INSTITUTE AND FACULTY OF ACTUARIES

EXAMINERS' REPORT

April 2018

CT2 – Finance and Financial Reporting
Core Technical

Introduction

The Examiners' Report is written by the Principal Examiner with the aim of helping candidates, both those who are sitting the examination for the first time and using past papers as a revision aid and also those who have previously failed the subject.

The Examiners are charged by Council with examining the published syllabus. The Examiners have access to the Core Reading, which is designed to interpret the syllabus, and will generally base questions around it but are not required to examine the content of Core Reading specifically or exclusively.

For numerical questions the Examiners' preferred approach to the solution is reproduced in this report; other valid approaches are given appropriate credit. For essay-style questions, particularly the open-ended questions in the later subjects, the report may contain more points than the Examiners will expect from a solution that scores full marks.

The report is written based on the legislative and regulatory context pertaining to the date that the examination was set. Candidates should take into account the possibility that circumstances may have changed if using these reports for revision.

Luke Hatter
Chair of the Board of Examiners
June 2018

A. General comments on the *aims of this subject and how it is marked*

1. The aim of the Finance and Financial Reporting subject is to provide a basic understanding of corporate finance including a knowledge of the instruments used by companies to raise finance and manage financial risk and to provide the ability to interpret the accounts and financial statements of companies and financial institutions.

2. This paper examines basic finance including raising funds by a variety of methods, taxation, net present value and project appraisal and other topics, it has both calculations and essay type questions on these topics. The paper also examines financial reporting including preparation of the main financial statements and interpretation of financial statements. It also considers the basis of the preparation of statements and the information needs of a variety of end users of financial statements.

3. Different numerical answers may be obtained to those shown in these solutions depending on whether figures obtained from tables or from calculators are used in the calculations but candidates are not penalised for this. However, candidates may lose marks where excessive rounding has been used or where insufficient working is shown.

B. General comments on *student performance in this diet of the examination*

Many candidates performed very well in this exam. Question 19 which was on preparation of financial statements was done exceptionally well with many candidates achieving full marks for the accounts preparation part of the question. Question 20 was not quite as well done; however there were some very good answers.

In general, the multiple choice questions were well done as were many of the short questions.

The area in which candidates' performance was weakest was finance; this is often the case with this exam.

Candidates were good at questions which mainly tested knowledge but were a little weaker on application of knowledge to scenarios.

Having said that the results were in line with previous diets and many candidates were excellent.

C. Pass Mark

The Pass Mark for this exam was 60.

Solutions

Q1 D
Q2 C
Q3 A
Q4 B
Q5 C
Q6 A
Q7 C
Q8 B
Q9 D
Q10 A

Q1–10:
In general marks were reasonable for this section. A few candidates achieved full marks and many achieved higher than 60%.

Q11 A partnership is a much simpler arrangement**.** [1]

The two parties simply need to agree a partnership arrangement and they can go into business immediately. [1]

Frank can pay an agreed sum into the business as his capital and future profits can be shared in accordance with the agreement**.** [1]

A limited company would require the requirements of the Companies Act to be met. [1]

It could involve the need to prepare and file audited financial statements, depending on the size of the business. [1]

The consultancy's business dealings will be simpler for a partnership. [1]

For example, the lenders and creditors know that Joan and Frank are personally liable for partnership debts. [1]

If they incorporate as a limited company then the company would be responsible for the debts and some lenders might feel that they should take steps to protect themselves, such as seeking personal guarantees from the directors. [1]

This question was done well by many candidates with most showing an understanding of partnerships. Some candidates did not compare partnerships with limited companies and so received a lower mark.

