
Answers

Section A

1 A The conversion value is lower than the face value of loan stock. There is normally an assumption that the value of the company's shares will increase over time. Convertible loan stock has a lower coupon rate than non-convertible loan stock. Investors are normally willing to accept a lower rate of interest for the potential to benefit from a rise in the company's share price.

	£
Original share (3 x £8.00)	24.00
Rights share (£8.00 x 0.60)	4.80
	28.80
Ex-rights price (£28.80/4)	7.20
Cost of acquiring rights share	4.80
	2.40
Value of rights per original share (2.40/3)	0.80

Option A is value of rights £2.40 divided by number of shares after rights issue (4) = £0.60.
 Option C is the ex-rights price (£7.20) divided by the number of shares after rights issue (4) = £1.80.
 Option D is the total value of the rights £2.40.

3 A Current assets (£30m/5) = £6m
 Current liabilities = £6m/2 = £3m
 Quick assets = 1.5 x £3m = £4.5m
 Stocks = £6m – £4.5m = £1.5m

Option B takes the stock as the difference between the current assets and current liabilities £6m – £3m = £3m.
 Option C takes the stock as equal to the quick assets (£4.5m).
 Option D adds the current assets to the quick assets to derive the stock figure (£6.0m + £4.5m) = £10.5m.

4 B The operating cash cycle is average stock turnover period + average debt collection period – average creditor payment period.

5 B Share price = £320m/80m = £4.00
 Dividend per share = {[(£32m x 1.25) x 0.4]/80m} = £0.20
 Expected return = (20/400) x 100 = 5.0%

Option A uses the current year profits and dividends.

Share price = £320m/80m = £4.00
 Dividend per share = (£32m x 0.4)/80m = £0.16
 Expected return = (16/400) x 100 = 4.0%

Option C calculates the dividend using pre-tax profits:

Dividend per share = {[(£48m x 1.25) x 0.4]/80m} = £0.30
 Expected return = (30/400) x 100 = 7.5%

Option D uses the par value of the shares in the calculations:
 = (20/50) x 100 = 40.0%

6 D Items 3 and 4 are correct. A bonus issue does not result in cash being raised by the company. A placing involves an issue to selected investors and not to the public.

	Leo	Taurus	Pisces
(a) Total present value	560	370	330
(b) Initial outlay	450	285	240
(c) Profitability index (a)/(b)	1.24	1.30	1.38
Ranking	3	2	1

	£
Cost of warrant	1.00
Exercise price	4.00
	<hr/>
	5.00
Less conversion premium	0.80
	<hr/>
Share price	4.20

Option A deducts the cost of the warrant from the exercise price

	£
Exercise price	4.00
Less cost of warrant	1.00
	<hr/>
	3.00
Less conversion premium	0.80
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Share price	2.20

Option B deducts the cost of the warrant from the exercise price and adds the conversion premium

	£
Exercise price	4.00
Less cost of warrant	1.00
	<hr/>
	3.00
Add conversion premium	0.80
	<hr/>
Share price	3.80

Option D adds the conversion premium

	£
Cost of warrant	1.00
Exercise price	4.00
	<hr/>
	5.00
Add conversion premium	0.80
	<hr/>
Share price	5.80

9 A $EOQ = \sqrt{(2 \times 40 \times 30,000)/0.6} = 2,000$ units
 Total cost = $\{[(30,000/2,000) \times £40] + [(2,000/2) \times £0.6]\} = \underline{£1,200}$

Option B does not take an average when deriving the stockholding cost

Total cost = $\{[(30,000/2,000) \times £40] + [2,000 \times £0.6]\} = \underline{£1,800}$

Option C uses an incorrect EOQ formula

$[\sqrt{(2 \times 0.6 \times 30,000)/40}] = 30$ units

Total cost = $\{[(30,000/30) \times £40] + [(2,000/2) \times £0.6]\} = \underline{£40,600}$

Option D uses an incorrect EOQ formula and does not take an average of the stockholding cost

$\sqrt{(2 \times 0.6 \times 30,000)/40} = 30$ units

Total cost = $\{[(30,000/30) \times £40] + [(2,000 \times £0.6)]\} = \underline{£41,200}$

10 A The first two statements are correct. Statements 3 and 4 are incorrect. The discount rate reflects the cost of capital which represents the minimum required returns from investors. The payback method takes account of all relevant cash flows when calculating the payback period.

