CMP Upgrade 2019/20

Subject CB1

CMP Upgrade

This CMP Upgrade lists the changes to the Syllabus objectives, Core Reading and the ActEd material since last year that might realistically affect your chance of success in the exam. It is produced so that you can manually amend your 2019 CMP to make it suitable for study for the 2020 exams. It includes replacement pages and additional pages where appropriate. Alternatively, you can buy a full set of up-to-date Course Notes / CMP at a significantly reduced price if you have previously bought the full-price Course Notes / CMP in this subject. Please see our 2020 *Student Brochure* for more details.

This CMP Upgrade contains:

- all significant changes to the Syllabus objectives and Core Reading.
- additional changes to the ActEd Course Notes and Assignments that will make them suitable for study for the 2020 exams.

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0 Changes to the Syllabus objectives

There are no changes to the CB1 Syllabus objectives for 2020.

1 Changes to the Core Reading

This section contains all the ***non-trivial*** changes to the Core Reading.

Chapter 1

Section 6

The material on the UK Corporate Governance Code and its main principles has been amended to reflect a new version of the Code, effective from 2019. Replacement pages 21-28 are attached.

Chapter 16

Section 3.2

The figures in Example 2 have been updated slightly. A replacement page 15-16 is attached.

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2 Changes to the ActEd material

This section contains all the ***non-trivial*** changes to the ActEd text.

Chapter 3

Page 6

The UK personal allowance has been updated to £12,500 for the 2019-20 tax year. The tax rates in Section 1.3 remain unchanged for the 2019-202 tax year.

Section 2.2

The UK capital gains allowance has been updated for 2019-2020 and the subsequent question changed accordingly. A replacement page 9-10 is attached.

Chapter 21

Section 0

An overview diagram of how the whole project appraisal process described in Chapters 21 and 22 fits together has been added at the end of Section 0. A replacement page (2a) is attached.

3 Changes to the X Assignments

Overall

There have been minor changes throughout the assignments.

More significant changes are listed below.

Assignment X1

X1.13 has been changed reflecting the changes to the UK Corporate Governance Code. The question now reads:

The main principles of the UK Corporate Governance Code are set out in five sections.

Describe these five sections of the Code. [5]

A replacement page with the solution is attached.

Assignment X3

The figures in X3.1 have been changed, so that the question is now:

A share has a beta of 1.5 relative to the diversified market portfolio. If the risk-free rate of interest over the previous year has been 3%, and the market index has risen 5%, by how much would the share price be expected to have risen?

A 3%

B 5%

C 6%

D 8% [2]

A replacement solution page 1-2 is attached.

Solution X3.11 has been amended. A replacement page 3-4 is attached.

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4 Other tuition services

In addition to the CMP you might find the following services helpful with your study.

4.1 Study material

We also offer the following study material in Subject CB1:

- Flashcards
- Revision Notes
- ASET (ActEd Solutions with Exam Technique) and Mini-ASET
- Mock Exam and AMP (Additional Mock Pack).

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4.2 Tutorials

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4.4 Feedback on the study material

ActEd is always pleased to get feedback from students about any aspect of our study programmes. Please let us know if you have any specific comments (*eg* about certain sections of the notes or particular questions) or general suggestions about how we can improve the study material. We will incorporate as many of your suggestions as we can when we update the course material each year.

If you have any comments on this course please send them by email to **CB1@bpp.com**.

6 Corporate governance and organisation

The Financial Reporting Council (FRC) is responsible for setting the UK Corporate Governance and Stewardship Codes and UK standards for accounting, auditing and actuarial work.

The focus of this section is just the first of these responsibilities.

6.1 What is corporate governance

Corporate governance is the system by which companies are directed and controlled.

According to the FRC:

> ***'the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'.***

The first version of the UK Corporate Governance Code (the Code) produced in 1992 defines corporate governance:

> ***Corporate governance is the system by which companies are directed and controlled.***
>
> ***Boards of directors are responsible for the governance of their companies.***
>
> ***The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.***
>
> ***The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.***
>
> ***The board's actions are subject to laws, regulations and the shareholders in general meeting.***

6.2 The UK Corporate Governance Code

The Code applies to companies with a full listing on the UK Stock Exchange.

To carry out its responsibilities effectively, the board must follow the Code's guidance on the underlying principles of good practice:

- **accountability**
- **transparency**
- **probity**
- **focus on the long-term success of the company.**

Probity means ethical behaviour.

