TREASURY AND TAX MANAGEMENT

Professional 2 examination
June 2000

MARKING SCHEME

Question 1

(a) Present

$$\sqrt{\frac{2 \text{ x } 50 \text{ x } 4000}{0.10 \text{ x } 5}} \quad = 894 \text{ panels}$$

Proposed

$$\sqrt{\frac{2 \text{ x } 100 \text{ x } 4000}{0.10 \text{ x } 4}} \quad = 1{,}414 \text{ panels}$$

3 marks per calculation up to a maximum of 6

(b)

Present ordering costs = 4,000/894 = 4.47 or 5 orders @ £50 = £250
Proposed ordering costs = 4,000/1414 = 2.82 or 3 orders @ £100 = £300
An increase of £50 per annum
Present storage costs 10% x £5 x 894/2 = £223.50
Proposed storage costs 10% x £4 x 1414/2 = £282.80
An increase of £59.30
Overall costs are:-
Present £250 + £ 223.50 = £473.50
Proposed £300 + £282.80 = £582.80
An increase of £109.30

However Lowtown will qualify for quantity discounts of 4,000 x (£5 - £4) = £4,000 pa
It would take 5 years to payback the investment of £20,000 ignoring the time value of money.

3 marks for storage costs
3 marks for overall costs
3 marks for quantity discount
3 marks for payback or equivalent
(12)

(c)

Stock control - major aspect of liquidity management

Sufficient but not excessive amounts – use of EOQ -applied to a chosen organisation.
Relevance of modern stock control methods which minimise holdings consistent with suppliers' ability to satisfy needs promptly.
Cash management use of Baumol model to determine optimum balances to be maintained.
Use of graph and formula to be rewarded.

7 marks for relevant comments
(25)

Question 2

(a) Forum for wholesale transactions

trading of products	—	sterling/foreign currency/bullion/bills	*2*
short-term	—	loans/investments of 364 days or less	
long-term	—	loans/investments of 365 days or more	*1*
institutions involved	—	banks, building societies, LA's pension funds, public sector institutions large businesses	*2*

(b) Discount Houses

- used by Bank of England – deal exclusively;
- buy/sell from institutions within the markets;
- intermediary between banks and the B of E;
- enable the B of E to regulate the money markets; *2*
- short term financial instruments including treasury and commercial bills.

Bank of England
- banker to the government;
- regulator of banking sector;
- carries out monetary policies set by treasury;
- influences short term interest rates;
- deals only with discount houses. *2*

(c) Demand versus Supply
- cash flow of the markets dependant upon institutions individual cash flow needs;
- B of E may/may not step in to satisfy the demand;
- long term easier to forecast and funds tend to be matched direct;
- discussion on interest rate movements LIBOR etc. *3*

(d) Gilts
- securities issued by central and local government which carry no risk of default;
- raise revenue for central/local government;
- varied periods – 5 year, 5-15 years, > 15 years;
- usually have a specific redemption date but can be undated which means effectively interest is paid only;
- issued often at auction.

Gilt market

- second hand market for gilts;
- the returns on fixed interest stocks – dependent upon future predictions for interest rates;
- coupon/current yield and yield to redemption should be explained. *6*

Gilt repo market:
- a transaction where two parties agree that one will sell gilt edge securities to the other and at the same time commit to repurchase equivalent securities on a specified future date, or at call at a specified price
- the selling of gilts with an agreement to repurchase
- a reverse repo is where an authority buys gilts with an agreement to sell
- involves the outright purchase and sale of securities and full title transfer to the buyer
- the risk is that the counterparty fails to repurchase equivalent gilts and they have to be sold to the market instead – they may have fallen in value
- Bank of England has published a gilt repo code of practice
- transactions should be subject to a legal agreement between the two participants

4

(10)

- general standards and responsibilities of brokers and principals;
- best practice which includes knowing your customer and establishing procedures:
- made clear whether prices quoted are firm;
- brokers should not divulge names of principals;
- prompt settlement;
- rigorous confirmation procedures. *3*

(25)

Question 3

Asset allocation: apportionment of the funds assets between different classes of investment and/or markets.

