

INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

01 October 2020 (am)

Subject CB1 – Business Finance Core Principles

Time allowed: Three hours and fifteen minutes

In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator from the approved list.

If you encounter any issues during the examination please contact the Examination Team on T. 0044 (0) 1865 268 873.

- 1** Which of the following best summarises the attitude that the directors of a quoted company should take towards social responsibility?
- A Social responsibility can and should constrain the creation of wealth.
 - B Social responsibility is just as important as the maximisation of shareholder wealth.
 - C The directors should place social responsibility before their own interests.
 - D The directors should take care to ensure that they are seen to be socially responsible, even if they are not.
- [2]
- 2** How should the directors of a quoted company view agency problems?
- A Agency problems are inevitable and so they should be ignored.
 - B Agency problems are perceived, but do not exist in reality.
 - C Agency problems concern the shareholders and not the directors.
 - D Agency problems may be reduced through transparency and accountability.
- [2]
- 3** In many countries, capital gains are not taxed until the assets on which the gain has arisen are sold. Which of the following is the most logical explanation of this practice?
- A It assists taxpayers in their tax planning.
 - B It ensures the maximum possible revenue into government funds.
 - C It is easier to determine an objective tax expense.
 - D It is unfair to tax capital gains.
- [2]
- 4** Which of the following best explains why many countries do not allow depreciation to be treated as an expense for tax purposes?
- A Depreciation is not a real expense.
 - B The calculation of depreciation allows too much discretion.
 - C The tax treatment of depreciation maximises the revenue from corporate tax.
 - D There is no relationship between depreciation and cash flows.
- [2]
- 5** Why might a manufacturing company's return on capital employed be overstated during times of inflation?
- A Competitors will increase selling prices.
 - B Depreciation on property, plant and equipment may be understated.
 - C Employee wages will decline in spending power.
 - D Sales revenue will be overstated.
- [2]

- 6** A wholesaling company has “prebooked” sales by recording revenues that will not be earned until the first month of the following financial year. Which of the following statements best describes the impact that this will have on the analysis of the company’s financial statements for this year?
- A Both sales and cost of sales will be overstated, so the accounting ratios will not be affected.
 - B Inventory will be understated and trade receivables overstated.
 - C Profit and cash will be overstated.
 - D Profit will be overstated, but return on capital employed will be unaffected.
- [2]
- 7** An insurance company’s financial statements show a conservatively high valuation of liabilities in respect of insured risks. Which of the following best explains this?
- A The directors wish to manipulate future profits.
 - B The external auditor has been negligent.
 - C The directors wish to manipulate the company’s tax bill.
 - D The nature of the industry makes such a valuation prudent.
- [2]
- 8** You are reviewing the financial statements of several major retailers. One company has a relatively high asset utilisation ratio and a relatively low profit margin. How should this be interpreted?
- A The company has a relatively high return on capital employed.
 - B The company has a relatively low return on capital employed.
 - C The company sets high prices in order to maximise profit.
 - D The company sets low prices in order to increase sales volume.
- [2]
- 9** What is implied by a beta of zero on a potential investment?
- A The investment is high risk.
 - B The investment is risk free.
 - C The investment will make a diversified portfolio less sensitive to movements on the market.
 - D The investment will make a diversified portfolio more sensitive to movements on the market.
- [2]

- 10** In times of inflation:
- A both real and nominal rates required from projects will be increased.
 - B both real and nominal rates required from projects will be unaffected.
 - C real rates required from projects will be increased, but nominal rates will be unaffected.
 - D real rates required from projects will be unaffected, but nominal rates will be increased.
- [2]
- 11** Describe how guidance such as that contained in the UK Corporate Governance Code might reduce concerns arising from agency theory. [5]
- 12** Describe how a company might determine whether it has the necessary “significant influence” required to classify another company as an associate. [5]
- 13** A company has traditionally evaluated projects on the basis of their net present value (NPV).
- Discuss the advantages of extending project evaluation to include strategic fit as an additional factor in investment appraisal. [5]
- 14** A commercial bank recently rejected a loan application from a large company. The loan would have been secured by a specific charge against property that was worth at least twice the amount borrowed, but the bank rejected the application on the grounds that the risk of default on the loan was too high.
- Discuss the bank’s decision to reject the loan application in these circumstances. [5]
- 15** A quoted company bases investment decisions on the internal rates of return (IRR) offered by potential projects. In order to be accepted, a project’s IRR must be greater than 12% per annum.
- Discuss this investment criterion. [5]

- 16** Discuss the proposition that the cost of equity is zero for an unquoted company because there is no observable share price. [5]
- 17** Discuss the proposition that the needs of all users of financial statements can be satisfied by a single set of financial statements. [5]
- 18** Explain the relevance of a qualified audit opinion in which the external audit report stated that the financial statements gave a true and fair view, except for a specified disagreement over an accounting choice made by the company's board. [5]

19 The information provided below was obtained from Dosco plc's bookkeeping records on 31 March 2020.

- (i) Prepare Dosco plc's financial statements in a form suitable for publication:
- statement of profit or loss [9]
 - statement of changes in equity [2]
 - statement of financial position. [4]
- (ii) Discuss the implications of the loss on revaluation of property for Dosco's shareholders. [5]
- [Total 20]

Dosco plc

List of balances as at 31 March 2020

	<i>\$000</i>
Administrative expenses	939
Cash at bank	155
Borrowings (long term)	361
Directors' remuneration	1,366
Dividends paid	101
Interest on borrowings	44
Manufacturing costs	1,734
Manufacturing materials – inventory at start of year	614
Manufacturing purchases	4,003
Manufacturing wages	1,120
Plant and equipment – accumulated depreciation	939
Plant and equipment – cost	7,081
Property – accumulated depreciation	1,543
Property – cost	3,251
Retained earnings	1,610
Revenue	16,927
Sales salaries	890
Selling expenses	888
Share capital	1,626
Share premium	434
Trade payables	184
Trade receivables	1,438

Further information:

- (1) Inventory was counted at 31 March 2020 and was valued at \$740,000.
- (2) Manufacturing costs exclude \$50,000 of compensation that will be paid in June 2020 to employees who were injured in an industrial accident.
- (3) Property was valued at \$1,500,000 on 31 March 2020. That valuation is to be incorporated into the financial statements.
- (4) Corporation tax of \$1,337,000 is to be provided for the year.

20 Pantro manufactures laptop computers. The company was established 20 years ago and has always had its factory in its home country. Pantro exports its products worldwide.

Pantro's directors are considering relocating production to a developing country that has suitable infrastructure, including excellent transport links, but much lower labour costs than the company's home country. The potential host country's government is prepared to offer generous grants and tax incentives to encourage Pantro to relocate.

Much of Pantro's production is mechanised, although the final assembly and packing of laptops is labour-intensive.

- (i) Identify the two most significant risks arising from the relocation of production, giving reasons for their selection and recommending a suitable mitigation for each. [10]
- (ii) Suggest the two most significant problems that will arise in budgeting for labour costs at the new factory, giving reasons for their selection and recommending a response to each. [10]

[Total 20]

END OF PAPER