The Code consists of a set of main and supporting principles and provisions. The principles form the core of the Code. However it allows some flexibility so that companies can adopt their practices to suit their business circumstances.

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The Code adopts a principles-based rather than rules-based approach. As a result, there is little detailed prescription of exactly how a board must conduct its business, with the focus instead on high-level outcomes.

The requirement to 'comply or explain' allows the board to determine how it complies with the code in carrying out its duties. Where the board, in its aim to achieve good governance, is able to justify following an alternative to a provision, it must clearly and carefully explain to the shareholders the reasons for doing so.

The most recent version of the Code, effective from January 2019, contains an updated set of principles which are summarised below.

6.3 The main principles of the Code

The main principles of the UK Corporate Governance Code are set out under five headings:

- **board leadership and company purpose**
- **division of responsibilities**
- **composition, succession and evaluation**
- **audit, risk and internal control**
- **remuneration.**

Board leadership and company purpose

The Code's first principle under this section is that 'a successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society'.

The other principles under this section require the board to:

- **set the company's purpose, values and strategy, satisfying itself that these and its culture are aligned**
- **assess and manage risk, with a framework of prudent and effective controls**
- **ensure effective engagement with shareholders and stakeholders**
- **ensure workforce policies and practices adhere to the company's values and support its long-term sustainable success.**

Division of responsibilities

Under this section, the principles set out the responsibilities of the chair, including the independence of their role.

For example, one person should not be both chair and chief executive of a company.

This section further sets out the requirements for:

- **effective contribution of all non-executive directors**
- **provision of accurate, timely and clear information to the directors**
- **no domination in the board's decision making**
- **non-executive directors having sufficient time to carry out their duties.**

Composition, succession and evaluation

This section sets out principles regarding:

- **rigorous procedures for board appointments, based on merit and objective criteria**
- **an effective succession plan for board and senior management**
- **promotion of diversity of gender, social and ethnic backgrounds**
- **formal and rigorous annual evaluation of the board's effectiveness.**

For example, all directors should be subject to annual re-election and should not normally remain in post for more than nine years.

Audit, risk and internal control

The board '*should present a fair, balanced and understandable assessment of the company's position and prospects*'.

In meeting this requirement, the board needs to put in place appropriate formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements. The board is also required to assess the risks involved in achieving its long-term strategic objectives and maintain sound risk management systems.

Much of the work associated with this principle will be performed by an audit committee established by the board.

Remuneration

According to the principles in this section: 'Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success'.

Further principles require the board to put in place a formal and transparent procedure to determine policy on executive, director and senior management remuneration. It also requires that individual directors must not be involved in deciding their own remuneration.

Much of the work associated with this principle will be performed by a remuneration committee established by the board.

The issue of executive pay is often contentious and may be subject to requirements set down by the government or bodies such as the FRC, *eg* requiring companies to disclose the ratio between the chief executive's (or other highest earner's) pay and that of an average employee.

The chapter summary starts on the next page so that you can keep all the chapter summaries together for revision purposes.

Chapter 1 Summary

Finance and real resources

Finance involves two basic decisions:

1. What real assets should the firm invest in? (The *capital budgeting decision*)
2. How should the cash for the investment be raised? (The *financing decision*)

Capital budgeting is important because the costs of mistakes are high. It is very difficult because there are often many options to assess and future cashflows are uncertain.

The main parties involved in financing decisions are the treasurer, the controller, the Chief Financial Officer and the board of directors.

Stakeholders and conflicts of interest

There are many groups of stakeholders in an organisation, each with its own objectives. These objectives may conflict, *eg* shareholders and managers, shareholders and lenders.

Capital markets and the maximisation of shareholder wealth

Capital markets are the markets in long-term capital, such as the share (or stock) market and the bond market. The capital market provides information to assess the performance of the financial managers and also to assist the financial managers when making financial decisions.

In practice, this separation of ownership and management can lead to *principal-agent problems* and *agency costs* if the interests of the owners and managers diverge.

Agency theory considers issues such as the nature of the agency costs, conflicts of interest (and how to avoid them) and how agents may be motivated and incentivised.

Conflicts of interest may be reinforced by *information asymmetries*.

The value of a company

The value of a company can be determined by discounting cashflows at an appropriate discount rate, *ie* an investor's required rate of return. As the needs and objectives of individual shareholders vary, their valuations of a company will vary.

Regulating financial reporting

Regulatory bodies such as the International Accounting Standards Board (IASB) and Financial Reporting Council (FRC) set standards for financial reporting so that companies' financial reports are reliable and useful.

