EXAMINATIONS

April 2001

Subject 108 — Finance and Financial Reporting

EXAMINERS' REPORT

Suggested answers:

1 C

2 A

3 B

4 B

5 D

6 A

7 B

8 A

9 A

10 C

Generally all Multiple Choice Questions were answered correctly with the majority of candidates scoring over 16.

11 Investment trusts are companies, most of which are listed on the Stock Exchange. Shares in investment trusts can be purchased and sold as for any other quoted company.

Unit trusts are not companies, but are trusts in the strict legal sense. They cannot, therefore, be quoted on the Stock Exchange. Units can only be bought from and sold to the management company which organises the trust.
Investment trusts tend to specialise in investments in other companies, although some invest in gilts, property and overseas companies.
Unit trusts are far more heavily constrained and regulated in terms of what they can invest in and they tend to restrict their investments to quoted securities.
Investment trusts can borrow in addition to raising funds from investors. Unit trusts must rely on the sale of units for finance. This means that investment trusts can offer their shareholders the benefits of gearing whereas unit trusts cannot.

Units in unit trusts are normally priced by taking the market value of the trust's underlying assets and dividing by the number of units. The management charges applied for running the fund are paid for by an initial charge levied on the fund invested. Shares in investment trusts are normally worth less than the market value of the assets divided by the number of shares. The main reason for this is that the managers take an annual fee for their management charge and this has the effect of depressing the value of the shares relative to their underlying assets.

This question was answered very well with most candidates scoring very high marks

12 A quotation will help to raise capital. If the company is quoted then it will be able to sell shares to a wide market and raise large sums cheaply. This is because the quotation will provide a free secondary market in the company's shares.
Providers of debt will lend more happily to a quoted company as they know that the company must comply with the Stock Exchange requirements on an ongoing basis.
Shareholders will also benefit from the fact that the shares will have a readily observable market price which may be useful for tax purposes and also for portfolio management. These advantages will also help the company to raise funds.
The ease with which shares in quoted companies can be traded means that shareholders have an easy exit route if they ever decide to sell their investment. The fact that they can do so means that they will feel far more secure when buying shares.
The ready availability of a market price means that the shares are far more acceptable to employees if they are granted as part of a share option scheme. It will be possible to attribute a value to the shares or options received.
The fact that the shares are listed will also make them more readily available to use as the purchase consideration in a takeover situation. Shareholders of the target company will have a far clearer impression of the relative values of the shares being offered compared with the ones that they already hold.

Excellent answers by many candidates. Candidates who had studied the core reading found this question straightforward.

13 The most common form of qualified opinion is the "except for" form. This is appropriate when the auditor has encountered a material disagreement over the financial statements or has been subject to a material uncertainty because the scope of the audit work has been restricted. The except for makes it clear that the financial statements give a true and fair view "except for" the changes that would have been necessary in order to correct for the disagreement or in response to the resolution of the uncertainty.

There are two more extreme forms of qualified opinion. Adverse opinions are used when the auditor disagrees with the impression created by the financial statements so violently that s/he is of the opinion that the financial statements do not give a true and fair view. Disclaimers of opinion are given when the auditor is faced with such fundamental uncertainty that it is impossible to tell whether the financial statements give a true and fair view. In this latter case, the auditor refuses to express an opinion.

In each of the cases described above, the auditor will describe the problems that have led to the need for a qualified opinion and will make their implications clear to the readers. Then the report will clearly state the opinion, making use of one of the prescribed forms of qualification.

This question was the most poorly answered in the paper, clearly most candidates had ignored this in the core reading. I would emphasis that all topics in the core reading are likely to be examined and it really pays to study all the areas.

14 Ordinary shareholders bear the risks and rewards of ownership. They are last to be repaid in the event that the company fails. They may also receive little or no dividend at difficult times. On the other hand, they will also be entitled to all of the profits after tax and any preference dividend. They will normally be the only ones entitled to vote at general meetings.

