

EXAMINATION

14 September 2006 (am)

Subject CT2 — Finance and Financial Reporting Core Technical

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 20 questions. From question 11 onwards begin your answer to each question on a separate sheet.*
5. *Candidates should show calculations where this is appropriate.*

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.

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

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

1 Within the UK, accounting standard setting evolved largely as a consequence of:

- A the UK joining the European Union
- B a lack of public confidence in the accounts prepared by accountants
- C the formation of the Financial Reporting Review Panel
- D company directors wishing to provide consistent information

[2]

2 The following statements relate to different types of business structures:

- I Limited companies pay income tax on their profits.
- II Partnerships are required to have a “partnership agreement” that sets out the rights of individual partners.
- III A Limited Liability Partnership is a separate legal entity.
- IV Sole traders may have employees working for them.

Which of the above statements are correct?

- A I and III only
- B I, II and III only
- C III and IV only
- D I, II and IV only

[2]

3 ABC Ltd started trading on 1 January 2005 and has a gross profit margin of 24%. It made sales of £184,650 during the year to 31 December 2005 and made purchases of £178,600. What is ABC Ltd’s closing stock?

- A £38,266
- B £40,316
- C £138,488
- D £142,334

[2]

4 If the auditor of a company cannot obtain sufficient evidence to give an opinion on whether or not the company's financial statements give a true and fair view, the auditor should issue:

- A an adverse opinion
- B a disclaimer of opinion
- C an unqualified opinion, but include a reference to this matter in the audit report
- D an unqualified opinion

[2]

5 Which of the following statements is NOT true of investment trusts?

- A They are public companies.
- B They can raise both loan and equity capital.
- C They are open-ended investment vehicles.
- D Their shares are usually quoted.

[2]

6 Agency theory identifies certain types of cost as agency costs.

- I Directors' salaries
- II Directors' bonuses
- III The auditor's fee
- IV Employees' pay rises

Which of the above would be an agency cost?

- A I and II only
- B I, II and III only
- C II and III only
- D All of the above

[2]

7 Which of the following is NOT true of Eurobonds?

- A They are issued in Euros.
- B They can be issued by a company or government.
- C They are traded through banks.
- D They are international bonds.

[2]

- 8** Project XYZ requires an initial cash outlay of £50m. It was initially believed that this investment would create cash inflows of £16m in each of the following three years, and £12m in each of the next two years, after which the project would be complete. The payback period and internal rate of return of the project were calculated for the project. A further review of project cash flows indicated that the final cash flow in year five had been overestimated, and would probably be only £4m. What effect would this have on the two calculations?

	<i>Payback period</i>	<i>Internal rate of return</i>
A	Unchanged	Decrease
B	Unchanged	Increase
C	Increase	Decrease
D	Increase	Increase

[2]

- 9** A business made a loss during the financial year just ended but has more cash at the end of the year than it did at the beginning. Which of the following could be a reason for this?

- A Dividends were lower this year than last year.
- B Some fixed assets were sold during the year.
- C Debtors took longer to pay this year than last.
- D Creditors were lower at the end of this year.

[2]

- 10** Which of the following is NOT true in relation to company taxation?

- A Interest payments are tax deductible.
- B Capital allowances are added to the company's accounting profit.
- C Lease of plant and equipment attracts tax relief.
- D Companies with overseas income may be able to offset tax paid overseas against their liability to UK corporation tax.

[2]

- 11** Companies dividend policies often make explicit assumptions about the tax implications for their shareholders for dividends rather than capital growth.

Compare and contrast the tax treatment of dividends versus capital gains on equity investments.

[5]

- 12** A firm of actuaries wishes to raise some medium term finance in order to acquire some new computer equipment.
- Compare TWO forms of medium term finance that they could use. [5]
- 13** In theory, companies exist to maximise the wealth of their owners.
- Explain the problems associated with demonstrating that companies actually do operate in such a way as to maximise their shareholders' wealth. [5]
- 14** Financial futures take many different forms.
- Explain the reasons for the existence of such financial instruments. [5]
- 15** Share issues are often, but not always, underwritten.
- Explain the factors that have to be considered by the directors in deciding whether or not to have an issue underwritten. [5]
- 16** The directors of G are deciding whether or not to invest in a major building project. They have used a Monte Carlo simulation process to model the cash flows from this project. They have run the simulation 10,000 times. The average net present value of the project is positive and the project has generated a positive net present value on 9,930 occasions.
- Explain how such a simulation exercise might be created. Your answer should indicate the factors that would be incorporated into the simulation model. [5]
- 17** Company financial statements contain many figures that are really matters of opinion rather than fact. The figures for tangible fixed assets are subject to a variety of estimates and assumptions.
- Explain the role of estimates and assumptions in arriving at the figures for tangible fixed assets in company balance sheets. [5]
- 18** One of the biggest problems arising from the preparation of consolidated financial statements is the identification of subsidiaries and associates.
- Explain how holding companies identify subsidiaries and associates. [5]

- 19** K plc has a weighted average cost of capital (WACC) of 12%. The directors are planning the acquisition of a factory and the rights to manufacture a new product line that would extend the company's product range.

The directors are deciding whether to finance this expansion by borrowing or by the issue of fresh equity. They have approached several potential lenders and have been able to secure the offer of a loan at a rate of 9%. This has led to considerable optimism because they believe that issuing debt will reduce the company's WACC, thereby making the expansion even more attractive in net present value (NPV) terms.

- (i) Explain why management might believe that issuing debt rather than issuing equity will reduce the company's WACC and explain whether their perception is necessarily correct. [8]
- (ii) Explain why it may be difficult for companies to determine their cost of equity in order to measure the WACC. [6]

It has been suggested that WACC is not always a suitable basis for calculating the NPV of a project.

- (iii) Explain why this is so and explain how the directors should arrive at a suitable discounting rate. [6]

[Total 20]

- 20** Mr Able, a potential investor, is considering purchasing ordinary shares in Evolution plc, a company which manufactures toys. Mr Able has approached you for advice. You are provided with extracts from Evolution plc's financial statements for the previous two years as follows:

	<i>Year to 31 Dec 2004</i>	<i>Year to 31 Dec 2005</i>
	<i>£000</i>	<i>£000</i>
Sales	2,000	2,600
Purchases	1,570	2,090
Opening stock	350	400
Closing stock	400	550
Expenses	359	474
Tax on profits	29	54
Proposed dividends	42	42
Fixed assets	500	670
Current assets	780	893
Current liabilities	370	563
300,000 ordinary shares of £1	300	300
100,000 8% preference shares of £1.50	150	150
Share premium	10	10
Profit and loss reserves	200	250
12% Debentures	200	200

In addition you are given the following information:

1. All Evolution plc's sales are credit sales, and all its purchases are credit purchases.
2. Expenses include interest payments.
3. The profit and loss reserve figures are the opening balances.
4. The market value of the company's shares at 31 December 2004 was 175p per share, and at 31 December 2005 the market value was 225p per share.

Based on your analysis of the information provided, draft a report to Mr Able, outlining the trading performance and financial position of Evolution plc, stating whether or not the company is well managed. You should use relevant ratios to support your analysis.

[20]

END OF PAPER