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Corporate governance

Corporate governance is the system by which companies are directed and controlled.

The main principles of the UK Corporate Governance Code are set out under five headings:

- board leadership and company purpose
- division of responsibilities
- composition, succession and evaluation
- audit, risk and internal control
- remuneration.

Chapter 1 Practice Questions

Exam style

All of the questions that follow are exam style.

1.1 Which of the following situations is least likely to give rise to agency costs?

A a car manufacturing business, which employs managers to carry out day-to-day operations
B an oil refining business in which the government takes a great interest
C wage negotiations in which managers have more information than unions
D a retailing business, which has one owner-manager [2]

1.2 Which of the following is NOT one of the headings in the UK Corporate Governance Code?

A division of responsibilities
B shareholders and profitability
C board leadership and company purpose
D remuneration [2]

1.3 Describe the role of the financial manager. [5]

1.4 Explain how businesses are subject to the disciplines of the capital markets. [5]

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The solutions start on the next page so that you can
separate the questions and solutions.

The examples below all use this formula. The critical step in any such example is to be clear what cashflow amounts are paid and when, *ie* at the time of borrowing or at the end of the borrowing period.

Example 1: Single bank loan

A company needs to raise £4,000,000 for 3 months and is considering a single loan at 7.5% *pa* with the interest deducted from the loan at the time of borrowing. There are no fees.

$$\textbf{financing cost} = \frac{\textbf{interest}}{\textbf{usable funds}}$$

As the 7.5% is an annual rate of interest, the amount of interest payable on the 3-month loan will be:

$$£4,000,000 \times 0.075 \times \frac{3}{12} = £75,000$$

As the interest is deducted from the loan at the time of borrowing, effectively the company is paying interest on borrowings it does not receive, and so the annual finance cost is slightly higher than 7.5%:

$$\textbf{annual financing cost} = \frac{\left(£4,000,000 \times 0.075 \times \frac{3}{12}\right)}{\left(£4,000,000 - \left(£4,000,000 \times 0.075 \times \frac{3}{12}\right)\right)} \times \frac{12}{3} = 7.64\%$$

Example 2: Line of credit

A company has a £500,000 line of credit at 7.25% *pa* with 0.5% *pa* commitment fee on the full amount. The company draws down £400,000 for 3 months.

Assuming that the interest and commitment fee are deducted at the time of borrowing:

usable funds = £4,000,000 – interest – commitment fee

$$\textbf{annual financing cost} = \frac{\textbf{interest + commitment fee}}{\textbf{usable funds}}$$

$$= \frac{\left(£400,000 \times 0.0725 \times \frac{3}{12}\right) + \left(£500,000 \times 0.005 \times \frac{3}{12}\right)}{£400,000 - \left(£400,000 \times 0.0725 \times \frac{3}{12}\right) - \left(£500,000 \times 0.005 \times \frac{3}{12}\right)} \times \frac{12}{3}$$

$$= 8.03\%$$

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Question

A company has a £500,000 line of credit at 7.25% *pa* with 0.5% *pa* commitment fee on the *unused* amount (*ie* the commitment fee will not be paid on any loan that is actually taken out). The interest and fee are paid at the end of the period of borrowing. The company draws down £400,000 for 3 months. Calculate the annual financing cost in this case.

Solution

$$\text{annual financing cost} = \frac{\text{interest + commitment fee}}{\text{usable funds}}$$

$$= \frac{\left(£400,000 \times 0.0725 \times \frac{3}{12}\right) + \left(£100,000 \times 0.005 \times \frac{3}{12}\right)}{£400,000} \times \frac{12}{3}$$

$$= 7.38\%$$

Example 3: Commercial paper

A company issues £4,000,000 of commercial paper at 7% *pa*. The dealer's commission on a 90 day issue is 1/8th percent of the issue.

Both interest and dealer's commission are deducted from the loan at the time of borrowing. The 0.125% fee is treated as an annual rate in the calculation below.

Commercial paper is issued at a discount and redeemed at par. As a result, we see a similar effect to that for the simple bank loan when we calculate the finance costs, *ie* the issuing company is effectively paying interest based on £4,000,000 but actually receiving less than £4,000,000. The actual cost is therefore higher than 7%.

$$\textbf{financing costs} = \frac{\textbf{interest + dealer's commission}}{\textbf{usable funds}}$$

$$\text{usable funds} = £4,000,000 - \text{interest} - \text{dealer's commission}$$

annual financing costs =

$$\frac{\left(£4,000,000 \times 0.07 \times \frac{3}{12}\right) + \left(£4,000,000 \times 0.00125 \times \frac{3}{12}\right)}{£4,000,000 - \left(£4,000,000 \times 0.07 \times \frac{3}{12}\right) - \left(£4,000,000 \times 0.00125 \times \frac{3}{12}\right)} \times \frac{12}{3}$$

=7.25%

Capital losses cannot, however, be offset against any other form of taxation.

