

# INSTITUTE AND FACULTY OF ACTUARIES



## EXAMINATION

16 April 2018 (pm)

### **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. *You have 15 minutes of planning and reading time before the start of this examination. You may make separate notes or write on the exam paper but not in your answer booklet. Calculators are not to be used during the reading time. You will then have three hours to complete the paper.*
4. *Mark allocations are shown in brackets.*
5. *Attempt all 20 questions. Answers to questions 1–10 should be indicated on the Multiple Choice Answer Sheet included in your booklet. From question 11 onwards begin your answer to each question on a new page.*
6. *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 from the approved list.*

- 1** Which of the following best explains why the maximisation of shareholder wealth is said to be the primary objective for company directors?
- A It aligns the directors' interests with those of the shareholders.
  - B It eliminates agency problems.
  - C It maximises profit.
  - D It provides a measurable basis for evaluating decisions.
- [2]
- 2** One of a firm's major customers buys large quantities of goods on trade credit. The customer's payments have started to become erratic and are often slightly overdue. Which of the following would be the most appropriate response of the firm to this behaviour?
- A Cease all future credit sales.
  - B Initiate court action against the customer for immediate payment of all overdue balances.
  - C Limit future credit sales while overdue balances are outstanding.
  - D Seize all unpaid goods from the customer's premises.
- [2]
- 3** Which of the following would indicate that Albion is an associated company of Bromwich?
- A Bromwich can appoint two of Albion's seven board members.
  - B Bromwich can appoint four of Albion's seven board members.
  - C Bromwich can insist on having a non-voting observer attend Albion's board meetings.
  - D Bromwich can replace any of Albion's board members as and when it wishes.
- [2]

- 4** Which of the following is NOT a correct interpretation of the prudence concept?
- A An asset that cost \$400,000 was professionally revalued at \$500,000 and that valuation has been recognised in the financial statements.
  - B An asset that could be sold for between \$500,000 and \$800,000 has been valued at \$400,000 in the financial statements.
  - C An asset that could be sold for between \$500,000 and \$800,000 has been valued at \$600,000 in the financial statements.
  - D An intangible asset could be worth up to \$800,000, but the asset's value has not been recognised in the financial statements.
- [2]

- 5** An investor cannot afford to construct a properly diversified portfolio. Which of the following best describes the significance of the beta of potential investments to that investor?
- A Betas have no use whatsoever to this investor.
  - B Low beta investments will be a safer investment for this investor.
  - C The investor should focus on high beta stocks if she believes that the stock market will rise.
  - D The beta co-efficient remains just as relevant even when the investor cannot hold a diversified portfolio.
- [2]

- 6** A project has been evaluated at its required rate of return of 12% p.a. and has been found to have a net present value of zero. How should this finding be interpreted?
- A The project delivers an internal rate of return of 12% and so it should be accepted.
  - B The project should be re-evaluated at a lower rate in order to justify its acceptance.
  - C The project will reduce shareholder wealth and so it should be rejected.
  - D There is no point in investing in this project and so it should be rejected.
- [2]

- 7** Which of the following best reflects the significance of a company receiving an unmodified audit opinion?
- A The company is a good investment.
  - B The company's financial statements are accurate.
  - C The company's financial statements can be relied upon for stewardship purposes.
  - D The directors have not abused their position of trust.
- [2]

- 8** Which of the following is the most realistic interpretation of a company having a low asset utilisation ratio and a high profit margin?
- A The company is trading at a loss.
  - B The company's selling prices are high, possibly restricting sales activity.
  - C The company's selling prices are low, possibly encouraging sales activity.
  - D The company's selling prices are optimal.
- [2]

- 9** Which of the following best explains why intangible assets are excluded from the calculation of asset cover?
- A Intangible assets are generally worthless.
  - B Intangible assets are not owned by the company.
  - C Intangible assets cannot be transferred to the lender in the event of default.
  - D Intangible assets may be difficult to realise in the event of the company's failure.
- [2]