11 C An interest rate cap is a series of borrowers' options on a notional loan. An American-style option may be exercised before the expiry date.

12 C The effective interest rate is made up as follows:

	%
Interest paid (4.0 + 0.8)	4.8
Net premium paid (0.6 – 0.4)	0.2
Cash settlement (4.3 – 4.0)	0.3
	<u>5.3</u>

Option A deducts the cash settlement.

	%
Interest paid (4.0 + 0.8)	4.8
Net premium paid (0.6 – 0.4)	0.2
Cash settlement (4.0 – 4.3)	(0.3)
	<u>4.7</u>

Option B ignores the cash settlement.

	%
Interest paid (4.0 + 0.8)	4.8
Net premium paid (0.6 – 0.4)	0.2
	<u>5.0</u>

Option D takes the cash settlement as the difference between the actual interest rate and the LIBOR floor.

	%
Interest paid (4.0 + 0.8)	4.8
Net premium paid (0.6 – 0.4)	0.2
Cash settlement (4.8 – 4.0)	0.8
	<u>5.8</u>

13 A Both statements are correct.

14 D As the level of capital gearing increases from zero, increases will occur in the value of the business and the cost of equity. The cost of loan capital will remain unchanged (until high levels of gearing) and the weighted average cost of capital will decrease.

15 B Using CAPM, the expected return for the equity shareholders is: $5\% + [1.4(12\% - 5\%)] = 14.8\%$

The predicted market value of a share is:

$$P_0 = D_1 / K_0$$

Where:

P_0 = the value of an ordinary share

D_1 = the dividend received at the end of period 1

K_0 = the required rate of return on the share

$$= \frac{50p}{0.148}$$

$$= \underline{\underline{\pounds 3.38}}$$

Option A multiplies the beta by the current market rate of return to obtain the expected return. $1.4 \times 12.0\% = 16.8\%$

The predicted market value of the share is:

$$= \frac{50p}{0.168}$$

$$= \underline{\underline{\pounds 2.98}}$$

Option C uses the market rate of return in the dividend formula

The predicted market value of the share is:

$$= \frac{\pounds 0.50}{0.12}$$

$$= \underline{\underline{\pounds 4.17}}$$

Option D multiplies the beta by the difference between the returns to the market and the risk-free rate [$1.4(12\% - 5\%) = 9.8\%$]

The predicted market value of the share is:

$$= \frac{50p}{0.098}$$

$$= \underline{\underline{\pounds 5.10}}$$

- 16 D** As the sale is invoiced in euros, there will be no gain or loss for the Spanish importer. However, the US exporter will suffer a loss as a strengthening US\$ will mean that fewer \$s will be received in exchange for the euros.
- 17 A** The US company needs to buy £s to make the payment. It should therefore buy sterling futures now and then close its position in three months' time by selling sterling futures. The US company needs to buy £s to pay the supplier and so a sterling call option is required.
- 18 D** Both statements are incorrect. Non-executive directors should comprise at least half of the board of large companies (excluding the chairman) and should comprise the whole membership of the audit committee.
- 19 A** Both statements are true. Insurance is most appropriate where there is a high severity and low frequency of loss. Self-insurance is appropriate where there is a low severity of loss and high frequency of loss.
- 20 D** Beta should be rejected as it offers higher risk than Alpha for a lower return. Delta should be rejected as it offers a lower return than Alpha for the same level of risk.

Section B

- 1 (a) The sales for the new devices will be as follows:

	Year 1	Year 2	Year 3	Year 4
Sales (000's units)	450	650	300	200
Selling price	£35	£35	£30	£25
Total sales (£000's)	15,750	22,750	9,000	5,000

Option (i) The incremental cash flows will be as follows:

	Year 0 £000's	Year 1 £000's	Year 2 £000's	Year 3 £000's	Year 4 £000's
Total sales		15,750	22,750	9,000	5,000
Plant	(8,500)				2,000
Working capital	(1,200)				1,200
Variable costs		(2,700)	(3,900)	(1,800)	(1,200)
Fixed costs		(6,100)	(6,100)	(6,100)	(6,100)
Cash flows	(9,700)	6,950	12,750	1,100	900
Discount rate 12%	1.00	0.89	0.80	0.71	0.64
Present value	(9,700)	6,185	10,200	781	576
NPV		8,042			