Pooled vehicles: funds set up by investment managers whereby clients monies are pooled to purchase assets, clients therefore buy "units" of investment, the advantage to clients is the reduction in management fees due to economies of scale.

Active management: active managers will make decisions on analysis of market trends and their forecast of future movements, the approach is proactive and will incur a higher level of risk, the aim of the active manger will be to out perform the market.

Passive management: passive managers will aim to track indices and perform in line with the market.

Balanced portfolio: portfolio will include a range of investments from long and short term bonds to equities across a spread of markets and in cash.

Performance measurement and benchmarking: performance measurement involves the calculation of a portfolio or manager's investment returns, and the application of comparative measures against other portfolios and managers using pre-determined criteria. Benchmarking is a process for further comparing investment returns with recognised industry or market indices.

up to a maximum of 2 marks per point
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(12)

The CIPFA code of practice has been produced to **support the quality and status** of Treasury Management and provide **guidance on the proper practices** to be employed by treasury managers. The code recommends that organisations adopt several clauses as part of **standing orders** or financial regs. *5½*

The policy statement should set out:

- A definition of approved activities of the treasury management operation;
- Formulation of treasury management strategy;
- Listing of approved methods of raising finance;
- List of approved sources of financing;
- A definition of approved organisations for investments;
- The policy on interest rate exposure;
- The policy on external managers;
- The policy on delegation;
- Review requirements and reporting arrangements. *4½*

An authority-wide ethical code would set standards of behaviour for all employees (the CIPFA code is only binding on members and students subject to the Institute's disciplinary code); and also for the authority as an employer. Individual employees would be expected to act with honesty, truthfulness and personal integrity, and serve the public with respect, courtesy and concern. The authority as an employer would be expected to adopt professional codes of conduct (such as the CIPFA code), encourage regular training and keep up to date.

3
(13)

(25)

Question 4

Capital allowances
(a)

		Plant	SLA	Car pool	Exp car		LLA	Total	
		£	£	£	£		£	Allowances	
Additions				40,000	18,000		140,000		½
Disposal				10,000					½
				30,000					
WDA 25%						fya			
x 10/12				6,250	2,500	12%	16,800	25,550	3
				23,750	15,500		123,200		
Additions		65,000	90,000						
FYA 50%		32,500	45,000					77,500	1
		32,500	45,000						
Addition	14,000								
FYA									
40%	5,600	8,400						5,600	1
WDV c/f		40,900	45,000	23,750	15,500		123,200	108,650	
								14,333	
								122,983	

IBA: £430,000 x 4% x 10/12 = £14,333. *2*

(8)

Adjustment of Profits	**£**	**£**	
Profit before tax		360,00	½
Add depreciation	14,200		½
loan interest (non-trade)	7,900		½
miscellaneous (2085 + 969 + 1,000)	4,054	26,154	1½
		386,154	
Less:bank interest	6,500		½
patent royalties	9,000		½
rental income	26,600	42,100	½
		344,054	
Less capital allowances		122,983	½
Schedule D Case I		221,071	

***Bonus mark** - assume directors' remuneration is paid within 9 months after the accounting period end. *1*

Corporation tax computation 10 months to 31 March 1999

	£	
Schedule DI	221,071	½
Schedule A	26,600	½
Patent royalties	9,000	½
Schedule DIII	-	
Non-trading deficit (6500 - 7900)	(1,400)	1
	255,271	
Less charges	1,000	½

PCTCT	254,271	
Profit limits: £1,500,000 /10 months = £1,250,000		*1*
£300,000/10 months = £250,000		
(Therefore marginal)		
Corporation tax:		
£254,271 x 31%	78,824	*1*
less 1/40 (1250,000 - 254,271)	24,893	
Corporation tax due 1 January 2000	53,931	*½*

