



Subject: Business Finance 1

Chapter: 5 (Unit 3)

Category: Practice Questions

1. Subject CT2 April 2010 Question 8 (updated)

S is a parent company that has two subsidiaries, T and U. During the year, S made sales of £1.0m, including sales of £0.2m to T.

T made sales of £2.0m, including sales of £0.3m to U. U made sales of £4.0m including sales of £0.6m to S. Which of the following is the correct figure for group sales according to the consolidated statement of profit or loss that will be prepared by S?

- A. £0.8m
- B. £1.0m
- C. £5.9m
- D. £7.0m

2. Subject CT2 April 2011 Question 9

Which of the following best describes the parent company / subsidiary company relationship?

- A. A subsidiary company is wholly owned by its parent.
- B. A subsidiary company is largely owned by its parent.
- C. A subsidiary company is influenced by its parent.
- D. A subsidiary company is controlled by its parent.

3. Subject CT2 April 2013 Question 8

Which of the following best describes the process of preparing consolidated financial statements for a group comprising a parent and an 80% subsidiary?

- A. Cancel all relationships between the group members and add the figures for assets and liabilities together.
- B. Cancel all relationships between the group members and add 80% of the subsidiary's assets and liabilities to the parent's.
- C. Cancel 80% of all relationships between the group members and add the remaining figures for assets and liabilities together.
- D. Cancel 20% of all relationships between the group members and add the remaining figures for assets and liabilities together.

4. Subject CT2 April 2014 Question 8

A parent company owns a 30% holding in an associate. The associate's profit for the year is £8m. The associate paid a dividend of £6m. How much income will appear in the parent's consolidated statement of profit or loss (or income statement) in respect of this associate?

- A. £1.8m
- B. £2.4m
- C. £6.0m
- D. £8.0m

5. Subject CT2 April 2015 Question 10

An 80% controlling interest was acquired in a subsidiary company when it had equity shares with a book value of £800,000 in issue and retained earnings of £600,000. The book value of the subsidiary's equity shares remains unchanged but retained earnings are now worth £900,000. What value should be attributed to the non-controlling interest in this subsidiary?

- A. £60,000
- B. £180,000
- C. £280,000
- D. £340,000

6. Subject CT2 April 2016 Question 10

Which of the following reflects the relationship between a parent and an associate company?

- A. The parent and the associate are linked through a joint venture.
- B. The parent and the associate trade with one another.
- C. The parent can control the associate.
- D. The parent can influence the management of the associate.

7. Subject CT2 April 2008 Question 1

A company has a high return on capital employed but a low gross profit percentage. Which of the following is the best interpretation of these results?

- A. The company is profitable because it prices its sales aggressively.
- B. The company should increase its selling prices.
- C. The company is unprofitable despite a high return on capital employed.
- D. Gross profit is a very straightforward measure, so the company should disregard the return on capital employed.

8. Subject CT2 April 2008 Question 2

A company has a high price earnings (PIE) ratio. Which of the following is the most likely explanation for this?

- A. The current share price is too high.
- B. The current share price is too low.
- C. If the directors could increase reported earnings then the share price would be even higher.
- D. The stock market is confident in the company.

9. Subject CT2 September 2008 Question 1

Which of the following best explains why an excessively high current ratio is undesirable?

- A. The business might run out of cash.
- B. Too much cash will encourage overspending.
- C. There is a cost associated with holding assets that do not generate a return.
- D. Too much working capital will lead to calls for higher dividends.

10. Subject CT2 September 2008 Question 10

A company has 5m ordinary shares in existence and 2m 7% convertible preference shares. Both categories of shares have a par value of 25p. The convertible shares can be exchanged for ordinary shares on a 1-for-1 basis. The company's net profit was £800,000.

What is the company's diluted earnings per share?

- A. 10.9p
- B. 11.4p
- C. 15.3p
- D. 16.0p

11. Subject CT2 April 2009 Question 6 (updated)

Which of the following is NOT a potentially valid interpretation of the fact that the payables turnover period based on figures from a company's annual report is very rapid?

- A. The company wishes to maintain an excellent relationship with its suppliers.
- B. There are limitations in the relevance of the figures in the annual report.
- C. The company is having difficulty in obtaining trade credit.
- D. The company has no liquidity problems.

12. Subject CT2 April 2012 Question 9

Which of the following best explains why investment analysts often calculate Earnings before Interest, Taxation, Depreciation and Amortisation (EBITDA)?

- A. EBITDA is less prone to fluctuations and volatility than net profit.
- B. Depreciation and amortisation are not real costs to the business.
- C. Investment analysts are only interested in performance before tax.
- D. EBITDA is regarded as less prone to manipulation than net profit.

13. Subject CT2 April 2012 Question 10

Net asset value per share is calculated by subtracting intangible assets from ordinary shareholders' equity and dividing the remainder by the number of shares in issue. Which of the following best explains the relevance of net asset value per share?