Option (ii) The incremental cash flows will be as follows:

	Year 0 £000's	Year 1 £000's	Year 2 £000's	Year 3 £000's	Year 4 £000's	Year 5 £000's
Total sales		18,900	27,300	10,800	6,000	
Loan	(3,000)			3,000		
Payments to supplier			(16,200)	(23,400)	(10,800)	(7,200)
Fixed costs		(2,800)	(2,800)	(2,800)	(2,800)	
Cash flows	(3,000)	16,100	8,300	(12,400)	(7,600)	(7,200)
Discount rate 12%	1.00	0.89	0.80	0.71	0.64	0.57
Present value	(3,000)	14,329	6,640	(8,804)	(4,864)	(4,104)
NPV		197.0				

Option (iii) NPV = £7.5 million

- (b) The calculations show that option (i) provides the highest NPV and, therefore, provides the greatest benefit to shareholders. However, there is not a large difference between the NPVs of options (i) and (iii). A careful review of the underlying estimates and assumptions relating to option (i) should be carried out before a final decision is made.

Option (i) assumes that the business has, or can quickly acquire, the expertise to produce the new devices. As the company is a medical research business, there may be difficulties setting up a manufacturing operation that have not been fully taken into account. In addition, the proposed move into manufacturing may not fit with the strategic objectives of the company.

Option (ii) avoids the problems just mentioned but relies on a supplier producing the devices at the required time and to the required standard. Furthermore, the NPV from this option is very low compared to the other options available. This is because the cost of purchasing the devices from the supplier is high and in the fourth year, is higher than their selling price.

Option (iii) provides a sum that is certain and so avoids the risk that future sales and costs will be worse than expected, although there may be a risk that the sale of the patent will damage the future prospects of Caerus plc. However, the upside potential of sales being greater than forecast is lost.

Subject to a review of the forecast information, option (i) appears to be the best choice.

(Examiner's note: Other answers to this part may have been acceptable.)

- 2 (a) A company may 'spin-off' part of its business operations for a variety of reasons. These include:

Market sentiment Where a business is a conglomerate, investors may lack confidence in the ability of the directors to manage efficiently a diverse range of operations and this may be reflected in the share price. By 'spinning-off' certain business operations, the managers of these operations will usually have greater autonomy and this can lead to improved performance. Any improvement in performance should, in turn, lead to enhanced shareholder value.

Market valuations The directors of a company may feel that a particular business operation is undervalued by the market. A 'spin-off' of this operation may help the market to value it separately, which may again lead to enhanced shareholder value.

Investor preferences Where a company is a conglomerate, investors may not be equally attracted to each of the different business operations that are being undertaken. By 'spinning-off' different business operations and creating separate companies for each, investors can adjust their share portfolios to reflect the investment that they wish to make in each type of operation.

Strategic objectives The directors of a company may feel that certain operations are not compatible with the strategic direction that has been set. As a result, 'non-core' operations may be 'spun-off'.

Takeover defence A company may attract the unwelcome attention of a predator which is interested in a particular part of the company's operations. By 'spinning-off' this part of its operations, the company may avoid the threat of a takeover, although the operations that have been 'spun-off' may still be under threat of a takeover.

(b) Where a company 'spins-off' part of its operations there will be a reduction in its overall size, which may bring with it a number of disadvantages including:

- An increased vulnerability to takeover
- A reduced ability to raise loan finance
- A reduced ability to benefit from economies of scale through bulk buying, common administrative functions etc
- A reduction in market status

(c) Value of one share in Hecate plc before the 'spin-off' $[(£300m \times 11.4)/400m]$ = £8.55
 Value of shareholding (10,000 x £8.55) = £85,500

Value of one share in Hecate plc after the 'spin-off' $[(£260m \times 11.0)/400m]$ = £7.15
 Value of shareholding (10,000 x £7.15) = £71,500

Value of shareholding in Elpis plc assuming a P/E ratio of 17 times

Value of one share in Elpis plc $[(£40m \times 17)/64]$ = £10.625
 Value of shareholding in Elpis plc $[(10,000/8) \times £10.625]$ = £13,281

Thus, the total wealth of the shareholder will be £84,781 (i.e. £71,500 + £13,281) compared to £85,500 before the 'spin-off'.