Q12 Bank overdrafts have the advantage of flexibility. The business arranges an overdraft facility and can use that as and when required to cover temporary cash deficits. [1]

That makes overdrafts ideal for companies that have large fluctuations in their bank balances because they can use the overdraft facility to ensure that they are always able to meet their commitments. [1]

No interest is paid on an overdraft unless the account is actually overdrawn, so it can be cheaper to arrange an overdraft than to take out a term loan. [1]
The interest charged on overdrafts reflects the convenience that is being offered. [1]

If the account is overdrawn by a fairly constant amount then it would be cheaper to take out a traditional loan and pay interest at a lower rate. [1]

There may also be an overdraft facility charge that is charged by the bank for offering an overdraft, which would offset some of the savings because that is paid whether the overdraft is used or not. [1]

The final problem with overdrafts is that they are repayable on demand. [1]

If the bank becomes nervous about the management of the account then it can withdraw the loan, forcing the company to find funds from alternative sources at a time that is likely to be very difficult. [1]

This question was done well by many candidates. The main reason for getting a lower mark was not discussing the issues around overdrafts being repayable on demand .

Q13 The earnings per share (EPS) ratio is a key measure of financial performance. It is so important that it is the subject of an accounting standard. [1]

It is the basis for the price/earnings ratio, which is a key indicator of the market's views of a company. [1]

Any distortion could prove very misleading.

Some of the financial instruments that companies issue can have the effect of permitting their holders to buy new shares at a preferential rate. [1]

For example, a warrant attached to a bond issue or a share option granted to a director could commit the company to increase the shares in issue without an equivalent inflow of funds. [1]

The purpose of the diluted earnings per share is to inform the shareholders of the impact of the exercise of any financial instruments so that they can be aware of the possible impact on EPS and P/E. [1]

If there are large numbers of options or warrants in issue then the existing shareholders interests could be badly diluted in the event of an exercise. [1]

There could be other effects, such as the cessation of interest payments on convertible bonds after conversion to equity. [1]

This question was done well. Many candidates clearly understood EPS and the impact on the price earnings ratio.

Q14 There is often a great deal of information in the absolute numbers that can be overlooked in the event of an excessive focus on ratios. [1]

For example, revenue has increased since last year or a comparative company is much smaller than the target. [1]

Dishonest directors focus on manipulating the ratios when they distort financial statements. [1]
The results may seem satisfactory because they have been distorted in order to appear so. [1]
For example, an accounting choice may have the effect of understating gearing or overstating profitability. [1]

Ratios may require an understanding of the business before they make sense. [1]

For example, the liquidity of many retailers may seem unduly poor when considering ratios, despite the fact that the cash flows through a typical retailer mean that such a low ratio is perfectly satisfactory. [1]

This question was done very well by most candidates and marks were high for this question. Some weaker candidates did not discuss problems of directors being able to use different accounting treatments when preparing financial statements.

Q15 The shareholder value approach bases the evaluation on the information that will be available to the shareholders and also the issues that might affect their understanding. [1]

For example, a project may seem like a sound investment to the directors, but it would be impossible to release all of the information that confirms that to the shareholders because it would assist competitors. [1]

The shareholders may also be slightly sceptical of claims made by the directors concerning their own performance. [1]

Finally, analysts or other industry experts may have expressed concern about the potential repercussions of a particular type of investment. [1]

In theory, the directors should be willing to invest in any positive NPV project, but they may be unwilling to do so if they fear that they will lose credibility in the shareholders' eyes as a result. [1]

This question was not done very well at all. Candidates were very vague and very few understood the interaction between director's interests and shareholders' interests. Few made the link with the investment and shareholder value.

Q16 The most obvious implication is that the founders will retain control over the company, even though they own a minority holding between them. [1]

That may be a significant psychological issue to the shareholders, who regard the company as a "family business" even though it has grown to a size where it can seek a quotation. [1]

The big question is whether this will impact on the marketability and price of the shares. There may be concerns that the founders will run the company in a manner that best suits them. [1]

Other shareholders may fear that they will be investing in a company with an entrenched board that has been selected by the founders and that will pay little regard to others' interests. [1]

Conversely, the founders may be forced to use their controlling interest in a fairly transparent and open way, otherwise they could impair the value of their own shares. [1]

Also, the shareholders in a quoted company rarely have a great deal of influence at an individual level, so they may be losing very little in terms of control because of the founders' shares. [1]

This question was reasonably well done. Candidates showed an understanding of a family business but not of the links between *shareholders and the founders. Generally, candidates gained enough marks to narrowly pass.*

Q17 Attaching a warrant essentially offers the bondholders two ways in which to benefit from the investment, with a potential capital gain from the warrant. [1]