- A. In the event that the entity is wound up the chances are that its intangible assets will not have any market value, but the shareholders will be certain to receive the value of the remaining net assets after disposal.
- B. In the event that the entity is wound up the net asset value per share is likely to represent the best possible outcome that the shareholders can expect.
- C. The shareholders should monitor the net asset value per share and should insist that the entity be wound up in the event that net asset value per share exceeds the market value of the company's shares.
- D. Net asset value per share is likely to correspond to the value that an unquoted company's shares would have on the open market.

14. Subject CT2 October 2012 Question 8

A company had cash sales of £60 million and credit sales of £150 million during its most recent financial year.

The company had trade receivables of £40 million and £5 million of sundry receivables for rental income and similar balances at the year end.

How long is the trade receivables turnover period?

- A. 70 days
- B. 78 days
- C. 97 days
- D. 110 days

15. Subject CT2 October 2012 Question 9

Which of the following best summarises the relevance of the income (interest) cover ratio?

- A. provides shareholders with an important insight into the risks associated with their investment, but is relatively unimportant to lenders
- B. provides no useful information to either shareholders or lenders
- C. provides lenders with an insight into the short-term risks associated with their loans, but is relatively unimportant to shareholders
- D. provides lenders with an insight into the short-term risks associated with their loans and is important to shareholders

16. Subject CT2 September 2013 Question 5

Use the following information to calculate return on capital employed.

Profit before interest and tax	£40m
Interest	£8m
Ordinary shares	£110m
Retained earnings	£300m
Revaluation reserve	£22m
Long term borrowings	£90m

- A. 6.1%
- B. 6.4%
- C. 7.7%
- D. 8.0%

17. Subject CT2 September 2016 Question 10

Which of the following is most likely to occur when a company's trade receivables turnover period, in days, has reduced?

- A. A decrease in trade receivables and a decrease in cash.
- B. A decrease in trade receivables and an increase in cash.
- C. An increase in trade receivables and a decrease in cash.
- D. An increase in trade receivables and an increase in cash.

18. Subject CT2 April 2017 Question 6

A company's diluted earnings per share is significantly lower than its basic earnings per share. How should that be interpreted?

- A. Heavy losses are expected.
- B. The company has a large number of warrants in issue.
- C. The company is a poor investment.
- D. There is an active market in traded options on the company's shares.

19. Subject CT2 April 2017 Question 8

A company has a low profit margin but a high return on capital employed when compared to its main competitors. Which of the following interpretations is most likely to explain this combination?

- A. The company's selling prices are at an optimal level.
- B. The company's selling prices are at an optimal level, but the company is spending too much on other operating activities.
- C. The company's selling prices are too high.
- D. The company's selling prices are too low.

20. Subject CT2 April 2017 Question 10

A company's operating profit is €2 million. Its finance charges were €0.5 million. Shareholder equity is €20 million and long term borrowings are €6 million. What is the company's return on capital employed?

- A. 5.8%
- B. 7.7%
- C. 9.6%
- D. 10.0%

21. Subject CT2 April 2008 Question 18 (updated)

- (a) Explain what is meant by the term "subsidiary company".
- (b) Explain why a parent is required to prepare a set of consolidated financial statements for its shareholders.

22. Subject CT2 October 2011 Question 15

- (a) Explain what is meant by the term "associate company".
- (b) Explain how associates are treated on consolidation.

23. Subject CT2 October 2011 Question 18 (updated)

Describe the process by which a parent will construct a set of consolidated financial statements.

24. Subject CT2 September 2013 Question 18

Alpha is reviewing bids for the construction of a major civil engineering project. One of the shortlisted bidders is Global (Midlands) PLC ("Global"). Alpha is concerned that Global may not have the necessary financial resources to complete this project and has asked for reassurance. Global's response is that the company is part of the Mega Group, whose parent company is quoted and is based in Alpha's home country. Global has submitted the Mega Group's latest consolidated financial statements to demonstrate the solvency of the group. Discuss the extent to which Alpha should rely on the Mega Group's consolidated financial statements in determining Global's ability to service this contract.

25. Subject CT2 September 2016 Question 12

A potential customer asserts that it is safe for a company to grant it trade credit because the customer is a wholly-owned subsidiary of a major group of companies.

Discuss the validity of the customer's claim.

26. Subject CT2 April 2008 Question 17

Explain why shareholders might be worried because a quoted company's diluted earnings per share is significantly lower than its basic earnings per share

27. Subject CT2 October 2011 Question 16

Discuss the reasons for requiring quoted companies to publish their diluted earnings per share (EPS) in addition to their basic EPS.

28. Discuss the potential risks and benefits associated with having very rapid receivables and inventory turnover ratios.

