

**Subject CT2 — Finance and Financial Reporting
Core Technical**

EXAMINERS' REPORT

April 2009

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

R D Muckart
Chairman of the Board of Examiners

June 2009

Comments

This paper was generally done fairly well by candidates which is reflected in the better pass rate achieved for this diet.

The marks were better than the previous diet which is excellent.

Most questions were done well by candidates. The poorest answers were for the last question on risk. Candidates can do the calculations well but have difficulty answering questions about them.

Some revision of that area is required.

It is heartening to see an improvement in the standard of answers, hopefully this will continue in the future.

Where relevant, comments for individual questions are given after each of the solutions that follow.

- | | |
|-----------|---|
| 1 | B |
| 2 | A |
| 3 | C |
| 4 | D |
| 5 | C |
| 6 | D |
| 7 | D |
| 8 | D |
| 9 | A |
| 10 | B |

Working for question 10:

$$A = 500 / (200 + 450)$$

$$B = 600 / (200 + 450) = \text{quick ratio}$$

$$C = 600 / 450$$

$$D = (500 + 600) / (200 + 450) = \text{current ratio}$$

Questions 1 to 10 were done well by most candidates.

- 11** In theory, incorporating as a limited company would restrict all claims to the company's assets. In theory, the worst that could happen would be for the two actuaries to lose everything that they have invested in the company.

In practice, it is unlikely that a lender would be so naïve. The company's assets are unlikely to amount to much as security for any loan. The rental deposit will probably go to the landlord to pay any rent arrears if the company fails, the IT equipment will have very little second hand value and the money spent on running costs will have no residual value.

Any rational lender is likely to demand a personal guarantee from the two actuaries as a condition of granting the loan. Incorporation is only likely to protect the actuaries from smaller creditors who did not take the precaution of seeking a guarantee.

This question was done reasonably well by candidates. Few candidates mentioned a personal guarantee which was surprising, but on the whole many good answers were given to this question.

- 12** The tax authorities do not wish to give companies too much discretion over the calculation of their taxable profit. The figure for depreciation can be affected by a host of estimates and assumptions about asset lives and residual values. This means that taxable profit would be open to manipulation in the event that the company felt that the tax charge would otherwise be too high. It would be difficult, if not impossible, to prove that an estimated useful life for depreciation purposes was too short if the company appeared to be overstating depreciation. Even if the tax authorities had the power to challenge such assumptions, this would lead to a great deal of time and energy being directed towards checking and negotiating assumptions.

The rules for the calculation of capital allowances may be unrealistic in terms of their estimates of residual values or asset lives, but they remove the element of subjectivity from the process.

This question was not done especially well. Candidates discussed all they knew about tax but did not focus on what was being asked. There was little discussion on the problem of asset lives and the lack of subjectivity in the capital allowance calculation.

Many candidates wasted time by discussing the different methods of calculating depreciation.

- 13** Debenture stock is normally backed by assets which reduces risk. Likewise, debenture holders are usually preferred creditors and have either a fixed or floating charge over assets.

The value of debentures will fluctuate in line with prevailing interest rates. If interest rates rise then the cash flows from the debenture will be worth less because they will be discounted at a higher rate.

Debentures might not be particularly liquid investments. Even if the company is quoted it may prove difficult to find a buyer to close out a position.

Debenture stock is subject to the same inflation risk as other fixed interest securities.

This question was generally done well by candidates.

- 14** It is unclear whether any particular dividend policy is better than the others. Modigliani and Miller (MM) argue that shareholders can achieve their own desired dividend policy and thereby render the dividend decision irrelevant.

Dividends are, however, a major signal of management's confidence. Any disturbance of a steady stream of dividends may be very difficult to manage. It may be the absolute value of dividends that matters, but the policy adopted by management may affect the volatility of dividend payments.

Even MM acknowledge that there may be a tax element to shareholders' preferred dividend strategies. Any shift in policy could affect shareholders who prefer income to capital gains or vice versa and hence affect the share price.

This question was poorly attempted by a number of candidates. The tax effect was ignored and there was no mention of theory.

That left candidates with little to say and several candidates missed this question out.

