordinary shares normally offer a higher expected return than other classes of security.

C A company's authorised share capital will be laid down in its Memorandum of Association.

D An appropriate way of valuing ordinary shares is to find the present value of the future dividend stream. [2]

2 One of G plc's employees developed a new product. This has just been patented. The development costs of this product were negligible, but the patent rights are almost certainly worth many millions of pounds. Which accounting concept would prevent the company from recognising the value of this patent as a fixed asset in its balance sheet?

A Going concern
B Materiality
C Money measurement
D Prudence [2]

3 Which of the following is not true for a finance lease?

A The lease agreement has a primary period which covers all or most of the useful economic life of the asset.

B The lessee is normally responsible for servicing and maintenance of the asset.

C The lease payments will appear in the profit and loss account as an expense.

D The lessee records the leased asset as a fixed asset in its balance sheet. [2]

4 Which of the following best describes the effects of an increase in the risk characteristics of a project when evaluating its net present value?

A The discount rate increases and the net present value increases.
B The discount rate increases and the net present value decreases.
C The discount rate remains constant, but the net present value decreases.
D The discount rate decreases and the net present value decreases. [2]

In questions 5–10 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*

5 Companies who wish to raise finance by issuing sterling commercial paper have to meet certain minimum standards. They must:

I be listed on the London Stock Exchange
II have a minimum level of net assets of £50m
III have a minimum level of share capital of £50m [2]

6 When choosing between two mutually exclusive projects, the internal rate of return can give a misleading decision. Which of the following may be reasons for this?

I Projects can have more than one rate of return.

II Internal rate of return ignores the rates of return available from other projects.

III Internal rate of return ignores the cost of capital. [2]

7 An increase in the value of a fixed asset due to revaluation would:

I increase the equity of a company
II make the balance sheet look stronger
III increase the profit of a company [2]

8 Which of the following would you normally expect to find in the external auditor's report to the shareholders:

I a certificate guaranteeing the truth and fairness of the financial statements

II a statement that the directors were responsible for preparing the financial statements

III a brief description of the work undertaken by the auditor prior to drafting the report [2]

9 A company might carry out a rights issue at a deep discount:

I to reduce the share premium account
II to avoid misunderstandings by unsophisticated shareholders
III to avoid having to pay underwriting costs [2]

10 Which of the following statements is true?

I Specific risk can be diversified away on a large, well spread portfolio.

II Systematic risk arises because of the volatility of the market as a whole.

III Diversification across a well diversified internationally-based portfolio will remove systematic risk entirely. [2]

11 Explain the shareholder value approach to project evaluation. [6]

12 X Plc is planning an expansion and requires £500,000 in order to do so. The directors are unsure whether to finance this by debt or equity. Discuss the factors they should take into account including any taxation implications. [8]

13 Describe the accounting standard setting process in the UK and explain why such a system is necessary. [8]

14 Describe the role life insurance offices play in the investment markets. [6]

15 Explain the taxation treatment of UK company dividends and also how franked investment income is treated. [6]

16 Companies throughout the world raise finance by issuing Eurobonds. Describe the main characteristics of Eurobonds and briefly explain their popularity. [6]

17 The profit and loss accounts and balance sheets of two manufacturing companies are shown below:

	T Plc		*Y Plc*	
	£000	*£000*	*£000*	*£000*
Sales		600		700
Cost of sales		240		210
Gross profit		360		490
Selling expenses	54		84	
Administrative expenses	60		35	
		114		119
Net profit		246		371
Taxation		64		100
		182		271
Dividend		80		110
		102		161
Retained profit b/fwd		106		230
		208		391

	T Plc		*Y Plc*	
	£000	*£000*	*£000*	*£000*
Fixed assets				
Property		-		500
Machinery		760		280
		760		780
Current assets				
Stock	48		26	
Debtors	150		105	
Bank	2		22	
	200		153	
Current liabilities				
Creditors (including Tax)	89		118	
Net current assets		111		35
		871		815
Share capital		663		424
Profit and loss		208		391
		871		815

Compare these two companies in terms of their profitability and solvency. Explain which company appears to be the better managed in respect of each of these matters. You should support your answer with ratios. [20]

 PLEASE TURN OVER

18 Z plc is a large, long established manufacturing company. The company is expanding and the directors are keen to identify new ways in which they might obtain the necessary finance. The finance director has warned that the company must obtain most of this new funding from the sale of new shares. The company has borrowed very heavily in the past and the company's existing loan agreements require it to seek the permission of existing lenders before obtaining further debt.

Z plc is not quoted on the stock exchange. The family of the company's founders owns most of the company's share capital. It is unlikely that these investors will be able to invest the sums required to take advantage of the opportunities that the directors have identified. It has been suggested that the company might seek a stock exchange quotation.

(i) Explain the advantages and disadvantages to Z plc of issuing fresh share capital. [6]

(ii) Explain the advantages and disadvantages of obtaining a stock exchange quotation. [6]

(iii) Assuming that Z plc obtains a quotation, identify the most appropriate method by which the company might issue fresh share capital and describe the steps that are involved. Your answer should explain why you have chosen this particular method. [8]

[Total 20]