29. Subject CT2 September 2015 Question 18

Discuss the proposition that none of a company's profitability ratios matter provided the return on capital employed ratio is satisfactory.

30. Subject CT2 April 2016 Question 14

Suggest possible reasons why acceptable gearing ratios often vary between countries.

31. Subject CT2 September 2016 Question 13

Describe the advantages and disadvantages of comparing the profitability of two competing companies in terms of their earnings before interest, taxation, depreciation and amortisation (EBITDA) rather than their profit for the year.

32. Subject CT2 September 2016 Question 18

Derek has a substantial shareholding in a quoted company. The company issued its latest financial statements recently.

There is a significant difference between the basic and the diluted earnings per share (EPS) figures.

Explain which EPS figure is more likely to be of interest to Derek.

33. Subject CT2 September 2008 Question 13

Explain why the interpretation of a company's accounting ratios requires some understanding of the nature of the business and the industry in which it operates.

34. Subject CT2 October 2012 Question 19

Dayton is a manufacturing company that is planning to expand by acquiring a business that operates in a complementary area. Dayton has identified two potential acquisitions, Echo and Foxton, that both appear to be suitable for consideration. Dayton will acquire only one company.

The following financial indicators have been gathered in order to assist with the decision:

	Dayton	Echo	Foxton
Revenue	£500m	£250m	£140m
Return on capital employed	18%	14%	11%
Profit margin	26%	22%	33%
Gearing	52%	44%	28%
Price/Earnings ratio	12.3	16.2	14.1

- i. Discuss the impact that the acquisition of each entity would have on Dayton's financial indicators.
- ii. Discuss the suitability of a typical set of published financial statements for the purpose of deciding a price for a controlling interest in a target company.
A subsequent analysis of the two potential target companies indicates that the purchase of Echo will lead to the recognition of a much larger amount for goodwill on consolidation than the purchase of Foxton.
- iii. Explain the significance of this difference between the goodwill figures.

35. Subject CT2 April 2015 Question 19

The directors of Vapor receive a set of financial statements every month for discussion at their regular board meetings.

The report for the month of February has just been prepared, along with comparative figures for the month of January.

(All figures in £000s)

Profit or loss statements for the month of:

	February	January
Revenue	900	700
Cost of goods sold	(368)	(175)
	532	525
Operating costs	(240)	(250)
Profit for the month	292	275

Statements of financial position at the end of:

Property, plant and equipment	1,898	1,500
Current assets		
Inventory	32	220
Trade receivables	1,010	720
Cash	12	
	1,042	952
	2,940	2,452

Equity		
Share capital	1,000	1,000
Retained earnings	1,384	1,092
	2,384	2,092
Current liabilities		
Cash	371	
Trade payables	185	360
	556	360
	2,940	2,452

During February, Vapor paid £400,000 for an item of equipment. The payment was funded using a bank overdraft as a temporary measure. Vapor will take out a £400,000 long-term loan in May.

February's revenue includes a £200,000 sale to a registered charity at cost price. Apart from supporting the charity's work, this sale generated some valuable publicity for the company.

Vapor's directors receive a short table of accounting ratios to accompany their monthly financial statements. The production director has suggested that this table should be extended to include the figure for return on capital employed. The finance director has replied that the return on capital employed ratio should not be calculated on a monthly basis, but should be monitored annually.

- i. Calculate the following ratios for January and February, making appropriate adjustments to the figures in respect of the information provided concerning the purchase of the new equipment and the sale to the charity:

- gross profit margin
- current ratio
- trade receivables turnover in days
- trade payables turnover in days.

- ii. Explain the reasons for the adjustments that you made in part (i) in respect of the information provided concerning the purchase of the new equipment and the sale to the charity.
- iii. Discuss the finance director's argument that the return on capital employed ratio should be reviewed annually, but not monthly.

36. Subject CT2 September 2013 Question 19 (part)

Paul has developed and patented a new product. He requires finance in order to put the product into production. A venture capital company has offered to finance Paul on the basis that Paul will incorporate his business as a limited company. The venture capitalist will provide all of the funding necessary to commence the manufacture and sale of the new product in return for 51% of the equity in this new company. The venture capitalist will appoint a board member and Paul will also be a director of the company. Paul will sign a five year employment contract with the company.

Paul's role with the company will be to work on improvements to the original product and to develop new products for sale by the company. In addition to working full-time as an employee, he must patent any new ideas in the company's name.

The company will be independently valued at the end of its first five years. The venture capitalist will then offer Paul the opportunity to buy its 51% holding for that proportion of the independent valuation plus 20%. If Paul does not take that offer then the venture capital company will retain its shareholding and the question of Paul's contract will be reviewed by both sides.

- i. Discuss the difficulties associated with the valuation of the company's shares at the end of year five.
- ii. Recommend the approach that should be taken to valuing the company at the end of year five.



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