Ordinary shareholders will normally have a relatively volatile return from their investment, but this will be compensated for by the possibility of unrestricted opportunity for capital growth. If the company is a massive success then the shareholders may find that their stake increases in value beyond all recognition.

Ordinary shares are backed by real trading assets. This means that they offer a measure of protection against inflation. This is reflected by the fact that, on average, ordinary shares have given a higher long term return than any other investment.

Ordinary shares are normally irredeemable. Indeed, there are provisions that are designed to ensure that shareholders cannot have their capital returned.

Shareholders normally receive a dividend, although the amount of this will be at the discretion of the directors. The amounts will be affected by the company's performance and also by the board's desire to retain funds for future expansion. Ordinary shares tend to be marketable because there is an active secondary market in the shares of quoted companies. This is assisted by the fact that the shares tend to be issued in large, homogenous blocks, making the creation of a market worthwhile. Other instruments are more likely to be issued in smaller, more fragmented tranches and so there is less scope for offering a liquid secondary market.

Again answered well.

15 Pension funds offer a vehicle for investment, in exactly the same manner as any other form of commercial entity. There are, however, significant features which makes their accounting principles different:

- Pensioners have far less scope for diversification in their pensions than in any other type of investing activity. This means that they have to be kept informed about the stewardship of their fund to reduce the risk of them being left exposed to the loss of their pensions.

- Pension funds have very long term commitments to pensioners and must demonstrate that they are being managed for the long term.
- The loss of a pension may be far more serious than the loss of any other type of investment. Pensioners may be far more vulnerable because they are unlikely to have the capacity to earn sufficient income to make up for any loss.

These factors come together to create a need for members of a pension fund to receive adequate accounting information to enable them to measure the stewardship and performance of the fund. The readers may be relatively unsophisticated and require even greater protection than that offered to the readers of the financial statements of limited companies.

Most points mentioned by candidates , however little mention of accounting information in most answers.

16 Convertibles are attractive to issuers when it is felt that the price of the ordinary shares is abnormally low. This might happen in the case of a start-up or a business which is dealing with considerable temporary uncertainty. Issuing fresh shares under such circumstances would dilute the equity of existing shareholders. There will still be some dilution when the debentures are converted, but this will hopefully be less than would arise if the shares had been issued when the company was at a transitional stage.

The company has to be reasonably confident that the share price is only temporarily depressed, otherwise the debenture holders would not convert. In that case the company would have to find cash in order to meet the redemption. Convertibles are essentially a means of raising equity during difficult periods. They can be preferable to straight loan stock because they are self-liquidating and can be issued at a slightly lower coupon rate. They might attract a particular group of investors who are looking for a guaranteed short term income plus the possibility of a capital gain at a later date.

This question was poorly answered, many candidates described convertibles but were at a loss to suggest why companies might wish to issue them. It would be beneficial if candidates could apply the core reading to different situations rather than simply memorising facts.

17 (a) The required rate of return is risk free rate + (beta x equity risk premium).
Required rate of return = 3% + (0.5 x 8%) = 7%.

(b) Investing in this project would increase the shareholders' wealth. The required rate of return, taking risk into account, is only 7%. The project actually offers 24%. This means that the project has a positive net present value (NPV) and the value of their shares will increase by the NPV of this project.
The increase will, however, only occur if the stock market has sufficient information to form a view on its likely outcome. It must also agree with management's evaluation of the project. If shareholders are less optimistic than the board then the share price will not rise by as much.

(c) The risks associate with investments are split into those that can be diversified away and those that cannot. The risks that can be diversified away can be ignored because any rational investor will hold a broad portfolio of assets. Some of the investments will do badly but this will be compensated by the fact that others will do well. Over the portfolio as a whole the investor should expect to have a return that tends towards that offered by the market as a whole.