- 15** Managers often have their own personal agendas in running departments, divisions or business segments. A manager might wish to attract capital investment in order to build a personal empire in the quest for promotion or greater recognition within the organisation. Optimistic capital investment proposals will be more likely to attract funding and so optimism may be in those managers' personal interests.

Not all managers behave in this way. Some are motivated more by loyalty to the company than by their own personal ambitions. Thus, senior management cannot necessarily distinguish borderline projects that should be rejected because of excessive optimism from those that have been evaluated in a conservative manner. Ultimately, it may take several years to detect undue optimism on the part of particular managers.

This question was answered well by candidates which was excellent.

- 16** Accounting statements provide an important basis for the shareholders to monitor and control the behaviour of their directors. That creates a great deal of pressure for the directors to manipulate the figures through the use of inappropriate accounting policies. The standard setting system is intended to reduce the numbers of acceptable treatments for specific accounting issues, with a view to standardising those treatments in use.

Standards should enable shareholders to have greater confidence in the figures and so they should reduce some of the problems of resolving agency issues. Thus, companies should find it easier to raise equity because shareholders will have greater confidence in the information being provided to them.

The standard setting process also enhances the credibility of the accountancy profession. Society may lose confidence in accounting statements in the wake of accounting “scandals” and anything that can be done to prevent those from occurring will only enhance the profession’s standing.

This question was answered well by most candidates. Most candidates managed to come up with enough reasons for having accounting standards to get a good mark for this question.

- 17** The directors might bias any estimates or assumptions in order to improve the impression created by the published figures. For example, closing inventory has to be valued at the lower of cost and net realisable value, with profit being affected by this valuation. An optimistic assumption about the net realisable value of every item in inventory will boost profits.

It may be possible to time transactions so that profits are enhanced. For example, offering discounts towards the year end to encourage customers to enter into contracts sooner than they might do otherwise would boost profits for the present year at the expense of the next.

Timing major capital transactions might also enhance the profitability figures. Delaying the acquisition of non-current assets may reduce capital employed by enough to more than compensate for the reduction in activity due to the weaker asset base.

Companies may indulge in creative accounting practices by looking for loopholes in accounting standards that permit the reporting of higher profit figures.

This question was done reasonably well by many candidates, however some could not think of any examples to illustrate the points they had made. Good examples will always enhance an answer so it is worth trying to think of some in advance when revising.

- 18** In theory, maximisation of shareholder wealth offers a simple and effective objective for evaluating managerial decisions. It is easy to justify the selection of a measure than increases shareholder wealth because it is clearly in line with shareholders objectives, and even allows for the interaction between risk and return.

In practice, it may be difficult to envisage the directors acting in this way. There are many ways in which maximising shareholder wealth could be against the directors' best interests. For example, shareholders can diversify risks in ways that directors cannot and so directors may be more risk averse in decision making than shareholders would prefer. Many directors have sufficient integrity to overcome any such pressures, but it will be difficult to distinguish them from those who have not.

This question was answered well by many candidates. Most agreed that maximising shareholder wealth was the main objective for companies. This is a generally accepted position and most other arguments are not valid.

19 (i)

**Maker plc
Income Statement
for the year ended 31 March 2009**

	£m
Revenue	1,200
Cost of sales	(670)
Gross profit	530
Distribution costs	(168)
Administrative expenses	(66)
Operating profit	296
Finance costs	(120)
Profit for the year	176

**Maker plc
Balance sheet
as at 31 March 2009**

	£m
ASSETS	
Non-current assets (note 1)	1,228
Current assets	
Inventories	16
Trade receivables	140
	156
Total assets	1,384

EQUITY AND LIABILITIES

Equity

Share capital	220
Revaluation reserve	164
Retained earnings	342
Total equity	726

Non-current liabilities

Loan	600
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Current liabilities

Trade payables	52
Bank overdraft	6
Total current liabilities	58

Total liabilities	658
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Total equity and liabilities	1,384
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Notes

(1) Non-current assets

	Cost/valuation	Depreciation	Net book value
	£m	£m	£m
Factory	700	(14)	686
Machinery	580	(218)	362
Delivery vehicles	380	(200)	180
	1,660	(432)	1,228

Workings

Depreciation

Delivery vehicles	$(380-140)*25\% =$	60
Factory	$700*2\%$	14
Machinery	$580*10\%$	58