Any 'unused' capital loss may be carried forward to be offset against capital gains in any future year(s).

Allowances

In most countries, individuals are given an allowance each year and only pay capital gains tax on chargeable gains in excess of this amount.

2.2 The rates of tax

For individuals, the amount chargeable to capital gains tax could be added on to the income liable to income tax and charged to CGT at the individual's marginal tax rate.

In the UK, a rate of 10% or 20% (from April 2016) has applied to capital gains above the allowance, depending on the level of taxable income. Higher rates can apply to some gains, such as in the UK, for property which is not the individual's main home.

In the UK, the capital gains allowance for individuals is £12,000 for the tax year 2019-20. Any gain in excess of this allowance is effectively treated as additional income. Gains that fall in the basic-rate tax band are taxed at 10% and any gains in excess of this are taxed at 20% (except for second homes where the rates are 18% and 28%).

Question

Assume that the capital gains allowance is £12,000 and the capital gains tax rate is 10% on any gains that fall within the basic rate tax band and 20% on any further gains.

(i) After income tax, Mr X has £1,000 of the basic-rate tax band left unused. His only chargeable gain in the tax year is £5,000. State how much capital gains tax he would pay.

(ii) Mrs Y has £1,000 of the basic-rate tax band left unused. Her only chargeable gain in the tax year is £15,000. Calculate how much capital gains tax she would pay.

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Solution

(i) Nothing, because he would only pay CGT on chargeable gains in excess of £12,000.

(ii) Mrs Y's chargeable gain is in excess of the annual allowance of £12,000. She will therefore pay capital gains tax on £15,000 – £12,000 = £3,000.

She has £1,000 of the basic rate allowance left so:

Tax rates	*Amount of gain*		*Tax due*
Taxed @ 10%	£1,000	⇒	£100
Taxed @ 20%	£2,000	⇒	£400
Total			£500

She will pay capital gains tax of £500.