(to a maximum of 17)

(b)

Quarter	Tax deducted	Tax suffered	Income tax payable/ (repayable)	
30 Sept 1998	230		230 due 14 Oct 1998	*1½*
31 Dec 1998		2070	(230)	*1½*
31 March 1999	1980		140 due 14 April 1999	*2*

Tax deducted is due to be paid over by the above dates. Tax suffered can be repaid but only up to the amount paid in a previous quarter in the accounting period. An excess of tax suffered over tax deducted can be offset against the corporation tax liability. However, this is not the case here as tax deducted exceeds tax suffered. *5*

(c)

Non-trading deficits can be used as follows:

- against total profits for same ap (after S.393(1) but before S.393A) and before non-trading deficits carried back *1*
- carried back 12 months against Schedule DIII income (after S.393A) *1*
- carried forward against non-trading profits (i.e. except Sch DI). Then forward *1*
- against Schedule DIII. *½*
- group relieved *½*

Two year claim limit for all or part of the loss.
Discussion of using as early as possible (cash flow) or carrying forward if tax rate is likely to be higher. As Jones is paying at the marginal rate, it would seem efficient to claim the loss in the current period. *1*

Up to a maximum of 3
(25)

Question 5a

	Cost	MV 31 March 1982	
	£	£	
Proceeds	700,000	700,000	*1*
less cost/MV	180,000	250,000	
	520,000	450,000	
Less indexation			
$\frac{154.4 - 79.4}{79.4}$			*1½*
= 0.945 x 250,000	236,250	236,250	
	283,750	213,750	

Take lower gain. *½*
All four companies form a group for capital gains purposes
Ceptor owns 75% of Pull; Pull owns 75% of Brush *1*

Rollover relief is therefore applicable
i.e. proceeds into a new asset within 3 years (or one year before sale) - gain is rolled over into the new asset. *1*

All the proceeds must be reinvested. *½*
Hence, £213,750 - £50,000 = £163,750 can be rolled over. £50,000 is chargeable to corporation tax in the year to 31 March 1997. *1½*

The base cost of the new asset becomes £650,000 - £163,750 = £486,250. *1*

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(b)

Accountability of group relief

Choice Ltd

1 July 1997	£4,000	30 June 1998	(48,000)	(48,000)	30 June 1999

1 Jan 1998	31 Dec 1998		30 June 1999
38,750	38,750	79,062	

Classic Ltd

Group Relief:
ap to 31 Dec 1998, Classic Ltd can take the lower of 96,000 x 6/12 or 77,500 x 6/12 *1*
ap to 30 June 1999, Classic Ltd can take the lower of 96,000 x 6/12 or 79,062 *1*

Classic Ltd Corporation tax computations

	12 mths to 31 Dec 1998	6 mths to 30 June 1999	
	£	£	
Adjusted profit	80,000	40,000	*1*
less capital allowances	2,500	938	*½*
Schedule DI	77,500	39,062	
Chargeable gain	-	40,000	
		79,062	
Group relief	38,750	48,000	
PCTCT	38,750	31,062	

Capital allowances:			
WDV b/f	10,000		
WDA 25%	2,500	for 12 months to 31 Dec 1998	*1*
	7,500		
WDA 25% x 6/12	938	for 6 months to 30 June 1999	*1*
WDV c/f	6,562		

Corporation tax computations

	Choice		Cooper		Classic		
	30 June 1998	30June 1999	30 June 1998	30 June 1999	31 Dec 1998	30 June 1999	
	£	£	£	£	£	£	
Sch DI	4,000	–	60,000	200,000	77,500	39,062	*½*
Ch gain						40,000	*½*
less charges			(12,000)	(12,000)			*1*
S.393A	(4,000)						*½*
Group relief					(38,750)	(48,000)	*1*
PCTCT	–	–	48,000	188,000	38,750	31,062	
CT	–	–	10,080	50,010	8138	6368	

