

INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

14 April 2022 (am)

Subject CB1 – Business Finance Core Principles

Time allowed: Three hours and twenty minutes

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

If you encounter any issues during the examination please contact the Assessment Team on
T. 0044 (0) 1865 268 873.

- 1** Which of the following is most likely to seek a microloan?
- A A charity that is attempting to raise the cost of a minibus to transport volunteers
 - B A qualified actuary who requires funding in order to rent an office and start a consultancy
 - C A subsidiary in a group of companies that requires finance to replace equipment
 - D An unemployed carpenter who wishes to buy basic tools in order to start a small business.
- [2]

- 2** Which of the following statements is true of an interest rate swap?
- A The need to use swaps implies poor financial management by the parties.
 - B The parties to the swap become responsible for one another's liabilities.
 - C The parties to the swap effectively make offsetting payments to one another for the swap's duration.
 - D There are no credit risks associated with swap arrangements.
- [2]

- 3** A quoted company is making a rights issue.
- Which of the following statements is correct?
- A Shareholders are required to exercise their rights.
 - B The new shares could be issued at a premium to the present market price.
 - C The new shares could be issued at a price that is less than their nominal value.
 - D The share price could increase after the issue.
- [2]

- 4** A company is obtaining a stock exchange quotation through an offer for sale by tender.
- Which of the following statements is correct?
- A All applicants will receive shares.
 - B All shares will be issued at the same price.
 - C Applicants making low tenders will depress the share price.
 - D The size of the issue will be decided after the tender process.
- [2]

5 A company offers an automatic dividend reinvestment plan.

Which of the following statements is true with regard to the shareholders who are enrolled in this plan?

- A No tax will be paid.
- B Shareholders will receive free shares.
- C The new shares will be acquired at a discount.
- D There is no benefit to the company.

[2]

6 The purpose of an ‘emphasis of matter’ paragraph in an external auditor’s report is to:

- A draw attention to a note to the financial statements.
- B explain a problem that arose during the audit.
- C highlight a major change to corporate strategy.
- D summarise the limitations of an external audit.

[2]

7 Which of the following reflects the accruals concept in the preparation of an insurer’s financial statements?

- A accounting for claim costs and premiums in the same period
- B determining costs based on pessimistic assumptions
- C excluding potential claims that cannot be measured objectively
- D recognising estimated costs of settling recent claims as expenses

[2]

8 A parent company owns a single subsidiary that was purchased for cash 10 years ago. Which of the following best explains the need to include the goodwill on acquisition of this subsidiary in the consolidated statement of financial position?

- A Goodwill always appears in the consolidated financial statements.
- B Shareholders need to be reminded of the value of loyal customers and similar intangibles.
- C The goodwill was paid for and must be included or the statement would not balance.
- D The shareholders would otherwise be misled because the group’s assets would otherwise be understated.

[2]

9 Which of the following best describes ‘other comprehensive income’?

- A dividends receivable
- B gains that are taken directly to reserves
- C income from financial assets
- D income from operations

[2]

- 10** Which of the following best describes the attitude that a company should have towards meeting its competitors' information needs when preparing its financial statements?
- A Competitors are legitimate users of financial statements.
 - B Competitors have no means of obtaining the financial statements, so their interest is irrelevant.
 - C Information that is of value to the shareholders is likely to be useful to competitors.
 - D Information that would assist the competitors should be withheld.
- [2]
- 11** Describe the challenges of identifying and evaluating the opportunity costs of an investment project. [5]
- 12** Outline the advantages of setting a standard hurdle rate of, for example, 15% p.a. for all investment projects undertaken by a large company. [5]
- 13** A film studio is about to start production of an action film. The film stars a major actor who wishes to perform their own stunts. The studio is concerned that the actor will be injured during filming.
- Outline, with reasons, a suitable approach to mitigating the risks associated with the actor performing stunts. [5]
- 14** Describe the implications of agency theory for the regulation of corporate governance. [5]
- 15** Outline why requiring large oil companies to publish sustainability reports will encourage them to behave in a manner that is socially responsible. [5]
- 16** A quoted company's board wishes to treat a large payment as an investment in an intangible asset, but the company's external auditor insists that the payment should be treated as an expense. The board's proposed treatment will result in a significantly higher reported profit and a stronger statement of financial position.
- Explain the governance mechanisms that are in place to ensure that the board cannot pressurise the external auditor into agreeing to a potentially misleading accounting treatment. [5]

- 17** An engineer has invented a new electric motor that can be fitted to bicycles. She believes that her invention has significant commercial potential because it will retail for \$600 per unit, which is substantially cheaper than existing products, all of which are technically inferior.

The engineer has a working prototype, but she cannot afford to launch it unless she can raise the \$400,000 that it will cost to have an initial batch of motors manufactured and to cover initial marketing.

Explain whether crowdfunding will be a suitable means for the engineer to raise the \$400,000 that she requires. [5]

- 18** The directors of an actuarial consultancy are working on next year's annual budget. The manager in charge of staff development has requested an increase in the staff training budget for next year.

Describe the challenges associated with determining an appropriate level of expenditure on the consultancy's staff training. [5]

- 19** A quoted manufacturing company has recently appointed a new Chief Executive Officer (CEO). It is close to the year end and the newly appointed CEO is working with the Finance Director on plans for the preparation of the company's annual financial statements.

The CEO has noted that the company's land and buildings have always been shown at cost less depreciation. The company owns a large plot of land that holds a factory that was built 15 years ago and an office block that was built 12 years ago. The land is shown in the financial statements at cost and the buildings are shown at cost less depreciation, with depreciation charged at 2% of cost each year.

The CEO believes that the land and buildings are worth far more than their depreciated cost and that the financial statements should use a revalued figure. They have asked the Finance Director to make the necessary arrangements with a professional valuer and also with the company's external auditor.

- (i) Describe the effects of the revaluation on the relevance and reliability of the company's financial statements. [7]
- (ii) Outline the effect of the revaluation on the company's return on capital employed ratio and its likely impact on the share price. [6]
- (iii) Explain why the external auditor should be consulted on the revaluation. [7]

[Total 20]

20 S is a major quoted transportation company that operates 2,500 Heavy Goods Vehicles (HGVs), delivering goods on behalf of several hundred customers, including manufacturers and supermarkets. In addition to 5,000 drivers, S employs 300 administrative staff, most of whom are based in the company's operations centre. The operations centre uses sophisticated computer software to track the navigation systems in S's HGVs, and to schedule collections and deliveries, to maximise operating efficiencies.

S's board is considering the acquisition of G, a competing quoted transportation company that operates 1,200 HGVs and employs 2,600 drivers and 170 administrative staff. G also has a computerised operations centre that tracks HGVs and schedules collections and deliveries. G's market capitalisation is currently roughly half that of S.

Confidential meetings have taken place with G's directors, who have agreed to support the bid. S will issue new shares worth 15% more than G's present market capitalisation and will exchange those for 100% of G's equity. S's board is confident that synergies will bring about a significant increase in the overall value of the merged group.

G's directors will step down after the merger, in return for a generous financial settlement. The merged group will be managed by S's existing board, whose remuneration will increase in line with the increase in the size of the merged entity.

- (i) Discuss the expectation by S's board that this merger will bring about significant synergies. [10]
 - (ii) Evaluate the proposal that G's directors should receive a generous financial settlement when they step down. [5]
 - (iii) Evaluate the proposal that S's directors should be paid more in recognition of the increase in the size of the merged entity. [5]
- [Total 20]

END OF PAPER