EXAMINATIONS

12 September 2003 (pm)

Subject 108 — Finance and Financial Reporting

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*

2. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*

3. *Mark allocations are shown in brackets.*

4. *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, with any additional sheets firmly attached, and this question paper.

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

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

1 Which of the following statements is correct?

A External auditors report to the directors.
B External auditors are required to give a report to the shareholders.
C External auditors correct errors in financial statements.
D External auditors are appointed by the directors. [2]

2 Which of the following types of financial instrument is best described as follows: a fixed return, a fixed repayment date, it is secured and the return is classified as an expense?

A medium term bank loan
B preference share
C ordinary share
D debenture [2]

3 Jennifer successfully applied to buy shares that had been offered for sale by tender. She tendered to pay £2.40 per share. The maximum tendered by any applicant was £2.50. The average tendered was £2.20. The strike price was £2.30. How much did Jennifer pay for each of the shares that she received from the company?

A £2.20
B £2.30
C £2.40
D £2.50 [2]

4 A plc owns shares in three companies, B Ltd (40% shareholding), C Ltd (100% shareholding) and D Ltd (25% shareholding). C Ltd also owns 30% of the shares of D Ltd. A plc has a contractual right to appoint two thirds of the board of B Ltd. A plc has used its voting rights to appoint all of the directors of C Ltd. Which companies are subsidiaries of A plc?

A C only
B B and C only
C B, C and D
D none of the above [2]

5 A company's share capital comprises 40,000 20 pence ordinary shares, which were all issued at a premium of 25%. The shares are fully paid up. The market value of the shares is currently 50 pence each. The figure for ordinary share capital appearing in the company's balance sheet will be:

A £8,000
B £10,000
C £18,000
D £20,000 [2]

6 In times of rising prices, the historical cost convention has the effect of:

A understating profits and overstating balance sheet items
B understating profits and understating balance sheet items
C overstating profits and overstating balance sheet items
D overstating profits and understating balance sheet items [2]

7 Assume the current corporation tax rate is 30%. The directors of ABC Ltd were surprised when they received a corporation tax assessment for less than 30% of its reported profits. Which of the following items may have contributed to ABC Ltd receiving a tax assessment which was lower than anticipated?

I losses carried forward from previous years
II capital allowances which are higher than depreciation
III entertaining expenses which are disallowed for tax

A I only
B II only
C I and II only
D I and II and III [2]

8 Which of the following would NOT appear in a cash flow statement, in the "reconciliation of operating profit to net cash inflow from operating activities"?

A Depreciation
B Wages
C Increase in creditors
D Increase in stocks [2]

9 A company is planning to expand and has prepared a set of discounted cash flow calculations for consideration by the board of directors. Prior to the final decision, the company's weighted average cost of capital has increased. How will this affect the discounted cash flow results?

A Net present value will decrease and internal rate of return will decrease.

B Net present value will decrease and internal rate of return will increase.

C Net present value will decrease and internal rate of return will remain the same.

D Net present value will increase and internal rate of return will remain the same.

[2]

10 Which of the following institutions do not normally invest in short dated gilts?

A General Insurance Company
B Discount House
C Life Insurance Company
D Clearing Banks [2]

11 Your company has traditionally used the net present value criterion for analysing investment opportunities. It has recently been proposed that it should switch to a shareholder value approach. Discuss the advantages of doing so. Your answer should consider the problems that would have to be overcome in order to implement this approach successfully. [8]

12 Explain how a company's UK corporation tax liability is calculated and when it must be paid. [6]

13 One of your relatives has recently received a substantial sum of money. He is keen to invest this for long term growth, so that he can provide for his retirement. He would like to invest in the shares of the quoted company for which he has worked for the past twenty years. He already owns some shares in that company and has always been satisfied with the returns that he has obtained.

Explain why it would be inadvisable for your relative to invest this sum in a single company, even one which he knows well and which has performed well in the past. Your answer should refer to the principles underlying the capital asset pricing model (CAPM). [6]

14 Explain how the Bank of England traditionally provided liquidity in the money markets, and how it provides liquidity now. [6]

15 The board of a major quoted company is considering making a scrip issue. It is weighing up the costs of doing so against the expected benefit in terms of a possible short-term boost to the company's share price.

Describe the costs associated with making a scrip issue and explain how it could increase the share price. [6]

16 The treasurer of a major multinational company is preparing a proposal to the board that the company should issue Eurobonds for the first time. The directors are unsure what is involved and have sought clarification of the issues involved.

Explain the advantages and disadvantages of the use of Eurobonds to an issuer. [8]

17 Trevor and Simone are directors of Make Ltd, a wholly owned subsidiary of a large group of companies. Make Ltd manufactures packaging for the other companies in the group.

The directors of the group's holding company have approached Trevor and Simone and have offered to sell them Make Ltd. If Trevor and Simone accept this offer, the group will continue to buy its packaging materials from Make Ltd for three years, after which time Make Ltd will have to compete for this business against other manufacturers. Make Ltd will be also be free to find new customers who are not part of the group. If Trevor and Simone do not accept the offer then the group will probably make the workforce of Make Ltd redundant and close the company down. They will then obtain their packaging from independent suppliers, probably from overseas.

Trevor and Simone have discussed this proposal. They could each raise 25% of the asking price by remortgaging their homes. They could raise the remainder of the price by inviting the workforce of Make Ltd to buy shares.

In the medium term, Make Ltd will have to invest heavily in new technology in order to compete for new business.

In the short term, Make Ltd will have to rearrange its short term finances to reflect the fact that it is no longer part of the group.

(i) Explain the main issues that Trevor and Simone should consider before committing themselves to acquiring this interest in Make Ltd. [8]

(ii) Describe the main sources of finance that Make Ltd should consider for the acquisition of new manufacturing equipment. Assume that this acquisition will only be made if the purchase of the company is completed. [6]

(iii) Describe the main sources of short term finance that will have to be organised by Make Ltd if Trevor and Simone complete the purchase. Describe the main problems that will have to be overcome when obtaining each form of finance. [6]

[Total 20]

18 PJ plc is a large retailer which sells electrical goods to the public. Every year the board obtains copies of the financial statements of their two main competitors: Pricecut and Bigstore. The directors of PJ plc try to obtain insights into their competitors' business practices so that they can improve their own performance.

The summary financial statements of the three companies are shown below:

Profit and loss accounts for the year ended 30 June 2003

	PJ plc	*Pricecut*	*Bigstore*
	£000	*£000*	*£000*
Sales	5,000	4,000	11,000
Cost of goods sold	(1,500)	(2,000)	(2,750)
Advertising	(400)	(480)	(880)
Sales staff	(350)	(400)	(880)
Other expenses	(600)	(160)	(1,430)
Net profit	2,150	960	5,060

Balance sheets as at 30 June 2003

	PJ plc	*Pricecut*	*Bigstore*
	£000	*£000*	*£000*
Tangible fixed assets	5,000	1,300	8,000
Current assets			
Stock	123	99	286
Bank	10	3	17
	133	102	303
Current liabilities			
Creditors	(115)	(82)	(286)
Net current assets	18	20	17
Total assets less current liabilities	5,018	1,320	8,017
Share capital and reserves	5,018	1,320	8,017

(i) Discuss the main differences between PJ plc's business practices and those of Pricecut and Bigstore, using relevant ratios to support your answer. [15]

(ii) Describe the limitations of the annual report as a basis for the comparison of companies in the manner suggested by the directors of PJ plc. [5]

[Total 20]