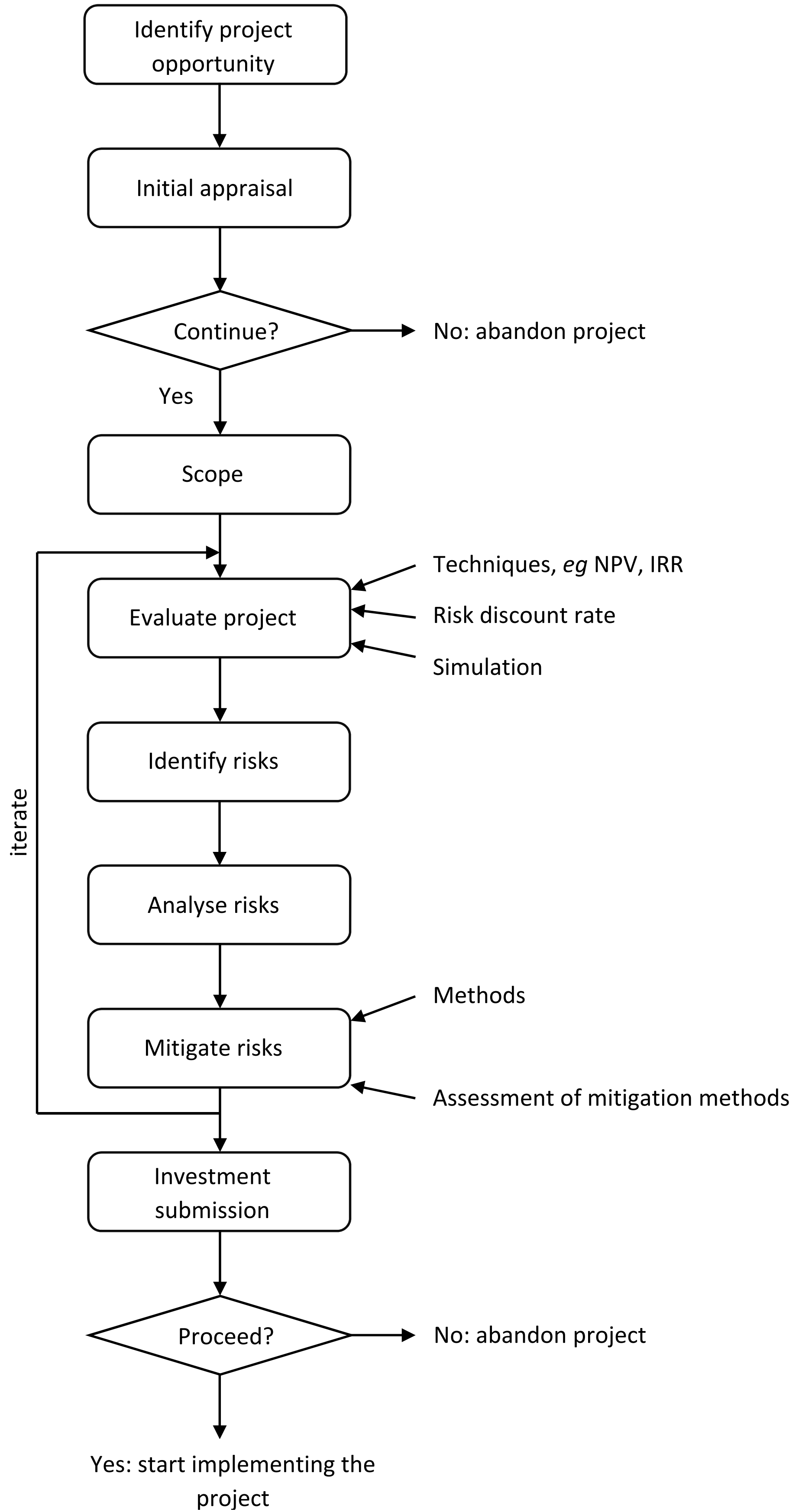
Question

State with reasons which of the following items would be subject to capital gains tax for Mr X, a UK resident and taxpayer.

1. The sale of Mr X's house.
2. The sale of a house that Mr X bought for his aunt to live in.
3. The sale of Mr X's car, a historic (pre-1976) Rolls Royce.
4. The sale of Mr X's collection of antique silver snuff boxes (collectively valued at £18,000).

Solution

1. No CGT, assuming it is Mr X's principal UK residence.
2. Liable to CGT, because the house was not Mr X's main residence.
3. No CGT, because CGT does not apply to private motor cars.
4. Liable to CGT, as no exemption for snuff boxes! (This collection is valued at more than the £6,000 chattels allowance).



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Solution X1.13

Course Reference: Chapter 1.

Board leadership and company purpose – the first principle in this section is that a successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company. [1]

Other principles in this section cover associated requirements of the board, for example:

- setting the company's purpose, values and strategy
- assess and manage risk, with a framework of prudent and effective control
- ensuring effective stakeholder engagement
- ensuring workforce policies adhere to the company's values. [1 for any one example]

Division of responsibilities – The principles in this section set out the responsibilities of the chair, including the independence of their role. [1]

Composition, succession and evaluation – The principles in this section cover procedures for board appointments, succession planning for board and senior management and methods of evaluation of the board's effectiveness. [1]

This section also covers promotion of diversity, *eg* of gender, social and ethnic backgrounds. [1]

Audit, risk and internal controls – The principles here require the board to establish appropriate procedures for internal and external audit and for risk management. [1]

Remuneration – Remuneration should be designed to promote the long-term success of the company. [1]

Formal and transparent procedures should be put in place, *eg* individual directors must not be involved in setting their own remuneration. [1]

[Maximum 5]

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Assignment X3 Solutions

Answers to multiple-choice questions

The following table gives a summary of the answers to the multiple-choice questions. The answers are repeated below with explanations.

1	C
2	C
3	D
4	C
5	A

6	D
7	C
8	C
9	B
10	C

Solution X3.1

Answer = C

The return on the share would be described by the following formula:

$$\begin{aligned} r_i &= r_f + \beta_i(r_m - r_f) \\ &= 3\% + 1.5 \times (5\% - 3\%) \\ &= 6\% \end{aligned}$$

[2]

Solution X3.2

Answer = C

In a tax-free world, the following formula links the returns:

$$\text{return on assets} = \frac{D}{D+E}(\text{return on debt}) + \frac{E}{D+E}(\text{return on equity})$$

$\Rightarrow$ $12\% = (0.25 \times 6\%) + (0.75 \times \text{return on equity})$

Thus: $\text{return on equity} = 14\%$

Alternatively, we could calculate the return on equity directly as $r_f + \beta_g(r_m - r_f)$.