Workings

Choice Ltd's loss	96,000	
surrendered to Classic	(38,750)	
	(48,000)	*2*
S.393A claim by Choice Ltd	(4,000)	
carried forward within Choice Ltd	5,252	

Profit limits: £1,500,000/3 = £500,000
£300,000/3 = £100,000 *1*

Cooper Ltd

Year to 30 June 1998 - split FY 97 and FY 98 but rates the same. Credit to be given for this statement OR for workings split into FYs. *1*

£48,000 x 21% = £10,080

Year to 30 June 1999	£	
FY 98 £141,000 x 31%	43,710	
less 1/40 (375,000 - 141,000)	(5,850)	*2*
FY99 £47,000 x 30%	14,100	
less 1/40 (125,000 - 47,000)	(1,950)	
50,010		

Classic Ltd

ap to 31 Dec 1998 - split FY 97 and FY 98 but rates the same. *1*

£38,750 x 21% = 8,138

ap to 30 June 1999	£	
FY 98 £15,531 x 21%		
	3,262	*1*
FY 99 £15,531 x 20%	3,106	
	6,368	

17

(25)

Question 6a

	£	
(i)		
Carol: Class 1 £64 x 2%	1.28	*1*
(400 - 64) x 10%	33.60	
	34.88 per week	
Ann: Class 1 £64 x 2%	1.28	*1*
(485 - 64) x 10%	42.10	
	43.38 per week	
Employer Class 1:		
Carol : £400 x 10%	40.00 per week	½
Ann :£500 x 10%	50.00 per week	½

Class 1A 2,500 + 1,890 = 4,390 x 10% = £439 (for the year) *1*

Students should explain that there is no Class 1 NIC ceiling for the employer. *1*

Jock:
Class 2 £6.35 per week *1*
Class 4 (20,000 - 7310) x 6% = 761.40 (for the year) *1*

No implications for the employer *1*

(ii)
Jock :
Class 2 as above *2*
Class 4 (25,220 - 7,310) x 6% = £1074.60 (for the year)

No implications for the employer *10*

(b)

(i)
Time of supply is determined by the tax point. This is the earliest of: *1*
- date service is completed/date goods removed or made available to customer, or if *1*
- invoice issue d within 14 days, then this date *1*
- date invoice is issued *1*
- date payment is received *4*

(ii)

Quarter to 31 May 1999

		£		
Outputs	20 March 1999	20,000		½
	10 April 1999	15,000		½
		35,000 x 7/47 =	£5,213	½

(balance falls into next quarter) ½

	£	
Inputs (18,000 - 1,500) x 17.5%	2,888	1
VAT payable 30.6.99	2,325	

NB All of the VAT on £18,000 could have been treated as input tax and the use of goods privately could have been a taxable supply to himself. *3*

		£	
(iii)	Errors: Input overclaimed £7,000 x 7/47	1,043	*1*
	Output tax overstated	(250)	*1*
		793	

Does not exceed £2,000, therefore may be corrected on current return, and payment added to the above amount for 30.6.99. No penalty for errors < £2,000. *1* *3*

(iv) Cash accounting scheme is for businesses whose turnover is under £350,000. *1* Effect is for the tax point to become the date payment is received instead of the invoice date. Usually this delays paying over VAT until the latest date possible. *1*

Main points are:

- account for VAT on basis of cash paid and received, instead of accruals basis; *1*
- automatic bad debt relief; *1*
- returns and payments must be up to date; *1*
- turnover must not exceed £350,000 excl. VAT; *1*
- trader must leave scheme if taxable supplies exceeded £437,500 in the 12 *1*
- months to the end of a VAT accounting period and ALSO exceeded £350,000 in the following 12 months. The normal method must then be used from the end of the second 12 months. *1*

up to a maximum of 5

(15)

(25)