

EXAMINATION

8 April 2005 (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.

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

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

- 1** 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]

- 2** A company expects to have net current liabilities at the financial year end. Raising funds by taking out a short term loan would:
- A increase the current ratio
 - B reduce the current ratio
 - C have no effect on the current ratio
 - D either increase or decrease the current ratio depending on the balances involved and the extra funds raised

[2]

- 3** Sales revenue should be recognised when goods and services have been supplied; costs are incurred when goods and services have been received.

The accounting concept which governs the above is the:

- A accruals concept
- B materiality concept
- C realisation concept
- D dual aspect concept

[2]

- 4** A bond has a value of £1,000 printed on its face. Its current open market value is £980. Analysts expect the value of the bond to rise to £985 within the next seven days. In your personal opinion it will rise to £982. What is the nominal value of this bond?

- A £980
- B £982
- C £985
- D £1,000

[2]

- 5** Preference shares are often thought of as being more like debt than equity. Which of the following best explains this?
- A the tax treatment of preference dividends
 - B the ability to buy and sell preference shares
 - C the fixed nature of participation in profits
 - D the ability to make capital gains or losses
- [2]
- 6** A business has decided to acquire a specialised piece of machinery using a finance lease. A bank has agreed to buy the asset on the business' behalf and will lease the asset for the whole of its useful life. When will the asset become the property of the business?
- A On delivery of the asset.
 - B On the first lease payment.
 - C Once the final lease payment has been made.
 - D Never.
- [2]
- 7** A company has 500,000 £1.00 ordinary shares in issue. The current market price is £1.80. The company will make a rights issue later today, issuing 50,000 new shares at a price of £1.50. What is the theoretical ex-rights price of the company's shares?
- A £1.50
 - B £1.65
 - C £1.77
 - D £1.80
- [2]
- 8** Which of the following best describes the purpose of the depreciation charge?
- A An adjustment to the balance sheet value to reflect market values.
 - B An adjustment to the balance sheet value to avoid overvaluing assets.
 - C An adjustment to the profit and loss account to reflect the use of the asset during the year.
 - D An adjustment to the profit and loss account to reflect the decline in values during the year.
- [2]

- 9** Which of the following best describes the purpose of the cash flow statement?
- A To show how much cash is available at the end of the accounting period.
 - B To explain any increase or decrease in the business's working capital.
 - C To establish the ability of the business to pay its liabilities.
 - D To explain what cash has been generated by operations, and how that cash has been utilised.
- [2]
- 10** An investor sold a holding of a stock with the intention of buying an identical holding of the same stock a few weeks later at roughly the same price. What possibility best explains the likely reason for this behaviour?
- A The investor is keen to develop a relationship with a new broker.
 - B The investor is trying to realise a capital gain in order to utilise an annual tax allowance that will be lost otherwise.
 - C The investor is trying to stimulate the market's interest in the shares by generating trading volume.
 - D The investor wishes to confirm the liquidity of the stock's market.
- [2]
- 11** Company A has invested in Company B. Explain how the directors of Company A can determine whether Company B is a subsidiary for reporting purposes.
- [5]
- 12** Describe how probability trees are used in capital project appraisal.
- [5]
- 13** Describe the role of the external auditor in financial reporting.
- [5]
- 14** Explain how market forces would discipline the managers of a quoted company if they were not performing in a satisfactory manner.
- [5]
- 15** The partners in a small business are considering becoming a limited company. Explain the difference in the taxation of a partnership and a limited company.
- [5]

- 16** T is starting an actuarial consultancy. He intends to borrow quite heavily in order to fund the initial startup. A friend has suggested incorporating this business as a limited company in order to avoid all personal risk associated with business liabilities.

Explain whether incorporation would be likely to be a cost-effective way of avoiding personal liability for the consultancy's borrowings.

[5]

- 17** H is considering buying shares in a major quoted company, but is concerned by the fact that the company has a large number of options outstanding that might dilute his investment.

- (a) Explain what is meant by dilution in this context; and
- (b) Explain how it might affect H's investment.

[5]

- 18** The directors of Cappemm plc are concerned that their beta coefficient is high and that this might deter potential investors.

- (a) Suggest a course of action for the reduction of the company's beta; and
- (b) Indicate whether reducing the beta is likely to be desirable to potential investors.

[5]

- 19** You are a member of a team responsible for the evaluation of investment proposals in a large multinational company that is quoted on a major stock exchange. The directors of one of the company's largest subsidiaries has proposed a major investment that would double that subsidiary's manufacturing capacity and would enable it to export to several new markets. The proposed investment would require the company to raise a great deal of money, either by borrowing or by the issue of equity. The amount involved is large enough to justify either a share issue or the sale of loan stock, but not a combination of the two.

The proposal has been backed by a detailed analysis of the cash flows that are expected to arise from this expansion.

The company has a policy of evaluating investment opportunities on the basis of the net present value (NPV) of estimated cash flows.

- (i) (a) Identify the factors that the company may use to determine the rate at which this proposal might be discounted; and
(b) Explain which of these factors would be most relevant to this project. [6]
 - (ii) Explain how the decision to raise finance using either loan stock or equity might affect the company's weighted average cost of capital (WACC). [8]
 - (iii) It has been suggested that "political", or subjective, factors within companies are often more relevant to investment decisions than objective economic factors in deciding whether a project should proceed. Explain why this might be so. [6]
- [Total 20]

- 20** You have been asked to advise on the distribution of the assets formerly owned by a recently deceased client. The client had owned all of the shares of a large but unquoted limited company, a large house and a substantial bank balance. His will had left everything to his two sons, to be shared equally "in a manner to be agreed by both". The sons have agreed that one will take the house and the other the company. They have agreed a valuation for the house, but cannot agree on the value to be attached to the shares. This valuation is important because it will affect the manner in which the bank balance will be split.

The sons have provided you with the company's most recent financial statements. The son who will take the house has argued that the company should be valued by taking the profit according to the latest year's profit and loss account and multiplying it by the price/earnings ratio of a quoted company in a similar line of business. The son who will take the company feels that it would be more appropriate to value the company at the net assets figure according to the balance sheet. Both sons have provided figures based on their respective methods and these differ widely.

- (i) Explain the relevance of each of the two methods proposed by the sons to the valuation of this company. [8]
- (ii) Indicate, with reasons, which method is likely to give the higher figure. [2]

- (iii) Explain whether the information in a typical company's financial statements is sufficiently reliable to provide the basis for an objective valuation of the company. [5]
 - (iv) Explain why an unquoted company should be required to prepare financial statements. [5]
- [Total 20]

END OF PAPER