INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

24 September 2021 (am)

Subject CB1 – Business Finance

Core Principles

Time allowed: Three hours and twenty minutes

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

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

1 Which of the following best explains a 'comply or explain' approach to codifying the principles of sound corporate governance?

A Directors who do not comply will be fined.
B Market forces can encourage compliance.
C Stakeholders do not care about compliance.
D There is no agreement on the principles.

[2]

2 Which of the following would be a valid justification for paying the directors of a quoted company a percentage of reported profits rather than fixed salaries?

A It would encourage better performance by the directors.
B It would encourage more accurate financial reporting.
C It would ensure that the directors are well paid.
D It would punish the directors for their mistakes.

[2]

3 Which of the following would be a suitable succession plan for the membership of a quoted company's board?

A A committee of non-executive directors should recruit replacement board members.
B Non-executive directors should be promoted to vacant executive positions.
C Outgoing directors should recommend their successors.
D The Chief Executive should select a replacement.

[2]

4 A quoted company has had a policy of reinvesting profits in ongoing expansion and has paid relatively small dividends. The company is now entering a phase where it no longer requires funds for expansion. The directors therefore intend to start paying out a larger proportion of profits as dividends.

Which of the following would be the most suitable approach to implementing this new policy?

A Announce the policy change at the time of the next dividend announcement.
B Announce the policy change well before the next dividend announcement.
C Continue with the present dividend policy and allow cash to accumulate.
D Increase dividend payments without announcing a change in policy.

[2]

5 A private company was established 5 years ago. A family friend of the founder contributed 10% of the initial equity. The company is now successful and solvent and no longer needs the friend's equity. The company's board has agreed that it will help the friend to liquidate their investment.

Which of the following would be the most suitable means of assisting the family friend?

A The company could pay a large dividend.
B The company could repurchase the shares from the friend.
C The company could seek a stock market quotation.
D The friend could sell their shares on the open market.

[2]

6 Jane has invented an innovative and exciting new device that will enable its wearers to monitor their calorie intake more efficiently. She requires $200,000 to develop this device into a marketable consumer product. To raise funds, she is considering a crowdfunding arrangement in which potential buyers of the device will prepay for their device in return for a 30% discount against the projected retail price.

Which of the following is an advantage of this arrangement to Jane?

A Jane is guaranteed the funding that she requires.
B Jane will receive free finance.
C There is no need to invest time and effort in raising finance.
D Traditional loans will be more complicated to arrange.

[2]

7 A quoted company has a significant loan secured against valuable land and buildings. The company has been making losses for several years, but it is not yet in danger of closure.

Which of the following best describes the reason for the company's cost of debt being high?

A The company cannot obtain tax relief on interest payments.
B The company cannot pay dividends.
C The lenders are likely to lose their principal.
D The lenders will request an increase in the rate of interest.

[2]

8 Which of the following best explains why the UK does not tax income from certain types of investment, such as an Individual Savings Account (ISA)?

A Income from investments such as ISAs is difficult to measure and so tax.
B Returns paid on investments such as ISAs are too low to tax.
C Taxpayers would otherwise transfer their savings offshore.
D The UK Government wishes to encourage citizens to save.

[2]

9 Which of the following could explain a significant difference between a company's basic earnings per share and diluted earnings per share?

A The company has convertible debt in issue.
B The company has fixed interest bonds in issue.
C The company plans to pay a substantial dividend.
D The company has recently made a large rights issue.

[2]

10 Which of the following would **NOT** be disclosed in a company's statement of changes in equity?

A An increase in the revaluation reserve
B The payment of a dividend
C The profit for the year
D The repayment of a significant loan.

[2]

11 Explain the relevance of a decrease in a quoted company's share price for its board of directors. [5]

12 The directors of a quoted company plan to make a major investment in a factory that will be used to manufacture a new product that is in development. This will be financed by a rights issue. The company's Finance Director believes that the share price will fall below the theoretical ex-rights weighted average price and has warned the board of this.

Explain the factors that would determine the share price after the rights issue. [5]

13 A quoted company merged with a slightly smaller competitor as part of an expansion strategy, but the acquisition has failed to deliver the planned synergies.

Outline possible reasons that would explain the problems associated with this merger.

[5]

14 Describe the usefulness of the Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) figure to financial analysts. [5]

15 Explain why imposing a requirement on a company to report on its sustainability will make little real change, unless the board wishes to behave in a socially responsible manner. [5]

16 A major company exploited a loophole in an International Financial Reporting Standard (IFRS) that permitted it to publish financial statements that complied with the IFRS, but which were nonetheless misleading.

Describe the implications for the International Accounting Standards Board (IASB). [5]

17 Explain whether businesses should aim to keep their working capital cycles as short as possible. [5]

18 A company sells bicycles through a chain of 30 shops. Unit selling prices are set centrally across the company. Shop managers are expected to motivate their sales assistants and to ensure that sales revenue is maximised. They must achieve monthly sales targets set by head office.

The company's directors are considering a new system for encouraging shop managers. The monthly sales targets will be withdrawn and replaced with the publication of a monthly table that ranks the shops in terms of sales revenue. Any shop manager who is in the bottom five places twice in a row will face dismissal.

Discuss the suitability of the proposed new system. [5]

19 T is an actuarial consultancy that was established 11 months ago. T is an unquoted limited company. The company's shares are held equally by the six founders, each of whom is a director in the company.

T employs 50 staff in addition to the directors.

The company owns a large office building in the business district of Capital City. This cost \$2 million when it was acquired 11 months ago, but the building has recently been valued at \$2.4 million by a local property expert.

T's directors have engaged an accounting firm to conduct the external audit of the company's first set of financial statements. These will cover the company's first full year of operation and so they have not yet been prepared. However, T's Chief Accountant has been gathering information and has been briefing the directors on some of the accounting issues that have to be decided.

T's directors have instructed the Chief Accountant **NOT** to depreciate the company's buildings because they wish the first year's reported profits to be as high as possible. The Chief Accountant has refused to agree to this, arguing that the building must be depreciated if the financial statements are to comply with International Financial Reporting Standards and pointing out that the external auditor will also refuse to agree to this treatment.

T's Chief Executive has asked for an explanation of the logic behind charging depreciation on an asset that is increasing in value. They have also asked whether recognising the building at its valuation would enhance the company's reported performance.

(i) Give an appropriate response, with reasons, to the Chief Executive's request for an explanation of the logic behind charging depreciation on T's office building even though it is increasing in value. [7]

(ii) Describe, with reasons, possible actions that T's external auditor will take in response to any refusal to depreciate the building. [7]

(iii) Describe the likely impact that revaluation of the property will have on T's reported performance. [6]

[Total 20]

20 G is a quoted company that manufactures mobile phones. The company's directors are considering expanding by investing in a new factory that will be designed to manufacture gym equipment. This will incorporate smart sensors that can track users' exercise routines.

G's beta coefficient is 1.3, based on historical observations. The directors believe that the proposed investment in the new factory will make G's future cash flows more volatile, but will have the effect of reducing beta to 1.1, ignoring the effects of funding the investment.

The funding of the proposed investment has yet to be decided. It may be in the form of debt or equity.

(i) Discuss the significance of the fact that the calculation of G's present beta coefficient was based on historical observations. [7]

(ii) Suggest possible reasons why the investment in the new factory could have the effect of increasing the volatility of G's cash flows while reducing its beta. [7]

(iii) Evaluate the likely effect of the choice between debt and equity for the funding of this investment for G's beta. [6]

[Total 20]

END OF PAPER