

# INSTITUTE AND FACULTY OF ACTUARIES



## EXAMINATION

5 April 2019 (pm)

### Subject CB1 – Business Finance Core Principles

*Time allowed: Three hours and fifteen minutes*

#### ***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 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.*
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 from the approved list.*

- 1** Which of the following statements best explains the role of the external auditor from an agency perspective?
- A The auditor enables the shareholders to rely on the financial statements prepared by the directors.
  - B The auditor ensures that the company is well managed.
  - C The auditor provides the directors with independent advice on accounting and financing matters.
  - D The shareholders can task the external auditor to examine particular areas of concern.
- [2]
- 2** Which of the following statements best describes the driver of the market price of a quoted company?
- A Expectations of future revenues.
  - B Expectations of future dividends.
  - C Historical trends of reported profits.
  - D Historical trends of dividend payments.
- [2]
- 3** Martin has just been admitted to a long established business partnership. He has bought 20% of the partnership equity, although he has not paid for this yet. He will be entitled to 15% of the partnership profit. If the firm incurs any liability, what proportion of that liability will be Martin's legal responsibility?
- A 0%
  - B 15%
  - C 20%
  - D 100%
- [2]
- 4** When does a bondholder receive the nominal value of a bond?
- A At the time of purchase.
  - B Annually.
  - C Whenever coupon payments are made.
  - D At maturity.
- [2]

- 5 Which of the following statements describes the agency problem?
- A Agents may feel that they cannot trust their principals.
  - B Agents may have insufficient authority to manage their principals' affairs.
  - C Principals may feel that they cannot trust their agents.
  - D Principals may not have the necessary expertise to manage their own businesses.
- [2]

- 6 Charlie is a 100% subsidiary of the Corpo Group. Corpo is a major quoted corporation. Charlie has serious cash flow problems and is struggling to meet its immediate liabilities. Which of the following statements is correct?
- A Corpo has no reason to support Charlie.
  - B Corpo is forbidden from supporting Charlie unless there is a contractual reason for doing so.
  - C Corpo is required by law to support Charlie and settle the liabilities.
  - D Corpo will make a commercial decision as to whether it will support Charlie.
- [2]

- 7 A parent company's only asset is an £8 million investment in a 60% subsidiary. The subsidiary's assets are valued at £25 million. What value will be attributed to group assets in the consolidated financial statements?
- A £8 million
  - B £15 million
  - C £25 million
  - D £33 million
- [2]

- 8 A newly formed company was funded by an equity injection, in which the shareholders purchased a total of 10,000 £1 fully-paid shares for £2.50 each. Which of the following figures will appear in the company's statement of financial position?

	<i>Share capital (£)</i>	<i>Share premium (£)</i>
A	10,000	15,000
B	10,000	25,000
C	25,000	0
D	25,000	15,000

[2]

- 9** Which of the following statements best describes the purpose of the depreciation charge?
- A The depreciation charge creates a reserve for the replacement of assets when they reach the end of their useful lives.
  - B The depreciation charge ensures that asset values remain realistic.
  - C The depreciation charge ensures that businesses obtain tax relief on the consumption of assets' values.
  - D The depreciation charge reflects the consumption of an asset's value during the period that benefits from that consumption.
- [2]

- 10** Which of the following statements is a valid interpretation of an unmodified external auditor's report?
- A The auditor has checked all transactions and balances and found everything to be in order.
  - B The auditor has material misgivings about the truth and fairness of the financial statements.
  - C The auditor is of the opinion that there are no material breaches of the applicable accounting reporting standards.
  - D The directors have properly discharged all of their duties with regard to the financial statements.
- [2]