Cost of sales

Depreciation – factory	14
Depreciation – machinery	58
Manufacturing costs	34
Raw materials	440
Wages	124
	<hr/>
	670
	<hr/>

Distribution costs

Depreciation - vehicles	60
Vehicle running costs	80
Wages	28
	<hr/>
	168
	<hr/>

Administration

Expenses	24
Wages	42
	<hr/>
	66
	<hr/>

Revaluation reserve

Cost	600
Depreciation	(64)
Book value	<hr/> 536
Valuation	<hr/> 700
Gain	<hr/> 164
	<hr/>

- (ii) The main advantage is that shareholders will have a better idea of the value of the property that their company controls. That should give a more realistic insight into the resources used by the company in order to generate income. A value might also enable the shareholders to make sensible decisions about, say, whether the property should be retained or sold.

The biggest disadvantage of a valuation is that it will be subjective and will be open to manipulation. There may be professional fees associated with

determining the value. Another disadvantage is that it reduces the return on capital employed.

- (iii) There are many transactions that might affect the bank balance but have no impact on profit, for example, the repayment of a loan. This appears to have happened part of the way through the year because the company has a very high interest charge relative to the amount borrowed at the year end.

Profit does not always generate cash immediately. Credit sales will be recognised before any cash is generated. Companies can even run into a problem called “overtrading” when they are growing and start to put a strain on their working capital.

Part (i) of this question was really well answered by candidates with many candidates scoring full marks. There were some variations in where to show some items but generally the attempts at this were very good. It is excellent that so many candidates can prepare accounts so well.

Part (ii) This part was done reasonably well with many candidates scoring a high mark. Most candidates mentioned subjectivity and the fact that 2 valuers may give different valuation for the same property.

Part (iii) Most candidates scored a reasonable mark for this part of the question. Well done!

- 20** (i) Present cost of equity = $4\% + (1.6 \times 6\%) = 13.6\%$

Estimated ungeared beta, with investment
 $= (1.6 \times 60/80) + (1.1 \times 20/80) = 1.475$

Working: Debt/equity ratio = $20/60 = 0.333$

Estimated geared beta, with investment = $1.475 \times (1 + (0.333 \times (1 - 0.28)))$
 $= 1.829$

Working: cost of equity, with investment = $4\% + (1.829 \times 6\%) = 14.974\%$
cost of debt = $8\% \times (1 - 0.28) = 5.76\%$

Weighted average cost of capital = $(14.974 \times 60/80) + (5.76\% \times 20/80)$
 $= 12.670\%$

- (ii) Arguably, each project should be evaluated in terms of its own individual risk. That means that the cost of capital is only an appropriate rate if the investment constitutes an overall expansion of the business. Even then, it is debatable whether the markets will view the expansion as having the same risk as the company as a whole. The existing cost of capital is, at best, a rough approximation to an appropriate discount rate.

The managers could, in fact, use the project's beta coefficient to calculate the relevant discount rate. With a beta of 1.1, the project should be discounted at $4\% + (1.1 \times 6\%) = 10.6\%$.

- (iii) The directors are mistaken because the project should really be evaluated in terms of its impact on shareholder wealth. The shareholders should have diversified portfolios already, so the additional diversification from this project should not really do them any good. The project has a lower beta than the company as a whole, so the project will reduce the shareholder's weighted average beta and reduce their overall risk profile. That is not necessarily a good thing because the shareholders may prefer a slightly higher risk in order to generate a slightly higher expected return.

Arguably, the directors will be the only real beneficiaries of the diversification effect. The fact that most directors will derive most of their income from that one company and that they have their career tied up in it will make them more exposed to any risks.

Part (i) Generally candidates did well in this part of the question. Most candidates were familiar with the calculations required. Unfortunately there were some candidates who scored zero for this part and they must revise this topic for the future.

Part (ii) This part was done very poorly with many candidates scoring zero marks. Again some revision of this topic is required before the next attempt.

Part (iii) This part of the question was also done very badly. Candidates showed very little understanding of the topic of risk. Candidates did mention diversifying portfolios but not in enough depth to get a high mark. Although candidates can do the calculations for this topic they seem to lack understanding of the topic and do not know what the calculations show. This is very important and should be revised.

This whole topic requires some revision.

END OF EXAMINERS' REPORT