Value of shareholding in Elpis plc assuming a P/E ratio of 18 times

Value of one share in Elpis plc $[(£40m \times 18)/64]$ = £11.25
 Value of shareholding in Elpis plc $[(10,000/8) \times £11.25]$ = £14,062

Under this scenario, the total wealth of the shareholder will be £85,562 (i.e. £71,500 + £14,062) compared to £85,500 before the 'spin-off'.

The above calculations reveal that the benefits to the shareholder of the 'spin-off' are, at best, marginal and that there is a risk that shareholder wealth will be reduced. The case for a 'spin-off' is, therefore, not clear.

3 (a) The term 'efficient' in the context of stock markets refers to the way in which information is processed by investors. A stock market is regarded as being efficient where relevant information is absorbed quickly and accurately by investors and where this information is faithfully reflected in share prices. The fact that new information is processed quickly and accurately means that, in an efficient market, it is not possible for an investor to make abnormal gains over the long term by swiftly responding to new information. It also means that there is no prospect of speculative bubbles as share prices will always faithfully reflect the information available.

Three levels of market efficiency have been identified. These are the weak form, the semi-strong form and the strong form. Each of these forms is considered below.

Weak form

Weak-form efficiency is said to occur when current share prices reflect all relevant published information relating to the past share price and trading performance. New information relating to companies, however, is not anticipated by the market. As new information concerning companies will arise on a random basis, and will not be anticipated by the market, changes in share prices will occur on a random basis. This means that it is not possible for investors to make abnormal gains over the long term by trying to detect trends or patterns in share prices.

Semi-strong form

Semi-strong form efficiency is said to occur when share prices quickly and accurately reflect all publicly available information. This will include information relating to future prospects as well as past performance and may include news relating specifically to the company (such as the published annual reports, takeover speculation, boardroom changes etc), news relating to the industry within which the company operates (such as changing levels of demand, competitive pressures etc), and news relating to the economy as a whole (such as interest rate changes, inflation etc). Where a semi-strong level of efficiency exists, investors will be unable to make abnormal gains on a consistent basis by studying 'fundamentals' such as company news, reported profits, industry reports and future prospects because this information is already incorporated in share prices.

Strong form

Where strong-form efficiency exists, share prices will reflect all information, whether publicly available or not, that is relevant to deriving the 'true value' of a share. This means that it is not possible for investors to make abnormal gains even if they have access to inside information. The stock market is considered to be a 'fair game', insofar that no investor has an information advantage over others.

- (b) Financial analysts and investment managers play a key role in ensuring stock markets are efficient. They provide information about listed companies to investors, which should help in ensuring that share prices reflect their 'true value'. In addition to disseminating information to others, they are constantly examining share prices in the hope of finding shares that are inefficiently priced. Where the price of a share in a listed company is below its 'true value', there is an incentive to buy the shares, assuming that the 'true value' will eventually be recognised by the market. The effect of buying the shares will be to eliminate the price inefficiency and so bring the share price into line with the 'true value'.

It is often claimed that an efficient market reflects a paradox. The search for inefficiently priced shares by financial analysts, investment managers and others is based on a belief that the market is inefficient. This search, however, eliminates any price inefficiencies that may exist and thereby helps to create an efficient market.

- (c) Although it is widely accepted that stock markets are efficient, there is a growing body of evidence to suggest that inefficiencies exist. Research has revealed certain predictable features concerning share price movements, which should not exist if the markets are efficient. These features include:

Investment timing A number of studies have shown that abnormal returns may be achieved by timing share trading transactions appropriately. For example, it has been shown that there are above-average falls in share prices on Mondays. One possible reason for this phenomenon is that investors review their portfolios over the weekend and then sell unwanted shares when the market opens on Monday. Other studies have shown timing share trading transactions at particular points within a day may also lead to abnormal returns.

Size effects Studies have shown that, other things being equal, small companies tend to produce higher returns than large companies.

P/E ratios Although P/E ratios are used as indicators of the growth potential of shares, studies have shown that, over time, shares of companies with low P/E ratios outperform shares of companies with high P/E ratios.

