INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

4 October 2017 (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. *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 A company often evaluates projects by means of the receipts/costs ratio:

$$\frac{\text{Net present value (NPV) of the gross revenues}}{\text{Net present value (NPV) of the capital and running costs}}$$

Which of the following best explains the usefulness of this ratio?

A It is easy to identify positive and negative net present value (NPV) projects on the basis of this ratio.

B The capital and running costs have been committed and a ratio that is just over 1.00 may indicate that the potential benefits do not justify the risks.

C The ratio helps with the evaluation of projects that can be abandoned before completion.

D The ratio is easier to calculate than internal rate of return (IRR).

[2]

2 Which of the following best explains what would happen if a quoted company's directors accept a positive net present value (NPV) project that has a very high opportunity cost?

A The opportunity cost will only be a problem if the shareholders are informed of it.

B Shareholder wealth cannot be affected by opportunity costs.

C The shareholders will discover the opportunity cost with the passage of time.

D The shareholders will not care about the opportunity cost provided positive NPV projects are being accepted.

[2]

3 It has been suggested that the long term returns from investing in equities are higher than those for many other types of investment. What does this tell us about the cost of equity to the issuing companies?

A Equities are a relatively expensive source of finance.

B Equities are a relatively inexpensive source of finance.

C It tells us very little because there is no link between the cost of equity and the returns offered to shareholders.

D The cost of equity finance is excessive.

[2]

4 A company has bonds in issue, repayable in seven years, with a nominal value of $100m and a coupon rate of 8% p.a. The company's credit rating has been downgraded. Which of the following statements best reflects the implications of the revised credit rating for the company's cost of debt?

A The cash flows will be unaffected, so the cost of debt will remain the same.

B The market value of the bonds will decline and the cost of debt will increase.

C The market value of the bonds will increase and the cost of debt will decline.

D The credit rating will affect future issues only.

[2]

5 A new International Financial Reporting Standard (IFRS) has come into effect, requiring companies to change an important accounting policy.

Which of the following best explains the implications of the concept of consistency in this case?

A Consistency requires that the new IFRS be ignored in order to give a true and fair view.

B The audit report should carry an emphasis of matter paragraph to highlight the change in the accounting policy.

C The financial statements should show two versions of the figures, both with and without the changes arising from the new IFRS.

D The International Accounting Standards Board is responsible for addressing the issues relating to consistency.

[2]

6 A typical cash flow statement adds depreciation back to operating profit in order to arrive at cash generated from operations.

Which of the following explains the treatment of depreciation?

A Depreciation affects cash flow but not profit.

B Depreciation affects profit but not cash flow.

C Depreciation is a subjective estimate.

D Depreciation is not an operating expense.

[2]

7 Which of the following best explains the implications of the going concern concept in financial accounting?

A It is a fact that businesses tend to continue indefinitely.

B Incorrect valuations of property, plant and equipment can be tolerated.

C The figures will remain the same if the business faces closure.

D The financial statements will be comparable from period to period.

[2]

8 Who is responsible for the truth and fairness of a company's financial statements?

A the board of directors

B the chief accountant

C the external auditors

D the International Accounting Standards Board (IASB)

[2]

9 A project that is under consideration has a net present value of \$100m. This evaluation takes no account of the very unlikely possibility that a natural disaster will cause significant disruption and leave the company exposed to serious losses. It is impossible to insure against this disaster.

Which of the following is the most appropriate response to the threat posed by the disaster?

A Abandon the project.

B Attach a description of the risk to the project evaluation.

C Increase the discount rate to compensate for the additional risk.

D Subtract the expected value of the costs of the disaster from the \$100m net present value.

[2]

10 Which of the following best describes the circumstances in which an emphasis of matter paragraph will be included in the external auditor's report?

A The auditor wishes to draw attention to a specific statement elsewhere in the audit report.

B The financial statements contain a material uncertainty.

C The financial statements do not give a true and fair view.

D There is an immaterial irregularity in the financial statements.

[2]

11 Describe why many countries give individuals a personal allowance which effectively means that income up to that amount is not taxed. [5]

12 Describe the relevance of the non-controlling interest in a set of consolidated financial statements to the shareholders of the parent company. [5]

13 An actuarial consultancy has purchased a new computer system.

Explain the difficulties associated with determining the useful life of that asset for depreciation purposes. [5]

14 Describe why it is necessary for the International Accounting Standards Board (IASB) to identify the users of financial statements. [5]

15 Some major accountancy firms have converted themselves from traditional partnerships to limited liability partnerships (LLP).

Explain the potential advantages of doing so. [5]

16 Test the proposition that agency problems can be eliminated by paying company directors with a mixture of shares and salary. [5]

17 Describe why swaps are mutually beneficial to both parties. [5]

18 A quoted company's share price has remained constant for almost a year and the shareholders are becoming impatient because they wish to see the price rise. One of the company's directors has suggested that the company should consider making a one for ten scrip issue, citing evidence that the capital markets often infer that the dividend per share will remain the same after such an arrangement and so the total dividend to be paid will increase, thereby increasing the share price.

Explain the logic of the director's suggestion. [5]

19 The following figures have been extracted from the financial statements of Fratton, a manufacturing company.

Extracts from income statement for the year ended 31 August

	2015	**2016**	**2017**
	$000	*$000*	*$000*
Revenue	800	900	1,000
Purchases	480	513	520
Cost of sales	476	506	515

Extracts from statement of financial position for the year ended 31 August

	2015	**2016**	**2017**
	$000	*$000*	*$000*
Current assets			
Inventory	40	47	52
Trade receivables	67	86	105
Cash at Bank	16	8	2
	123	141	159
Current liabilities			
Trade payables	72	90	104
Tax	14	20	28
	86	110	132

The following liquidity ratios have been calculated for the first two sets of figures:

	2015	**2016**
Current ratio	1.4 :1	1.3 :1
Quick ratio	1.0 :1	0.9 :1
Inventory turnover	31 days	34 days
Trade receivables turnover	31 days	35 days
Trade payables turnover	55 days	64 days

(i) Calculate the liquidity ratios for 2017. [5]

(ii) Explain why it may be important to consider trends in liquidity ratios rather than the figures as at a single point in time. [4]

(iii) Discuss Fratton's liquidity. [6]

(iv) Explain Fratton's treatment of its trade payables. [5]

[Total 20]

20 Bowmax is a growing company in the hotel industry that has recently been listed on the stock market. When the company was privately owned, the directors could meet informally with the shareholders in order to establish their personal preferences for the company's financial strategy. Now there are many more shareholders and the shares trade freely on the open market.

The company's latest statement of financial position has been summarised as follows:

Bowmax
Summarised statement of financial position as at 31 August 2017

	$m
Property at valuation	180
Plant and equipment at cost less depreciation	17
Current assets	14
	211
Share capital	20
Revaluation reserve	40
Retained earnings	146
Current liabilities	5
	211

The profit for the year was $32m.

Bowmax's directors are debating the advantages and disadvantages of paying a significant large dividend, perhaps $25m. Other quoted companies in the industry tend to pay out a substantial proportion of their earnings.

A dividend of that size would require Bowmax to borrow cash. The board is considering issuing $30m of debentures.

(i) Discuss the relevance of similar companies' dividend policies in informing Bowmax's directors. [12]

(ii) Discuss the advantages to Bowmax of making the proposed debenture issue. [8]

[Total 20]

END OF PAPER