- 11** Discuss the proposition that businesses should take account of social responsibility when conducting their operations. [5]
- 12** Describe whether preference shares should be treated as debt rather than equity when evaluating a company's gearing. [5]
- 13** Explain the implications of credit risk for entities which are considering entering into interest rate swaps. [5]
- 14** Explain why top-down budgeting might be a more effective basis than bottom-up for setting a consultancy firm's annual budget for consultancy staff travel and accommodation. [5]
- 15** The chief executive of a large actuarial consultancy has remarked that the head office stationery cupboard is heavily stocked with basic office supplies such as pens, pencils, paper clips and staples.
- Discuss the implications of introducing a formal inventory management system to reduce the value of the inventory held in the stationery cupboard. [5]
- 16** Discuss the proposition that the cash flow statement is a more suitable basis for understanding a business' performance than the statement of profit or loss. [5]
- 17** Discuss the implications of the fact that an actuarial consultancy's statement of financial position will typically make no reference to the value of staff. [5]
- 18** The development and implementation of International Financial Reporting Standards (IFRS) is sometimes a contentious and prolonged process.
- Describe the implications of this. [5]

- 19** Jill is the chief executive of Gearworks, a small company which manufactures components for the car industry. Gearworks is a member of a trade association. The latest issue of the trade association's journal contains an article that summarises the averages of the accounting ratios of 20 companies which are members of the trade association. The article includes the following table of accounting ratios:

	<i>Average</i>
Return on capital employed, excluding debt	26%
Return on capital employed, including debt	22%
Gross profit margin %	25%
Current ratio	2.1:1
Inventory turnover	42 days
Receivables turnover	50 days

The latest draft financial statements for Gearworks are summarised below:

### **Gearworks**

#### **Statement of profit or loss for the year ended 31 March 2019**

	<i>€000</i>
Revenue	1,200
Cost of sales	<u>(840)</u>
Gross profit	360
Administrative expenses	(22)
Distribution costs	<u>(14)</u>
Operating profit	324
Finance charges	<u>(54)</u>
Profit for the year	<u><u>270</u></u>

### **Gearworks**

#### **Statement of financial position as at 31 March 2019**

	<i>€000</i>
Non-current assets	1,800
<u>Current assets</u>	
Inventory	76
Trade receivables	150
Cash at bank	<u>11</u>
	<u>237</u>
Total assets	<u><u>2,037</u></u>
Share capital	500
Retained earnings	<u>862</u>
	1,362
<u>Non-current liabilities</u>	
Loans	600
<u>Current liabilities</u>	
Trade payables	<u>75</u>
Total equity and liabilities	<u><u>2,037</u></u>

- (i) Calculate each of the six ratios listed in the magazine article using Gearworks' financial statements. You can assume that Revenue consists of credit sales. [6]
- (ii) Comment on Gearworks' performance in comparison to the industrial averages. [9]

The draft financial statements provided above were prepared before the estimated tax charge for the year had been calculated.

- (iii) Explain how the inclusion of tax would have affected your understanding of Gearworks' performance. [5]
- [Total 20]

**20** Central is a major quoted company which manufactures highly specialised equipment for use in the mining industry. Central has very limited scope for expansion. It dominates the markets for its equipment and there is no real scope to develop sales in alternative markets. Central has been highly profitable and it has amassed significant retained earnings and has a large cash balance.

Central's board has sought advice about the most efficient use of that cash balance. Three main options are under consideration:

- The first possibility is that the cash might be retained for the foreseeable future, so that Central has the necessary funding in place if any new opportunities arise.
- Alternatively, the board could use the funds in order to diversify into a completely different line of business. Central's cash reserves are large enough to fund the creation of a significant business in another industry, such as leisure.
- Finally, Central could implement a share buyback under which Central would buy shares back using the surplus funds.

- (i) Discuss the implications of Central retaining the surplus cash in order to take advantage of any new opportunity which might arise. [6]
- (ii) Discuss the potential advantages and disadvantages of Central using the surplus funds in order to diversify. [7]
- (iii) Discuss the suitability of a share buyback to Central's circumstances. [7]
- [Total 20]

**END OF PAPER**