In addition to these regular features that exist within stock markets, it has been suggested that stock markets suffer from 'speculative bubbles' from time to time. Share price bubbles occur as a result of investors chasing a rising trend in share prices in the belief that prices will continue to rise in the future. The existence of bubbles imply that investors do not always act in a rational way and, for a time at least, ignore 'fundamentals' such as future cash flows, profits and growth potential. At a certain point, however, investors will recognise that the rise in share prices must end and will sell their shares. Thus, the bubble will burst, perhaps as a result of bad news becoming available, and share prices will rapidly fall. Many believe that stock market crashes, which occur from time to time, can be explained in this way.

Although it may be the case that stock markets are not as efficient as was once widely believed, this does not necessarily mean that the inefficiencies identified, seriously undermine the idea of market efficiency. The weight of evidence available still suggests that share prices tend to react quickly and rapidly to new information becoming available. Thus, the directors of Triton Holdings plc should be wary. If it is clear that market inefficiencies exist, they should be prepared to exploit the opportunities that this provides. However, it may be dangerous and costly simply to assume that the market is inefficient.

(Examiner's note: Other answers to this part of the question may have been acceptable.)

Section C

- 4 (a) There are various factors that should be considered when seeking to implement risk management processes within a company. These include:

Initial planning The scope of the processes to be implemented and a feasible time period for implementation must be clearly determined at the outset. In addition, key stages in the implementation process should also be identified and the availability of appropriate resources must be confirmed to ensure that the implementation process is successfully carried out.

Senior management support When implementing any major process of change within a company, it is vital that the senior managers demonstrate their commitment to the process. Whilst the chief risk officer may be most heavily involved in implementing the new processes, other senior managers should also be encouraged to contribute. It is important that employees recognise that the implementation process has the full support of top management.

Employee support Successful risk management processes will ultimately depend on the support of employees. They should, therefore, become involved in developing the new processes, insofar as possible, to ensure a greater sense of ownership. This involvement should also help them to gain a better understanding of the processes.

Recognising the existing culture Introducing new risk management processes may have a significant impact on the existing culture of the company. Failure to recognise this, may lead to resistance to change or to staff turnover. Where it is necessary to change the culture, employees should be provided with appropriate support, reassurance and training.

Building on existing systems It is often helpful to 'go with the grain' when implementing new systems. Thus where existing systems have proved to be useful, this should be acknowledged and new systems should build on, rather than replace, these systems. By so doing, greater support for the new systems may be achieved.

Embedding risk management processes The risk management processes introduced should be linked to the strategic objectives of the company and reporting processes should be developed to ensure that management can monitor their effectiveness. To ensure that the processes are carried out, they should become an integral part of the tasks and routines undertaken by employees and managers.

- (b) If shareholders can see that the objectives of the business are likely to be achieved because risks are being managed properly, it should lead to greater confidence in the future of the company which, in turn, should lead to a higher share price. In particular, risk management processes should help to increase shareholder value in the following ways:

- aligning the processes to the strategic objectives of the business can help to ensure that the risk appetite of the business is reflected in the decisions and actions of managers.
- investing in new ventures can take explicit account of risk. This should help ensure that an appropriate response to risk is developed and that the required returns from new ventures are commensurate with the risks involved.
- risk-transfer policies can be developed to achieve the required balance between risk and return.
- managers will become more skillful in forecasting and managing risks, which should help to avoid 'surprises' that result in large losses or reputation damage.

(Examiner's note: Other answers to each part of this question may have been acceptable.)

- 5 (a) (i) The relevant MM formula is:

$$V_g = V_u + D_t$$

Where:

V_g = value of a geared company

V_u = value of an ungeared company

D_t = value of the tax shield on debt

The market value of Janus plc is:

$$100\text{m} \times \text{£}2.05 = \text{£}205\text{m}$$

As profit (before interest) of Janus plc is double that of Nereus plc, the value of Nereus plc should be:

$$\begin{aligned} V_u &= \text{£}205\text{m}/2 \\ &= \underline{\text{£}102.5\text{m}} \end{aligned}$$