If the portfolio has been well constructed, the only variation from market returns should be because of any deliberate structuring of the portfolio to leave the shareholder exposed to more or less of the risks faced by the market as a whole. These risks cannot ever be diversified away because they affect all companies to some extent or another. For example, an increase in interest rates will push down most share prices to some extent and so all investments will suffer.

Looking at PQR plc's project from the shareholders' perspective, many of the risks are very specific to the investment. The risk that the technology will not work or that the staff will leave can be countered by investing in a sufficient spread of other securities to cancel the highs and lows on this project with those obtained from others. The project might not be particularly sensitive to factors that affect the market as a whole and so it need not require a high rate of return.

(d) In theory the directors should only be concerned with the shareholders' wealth. That means that they should invest in this project because it has a positive NPV. The fact that it might threaten the company's existence would not matter because their portfolios will include some companies that will fail and others that will thrive.

The directors cannot, however, diversify in quite the same manner. Most of their income will come from this one company and their personal reputations will be associated with its success or failure. They will, therefore, have a great deal to lose if they put the shareholders' interests first. The directors might also feel a moral responsibility towards the other employees to ensure that the company survives in order to keep them in employment.

The directors might also be concerned that many investors will not appreciate the importance of planning their investments on a portfolio basis. They might criticise the directors for taking a risk that is, in fact, justified by the returns offered. If they do not accept that many of the risks are specific to the project and can be diversified away they might accuse the directors of mismanagement.

Part a was well answered , the remaining parts of the question were poorly answered, most candidates had learned facts but found it difficult to apply these to practical situations.

18 (a)

	Eastern			Western		
Return on capital employed	$\frac{312+24}{893+200}$	31 %		$\frac{647+11}{1333+100}$	46 %	
Profit margin	$\frac{336}{800}$	42%		$\frac{658}{1,400}$	47%	
Gross profit %	$\frac{480}{800}$	60 %		$\frac{910}{1400}$	65 %	
Advertising / sales	$\frac{80}{800}$	10%		$\frac{196}{1400}$	14%	
Administration / sales	$\frac{64}{800}$	8%		$\frac{56}{1400}$	4%	
Asset turnover	$\frac{800}{1000}$	0.8	times	$\frac{1400}{1200}$	1.2	times
Current ratio	$\frac{141}{48}$	2.9	times	$\frac{286}{53}$	5.4	times
Quick ratio	$\frac{141-51}{48}$	1.9	times	$\frac{286-57}{53}$	4.3	times
Stock turnover	$\frac{51}{320}$ x365	58 days		$\frac{57}{490}$ x 365	42 days	
Debtors turnover	$\frac{80}{800}$	37 days		$\frac{222}{1400}$	58 days	
Creditors turnover	$\frac{48}{320}$	55 days		$\frac{53}{490}$	39 days	

Western has a higher return on capital employed. That is enough in itself to indicate that it is the more profitable of the two companies.
Western appears to have spent more on advertising with a view to seeking a higher selling price per unit. This may have contributed to a higher overall profitability. The company has also managed to save considerably on administration costs, spending only 4% of turnover as opposed to 8%. Finally, Western has managed to obtain a higher asset turnover.
Western has also managed liquidity more effectively. The company has leaner current and quick asset ratios. Eastern appears to be heavily over invested in unproductive assets.
Finally, Western also appears to have a better strategy for the management of stock, debtors and creditors. It is turning stock over rapidly, thereby managing cash flows. It has managed to offer debtors a reasonable period of credit, possibly justifying its premium pricing policy. It is also paying creditors within a realistic period, thereby maintaining its credit rating.

(b)
There is always a risk that accounting figures are not comparable. The accounting policies could be different or the companies' accountants could have made different estimates and assumptions.
Western is also 50% larger in terms of turnover. That might make the company appear to be more efficient, when it is actually enjoying economies of scale. These economies could mask an underlying weakness in management.
There could be other structural reasons why Western enjoys greater success. The company could, for example, sell to a different, more profitable market segment. Barriers to entry might make it impossible for Eastern to compete directly.

Well answered by most candidates.