The capital gain will arise from the issue of fresh shares at the exercise price stated in the warrant, so the company does not need to find any cash to make that payment. [1]

This is in contrast to the cash flows that are associated with paying interest and capital on a traditional bond. [1]

If the warrant is exercised then the existing shares in issue will be diluted. [1]

In other words, the market value of each share will fall in response to the discount implicit in the exercise price relative to the market value at exercise. [1]

The warrant may never be exercised, in which case there will be no long-term cost to the entity or the shareholders. [1]

This question was done well by many candidates which was excellent. There were a few candidates who did not seem to understand what warrants are and just discussed bonds in a general manner.

Q18 The primary purpose of consolidated financial statements is to present the group as a single economic entity. [1]

The parent-subsidiary relationship is defined in terms of control and the parent's directors are understood to exercise control over the entire entity. [1]

The problem arising with foreign subsidiaries is host country legislation may make it difficult to exercise control in every respect. [1]

For example, it may be difficult to repatriate profits without incurring heavy tax charges and so the extent to which the parent company can manage, say, the total group bank balance may be called into doubt. [1]

In some cases, the synergies implied by the consolidated financial statements may not be viable. [1]

For example, two factories in different countries may have to operate independently because of distance and shipping costs and so there may be little scope for cost savings through economies of scale such as bulk ordering. [1]

This question was done badly with many candidates scoring only one or two marks. The main problem was lack of knowledge and a failure to answer what was asked. Many candidates turned this into a question on translating foreign currency and the possible risks associated with volatility in exchange rates, this was not what was asked..

Q19 (i) **Barlo plc**
Statement of Profit or Loss for the year ended 30 June 2017

	£000	
Revenue	47,896	0.5
Cost of Sales	(23,160)	
Gross profit	24,736	
Distribution Costs	(4,920)	
Administrative Expenses	(6,380)	
Operating profit	13,436	
Finance costs	(123)	0.5
Profit before tax	13,313	
Income Tax Expense	(2,600)	1
Profit for the year	10,713	

Barlo plc
Statement of Changes in Equity for the year ended 30 June 2017

	Share capital £000	*Share premium £000*	*Retained Earnings £000*	*Total £000*
Opening balance	4,500	1,200	3,418	9,118
Profit for the year			10,713	10,713
Dividends			(280)	(280)
Closing balance	4,500	1,200	13,851	19,551
	0.5	0.5	1	

Barlo plc
Statement of Financial Position as at 30 June 2017

	Notes	*£000*	
Non-current assets			
Property, plant and equipment	**1.**	17,300	1
Current Assets			
Inventory		1,950	0.5

Trade receivables	3,982	0.5
Bank	428	0.5
	6,360	
Total assets	23,660	

EQUITY AND LIABILITIES

Equity		
Called-up share capital	4,500	0.5
Share premium account	1,200	0.5
Retained earnings	13,851	
Total equity	19,551	
Non-current liabilities		
Loans	1,000	0.5
Current liabilities		
Trade payables	509	0.5
Tax	2,600	0.5
	3,109	
Total of equity and liabilities	23,660	

Notes

1. Property, plant and equipment

	Property *£000*	*Plant and equipment* *£000*	*Total* *£000*
Cost or valuation			
At 30 June 2017	9,000	19,600	28,600
Depreciation			
At 30 June 2016	4,270	2,600	6,870
Charge for year	180 (1)	4,250(1)	4,430
At 30 June 2017	4,450	6,850	11,300
Net book value			
At 30 June 2017	4,550	12,750	17,300
At 30 June 2016	4,730	17,000	21,730

Workings

Cost of sales

Opening inventory	1,700	0.5
Production expenses	4,800	0.5
Production materials	11,080	0.5
Wages paid to production staff	3,100	0.5
Depreciation – property	180	
Depreciation – plant and equipment	4,250	0.5
Closing inventory	(1,950)	0.5
	23,160	

Distribution

Marketing costs	2,457	0.5
Sales salaries	2,463	0.5
	4,920	

Admin

Administrative expenses	2,600	0.5
Directors' salaries	3,780	0.5
	6,380	

Max 15 marks

(ii) The starting point will be the reported profit according to the financial statements. [1]