As the corporation tax rate is 25%

$$\begin{aligned} D_t &= [\text{£}20\text{m} \times 90/100] \times 25\% \\ &= \underline{\text{£}4.5\text{m}} \end{aligned}$$

$$\begin{aligned} V_g &= \text{£}102.5\text{m} + \text{£}4.5\text{m} \\ &= \underline{\text{£}107.0\text{m}} \end{aligned}$$

As the value of the loan capital is £18m [$\text{£}20\text{m} \times 90/100$], the value of the ordinary shares in Nereus plc is:

$$\text{£}107.0\text{m} - \text{£}18.0\text{m} = \text{£}89.0\text{m}$$

The equilibrium price of an ordinary share is, therefore:

$$\text{£}89.0/50\text{m} = \underline{\text{£}1.78}$$

- (ii) The amount of debt raised would be $40\text{m} \times \text{£}2.05 = \text{£}82\text{m}$

The market value of Janus plc is currently $\text{£}205\text{m}$. The value of the company following the issue of debt and cancellation of ordinary shares would be:

$$\begin{aligned}V_g &= V_u + D_t \\V_g &= \text{£}205\text{m} + (25\% \times \text{£}82\text{m}) \\V_g &= \text{£}225.5\text{m}\end{aligned}$$

The market value of an ordinary share in Janus plc following the proposed change in capital structure is, therefore:

$$\begin{aligned}&= (\text{£}225.5\text{m} - \text{£}82\text{m}) / (100\text{m} - 40\text{m}) \\&= \text{£}143.5\text{m} / 60\text{m} \\&= \text{£}2.39\end{aligned}$$

- (b) On the basis of the calculations shown in (a)(i) above, the shares in Nereus plc appear to be undervalued and so the concerns of the directors of the company may have some substance. However, the calculations are based on the assumption that the two companies have identical business and operational risk characteristics. In practice, this would be a rare occurrence and the difference between the current market price of Nereus plc and the figure calculated above may be due to differences in risk characteristics.

The calculations in (a)(ii) show that the remaining shareholders of Janus plc would benefit from the tax shield effect of loan capital and would see an increase in their share price by more than 16%, assuming the benefits of repurchase are in proportion to their holdings.

- (c) Possible weaknesses in the assumptions of Modigliani and Miller (MM) that remain after taxation has been taken into account, include the following:

Bankruptcy costs High levels of borrowing may place a business at risk of being unable to meet its contractual obligations to pay interest and to make capital repayments when they fall due. This can, in turn, lead to bankruptcy, which can be very costly for both lenders and shareholders. MM assumed that it would be possible to issue loan capital at high levels of gearing, but the fear of bankruptcy among lenders and shareholders may make this impossible in practice.

Interest rates MM assumed that interest rates demanded by lenders would remain constant even at high levels of gearing. However, at very high levels of gearing, lenders will be providing most of the capital of the business and will consequently be taking on most of the risk. They will expect to be compensated for this by receiving higher returns.

Shareholder behaviour MM assume that equity shareholders will be unconcerned by increases in gearing as they can adjust their portfolio of investments to take account of changes in the financial risk of one particular business. However, many investors do not hold a well-diversified portfolio of investments and so, in practice, changes in the risk characteristics of a particular business may concern them.

- 6 (a) It can be argued that there are three key tasks of the board of directors of a public listed company. These are:

Development of strategy The board of directors has an important role in setting the strategic direction of the company. Developing strategy involves:

- Defining the nature and focus of operations
- Developing the mission and values for the company
- Assessing the opportunities and threats
- Developing and screening strategic proposals
- Selecting and implementing appropriate strategic proposals

The level of involvement in the above tasks will vary between boards. Some boards of directors may view their role as simply setting the context for the development of strategy, by defining the nature of the business that the company is in and by articulating its mission and values, whereas other boards may become involved in all the tasks identified.

Control The board of directors has a responsibility for monitoring and controlling the activities of the company. To ensure that managers and employees work towards the agreed strategic objectives that have been set, control mechanisms involving plans, budgets, quality indicators and benchmarking may be used. To ensure the integrity of financial information that is being produced, internal checks and controls may be implemented and an audit committee may be established to oversee the audit process and to establish a good working relationship with the external auditors. To ensure that the directors perform effectively, appraisals may be carried out based on contributions that have been made, or based on outcomes that have been achieved, and which may form the basis for rewards or sanctions.