We know that $r_m = 12\%$, $r_f = 6\%$. We also know that the assets of the company are invested to give a market return.

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Therefore, we can say that the beta of the assets must be 1 and β_u, the ungeared beta, is also 1. However, since there is debt, we adjust the beta according to the following formula:

$$\beta_g = \beta_u \times \left[1 + \frac{D}{E}(1-t)\right] = 1 \times \left[1 + \frac{25}{75}(1-0)\right] = 1.333$$

where β_g is the geared equity beta.

So, the return on the geared shares is:

$$r_f + \beta_g \times (r_m - r_f) = 6\% + 1.333 \times (12\% - 6\%) = 14\%$$ [2]

Solution X3.3

Answer = D

A project with a *shorter* payback period will be preferred. The payback period approach is of most value when payback periods are less than 3 years due to the impact of discounting. The payback period approach tends to be most important for *small* companies which often struggle most with cashflow issues. So all of answers A to C are incorrect. [2]

Solution X3.4

Answer = C

An LBO will result in a public company de-listing and becoming private. [2]

Solution X3.5

Answer = A

A company that has a high proportion of intangible assets is likely to have relatively few tangible assets to act as security for a loan.

All of B, C and D would lead to debt being more attractive and so tend to suggest a higher level of gearing. Increased debt interest reduces taxable profits and therefore reduces the tax paid by the company. This becomes more important as tax rates rise. [2]

Solution X3.6

Answer = D

Systematic risk arises because of the volatility of the market as a whole. [2]

Solution X3.7

Answer = C

Only the effects of regional price variation can be diversified away by investing in a large portfolio of risky assets and projects. [2]

Solution X3.8

Answer = C

Interest = $0.015 \times £25,000,000 \times \frac{90}{365} = £92,466$

Usable funds = £25,000,000 – interest – broker's fee = £24,857,534

$$\text{Annual financing costs} = \frac{\text{interest + broker's fee}}{\text{usable funds}} \times \frac{365}{90}$$

$$= \frac{92,466 + 50,000}{24,857,534} \times \frac{365}{90}$$

= 2.3% *pa* [2]

Solution X3.9

Answer = B

An increase in gearing increases the risk of default and thus the company's credit rating will fall. It will have to pay more for its debt finance. [2]

Solution X3.10

Answer = C

Systematic risk is allowed for by using an appropriate discount rate. Specific risk is allowed for in the other ways mentioned in the question. [2]

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Solution X3.11

Course Reference: Chapter 16.

(a) ***Reductions in sales revenue and trade receivables***

Reduction in sales revenue = credit sales × discount × proportion of customers using discount

= £150*m* × 0.02 × 0.4 = £1.2*m* [1]

$$\text{trade receivables turnover period} = \frac{\text{trade receivables}}{\text{credit sales}} \times 365$$

Prior to the introduction of the proposed discount:

$$70\text{ days} = \frac{\text{trade receivables}}{£150m} \times 365\text{ days}$$, *ie* trade receivables are £28.767*m*. [1]

It is expected that the introduction of the discount would result in a trade receivables turnover period of 50 days and credit sales of £150*m* – £1.2*m* = £148.8*m*. This would give:

$$50\text{ days} = \frac{\text{trade receivables}}{£148.8m} \times 365\text{ days}$$, *ie* estimated trade receivables of £20.384*m.*

Therefore the expected reduction in trade receivables is £28.767*m* – £20.384*m* = £8.4*m*. [1]

Markers: give credit for alternative reasonable approximations of the fall in trade receivables.

(b) ***Company Y's decision***

Company Y should go ahead with the proposal if the expected benefits of offering the discount exceed the expected costs, *ie* £1.2*m* of lost sales revenue. [1]

Company Y may consider that the discount offer, which is equivalent to an annual interest rate of $1.02^{365/20} = 44\%\,pa$ is too high. [1]

Company Y would benefit from not having to finance £8.4*m* of trade receivables. It might evaluate this as the interest gained by having this amount in cash on deposit or as the cost of borrowing this amount. [1]

However, other factors may also affect the decision on whether to implement the proposal:

- There may be further benefits, *eg* the company may make additional sales if it offers the discount. [1]
- There may be further costs, *eg* some customers may take the discount, but still pay late on the assumption that Company Y will not chase them and will still let benefit from the discount. [1]
- The level of confidence Company Y has in its assumptions. [1]

[Maximum 5]