That figure will then be adjusted in accordance with the rules set out in tax law. [1]

For example, there may be revenues and expenses that are not taxed or permitted as deductions for tax purposes. [1]

There may also be allowances that do not appear in the financial statements that must be deducted. [1]

For example, depreciation is not an expense for tax purposes, but capital allowances are granted instead. [1]

Making these adjustments leaves taxable profit, which must be multiplied by the appropriate rate, as set by government or tax authorities. [1]

This question was done exceptionally well by most candidates. The calculations and the set of financial statements were excellent and many candidates scored full marks. The written part was also done well.

Q20 (i) The lenders will be keen to avoid any loss in the event that Mountain is unable to keep up with payments. [1]

Setting an upper limit on gearing will automatically leave a buffer of assets that have been funded by the shareholders. [1]

In the event that the company defaults, those assets will provide a margin to protect the lenders' interests because the shareholders are not paid until all liabilities have been repaid. [1]

Setting an upper limit for gearing deters further borrowing, which prevents the existing lenders from having to share the company's assets in the event of a corporate failure. [1]

The directors will be keen to avoid getting too close to any upper limit in a debt covenant because it could lead them into technical default. [1]

For example, a series of operating losses or a loss on the revaluation of property could reduce equity while leaving debt unchanged. [1]

If that raises the gearing ratio beyond the upper limit then the lenders will have the right to foreclose on their loans and that may prove catastrophic. [1]

Gearing also makes the profit for the year more volatile because the cost of debt remains constant in the event of a downturn in operating profit. [1]

That may leave a much smaller profit after tax, with any fluctuations in revenue and operating costs leading to a disproportionate decrease in earnings attributable to the shareholders. [1]

(ii) It is debatable whether Mountain will be obliged to report this reduction in advance, although it may well be prudent do so in order to prevent an excessive reaction from the stock market. [1]

The danger of making an early announcement is that the shareholders may believe that the directors are preparing them to expect further "bad" news as the year unfolds. [1]

The share price may be depressed because of that inference and it could put the directors in a very weak position in dealing with the shareholders if they are viewed as acting defensively. [1]

On the other hand, if the directors announce the change of policy at the last minute then there could be a very negative reaction and the share price could fall significantly. [1]

If the directors announce in September then they will have more time to explain their reasoning and to enable the shareholders to get used to the idea. [1]

The planned expansion should, hopefully, have increased the share price and so shareholders who were counting on the usual dividend might appreciate the extra notice so that they can find an alternative source of cash, such as selling some of their shares. [1]

The longer period would also give the directors a longer opportunity to reverse their decision and find a way to maintain the dividend if the shareholders' response is unexpectedly violent. [1]

(iii) From a purely economic point of view, this is a highly illogical proposition. Raising equity by means of a rights issue, purely to permit equity to be paid out as a dividend seems rather contradictory. [1]

The rights issue will prove expensive once fees have been met and so there will be a significant net cost. [1]

The financial press may portray this as a rather desperate act by the board that implies a failure to understand the basics of financial management. [1]

If the rights issue is to proceed then the board could raise additional finance at very little additional cost in order to restore some balance between debt and equity or in order to provide a basis for further expansion. [1]

The fact that the board is prepared to take this extreme step would send a very clear message to the markets that Mountain's dividend will be maintained. [1]

That signal could prompt greater confidence in the company and so support the share price. [1]

Shareholders are attracted to companies with known and stable dividend policies because they assist them to plan their cash flows and also ensure that their investments are tax-efficient. [1]

Part (i) was mixed; some candidates did this well and others very badly.
Some candidates did not apply their knowledge very well to the question. Many candidates discussed lenders and covenants but few discussed the directors' position on gearing.

Part (ii) was not done very well and candidates did not seem to understand the effects of an announcement. Many candidates passed this part but few scored a high mark.
Part (iii) was done badly. Candidates gained marks by discussing rights issues but few could discuss the dividend issue. A number of candidates did not seem to realise that rights issues raised money and most did not see how the rights issue would be seen by the stock market.

END OF EXAMINERS' REPORT