External role The board has a role in raising the profile of the company and in developing contacts with the outside world in order to promote the interests of the company. It also has a role in maintaining good relationships with shareholders. This latter role can be important in ensuring that shareholders take a long-term perspective when assessing company performance and in ensuring support for difficult decisions over the future of the company that may have to be made. Relationships with shareholders are often maintained through informal meetings, particularly with institutional shareholders, during which views may be exchanged over the future direction of the business. In recent years there has been an increasing trend for companies to report to shareholders and other stakeholders through electronic form. Company websites are often maintained which

include material covering a wide range such as product details, social reports, environmental reports etc. In addition to informal or voluntary forms of communication, the board is also obliged to communicate formally to shareholders through the annual general meeting, and through the dissemination of interim and annual financial reports.

- (b) The particular contribution that non-executives provide in carrying out the tasks identified may include the following:

Development of strategy Many non-executive directors of listed companies hold executive directorships in other listed companies and so will be experienced in strategic decision making. They should, therefore, be able to contribute fully to discussions on strategy and be able to bring different perspectives to the discussions. Some non-executive directors may bring experience in other fields that can be of value in discussions over future strategy. For example, a company that undertakes a significant amount of work for the government may find it useful to be able to draw on the expertise of a non-executive director who is a former member of the government or a former civil servant in order to gain an understanding of the kind of initiatives or proposals that are likely to find favour.

Control Since the publication of the Cadbury Report, the 'policing' role of non-executive directors has taken on much greater importance, particularly with respect to financial control systems and executive directors' performance. Most listed companies have an audit committee that is made up entirely of non-executive directors. This committee is an important mechanism for monitoring the robustness of financial control systems and ensuring the integrity of financial information produced. In addition, most listed companies have a remuneration committee that is also entirely made up of non-executive directors and which is charged with recommending to the board the remuneration of executive directors. The incentives provided and levels of compensation for executive directors can be very important in ensuring that their interests are aligned with those of the shareholders. The performance of executive directors against agreed targets is often monitored by non-executive directors and can help to identify poor-performing individuals.

External role Non-executive directors often have a strong reputation in their chosen field and this may be of considerable value in raising the profile of the company. They may also have strong links with a wide range of organisations such as research bodies, government agencies and foreign companies. These links may be extremely helpful in developing new contacts and in promoting the company's interests. Non-executive directors are not involved in detailed operational matters and often hold a more objective view of the company than the executive directors. As a result, shareholders may wish to discuss with non-executive directors any concerns they may feel over the direction of the company, particularly if earlier discussions with executive directors were fruitless. By acting as a channel for shareholder concerns, the non-executive directors can help maintain good relationships between the board and shareholders.

(Examiner's note: Other answers to each part of this question may have been acceptable.)

Section B

1	(a) 7 marks Option (i), 7 marks Option (ii), 1 mark Option (iii)	15
	(b) 1 mark per point, 1 mark for the correct decision (max. 5 marks)	5
		20
2	(a) 2 marks per reason (max. 8 marks)	8
	(b) 1 mark per point (max. 4 marks)	4
	(c) 2 marks for value of shareholding in Hecate plc before 'spin-off', 1 mark for the value of shareholding after 'spin-off', 2 marks for total shareholder wealth assuming a P/E ratio of 17 times and 2 marks for total shareholder wealth assuming a P/E ratio of 18 times, 1 mark for relevant comment	8
		20
3	(a) 2 marks for describing 'efficiency', 2 marks for each level of efficiency	8
	(b) 3 marks for role in eliminating pricing inefficiency, 1 mark for role in providing information	4
	(c) 5 marks for inefficiencies, 3 marks for advice	8
		20

Section C

4	(a) 2 marks per point (max. 12 marks)	12
	(b) 2 marks per point (max. 8 marks)	8
		20
5	(a) 6 marks part (i), 4 marks part (ii)	10
	(b) 2 marks comments on (a)(i), 2 marks comments (a)(ii)	4
	(c) 2 marks per weakness (max. 6 marks)	6
		20
6	(a) 3 marks per task (max. 9 marks)	9
	(b) 3 marks strategy, 4 marks control, 4 marks external role	11
		20