- 10** An investment project has been evaluated using Monte Carlo simulation. After running the simulation 2.5 million times, the results have stabilised and the expected net present value is positive and averages \$1 million, with a range of outcomes varying from minus \$200,000 to plus \$1.8 million. Which of the following statements best interprets these results?
- A The project satisfies the net present value criterion.
  - B The project should definitely proceed.
  - C This is a low risk project.
  - D The model should be run another 2.5 million times in order to be certain.
- [2]
- 11** Joan is an actuarial consultant who has operated as a sole trader for several years. She has decided to bring Frank, a colleague, into the business.
- Describe the advantages to Joan of a traditional partnership over a limited company for the business arrangement with Frank.
- [5]
- 12** Describe the usefulness of bank overdrafts in managing a company's working capital requirements.
- [5]
- 13** Describe why quoted companies are required to disclose their diluted earnings per share (EPS).
- [5]
- 14** Describe why users of financial statements should be careful not to place too much emphasis on accounting ratios.
- [5]
- 15** Explain why an investment opportunity could be rejected when evaluated using the shareholder value approach despite having a positive net present value (NPV).
- [5]
- 16** A long-established family company has grown to the point where it is about to seek a stock market quotation. The members of the founding family, who presently own 100% of the equity, are considering converting their own shares into a special class of shares so that they will control 51% of the votes, while retaining 30% of the equity post-quotation.
- Discuss the implications of creating this special class of shares.
- [5]
- 17** A listed company is planning a bond issue.
- Describe the implications of attaching warrants to the issue in return for a lower interest rate.
- [5]

- 18** A parent company has two subsidiary companies, both in distant foreign countries.

Explain the difficulties associated with interpreting this parent company's consolidated financial statements. [5]

- 19** The information provided below was obtained from the bookkeeping records of Barlo plc on 30 June 2017.

(i) Prepare Barlo plc's financial statements in a form suitable for publication:

- statement of profit or loss [9]
- statement of changes in equity [2]
- statement of financial position [4]

(ii) Describe the steps by which the estimated tax charge would have been determined. [5]

[Total 20]

**Barlo plc**

**Trial Balance as at 30 June 2017**

	£000	£000
Administrative expenses	2,600	
Cash at Bank	428	
Directors' salaries	3,780	
Dividends paid	280	
Loan interest	123	
Loans		1,000
Marketing costs	2,457	
Opening inventory	1,700	
Plant and equipment – accumulated depreciation		2,600
Plant and equipment – cost	19,600	
Production expenses	4,800	
Production materials	11,080	
Property – accumulated depreciation		4,270
Property – cost	9,000	
Retained earnings		3,418
Revenue		47,896
Sales salaries	2,463	
Share capital		4,500
Share premium		1,200
Trade payables		509
Trade receivables	3,982	
Wages paid to production staff	3,100	
	<u>65,393</u>	<u>65,393</u>

*Further information:*

- (1) Inventory was counted at 30 June 2017 and was valued at £1,950,000.
- (2) Property is to be depreciated at 2% of cost and plant and equipment is to be depreciated at 25% on the reducing balance basis.
- (3) Corporation tax of £2,600,000 is to be provided for the year.

- 20** Mountain plc is a quoted company with a year end of 31 December. The directors have traditionally published the financial statements in the second week of February following the year end and have always announced the dividend for the year alongside the publication of the financial statements.

Mountain plc's dividend has grown by between 3% and 5% each year for the past eight years.

During September 2016 the directors updated their projections of Mountain plc's financial position. They realised that it would probably not be prudent to increase the dividend compared to last year. Indeed, it may be desirable to reduce the dividend by 5% compared to that for the year ended 31 December 2015.

Mountain plc continues to be profitable. However, a large loan has been negotiated in order to fund expansion. If the market's expectations concerning the dividend for the year ended 31 December 2016 are met then the company's projected gearing ratio will be at the upper limits of the terms specified by the lender. The directors themselves would be uncomfortable with a gearing ratio that was that high.

The directors are debating the best way to address the question of the dividend. Three suggestions have been made:

- Announce the expected reduction in dividend immediately (i.e. in September 2016) with a clear explanation of the reasons.
  - Wait and announce the reduced dividend, again with an explanation of the reasons, at the publication of the financial statements (i.e. in February 2017).
  - Maintain the dividend growth, but organise a rights issue in order to ensure that there is sufficient equity to maintain the gearing ratio at an acceptable level.
- (i) Explain why both the lender and Mountain plc's directors would wish to set an upper limit for the company's gearing ratio. [8]
- (ii) Discuss the advantages and disadvantages of announcing the proposed reduction in the dividend in September 2016 or in February 2017. [6]
- (iii) Discuss the advantages and disadvantages of conducting a rights issue to raise equity in order to continue the trend of dividend growth. [6]
- [Total 20]

**END OF PAPER**