Subject no. 56A

Diploma in Offshore Finance and Administration

Financial Reporting and Governance

June 2015

Friday morning, 5 June 2015

Time allowed: 3 hours

Do not open this examination paper until the presiding officer or an invigilator tells you to.

You must not take this paper out of the examination room.

This examination paper is divided into three sections. You must attempt all parts of Question 1 in Section A, all questions in Section B, and two questions only in Section C.

Section A carries 10 marks (1 mark for each part of Question 1). Section B carries 40 marks (4 marks for each question). Questions in Section C each carry 25 marks.

You should allow yourself approximately 20 minutes in total to answer the questions in Section A, 70 minutes in total to answer the questions in Section B and 45 minutes for each of the questions attempted in Section C.

Note: Unless otherwise specified, you should assume that an Act or an organisation referred to in the questions is a UK Act or organisation.
Section A

Answer all parts of Question 1. Select only one of the options A, B, C or D for each part.

1 (i) A company had turnover of £16,000,000 for the year and receivables balance of £3,750,000 at the end of the year. What is the receivables days?

A 23  
B 42  
C 86  
D 155

(ii) Under the terms of the UK Companies Act 2006, what is the minimum number of natural directors a company must have?

A 0  
B 1  
C 2  
D 3

(iii) In UK codes of governance, which of the following is not a role of the audit committee?

A To make recommendations to the board on the appointment of the internal auditor.
B To appoint the external auditor.
C To set company policy on the provision of non-audit services provided by the external auditor, ensuring that these do not conflict with the independence of the auditor.
D To regularly review the external auditor’s terms of appointment, independence, objectivity and effectiveness.

(iv) In the context of agency theory, if auditors are an agent then who is the principal?

A Directors  
B Employees  
C The Financial Reporting Council  
D Shareholders

(v) In terms of interest rate contracts, what is the upper limit on an interest rate cap called?

A Strike rate  
B Collar rate  
C LIBOR  
D Market rate
(vi) A company has turnover of £600,000 and cost of sales of £335,000 for one year. What is the gross profit percentage?

A  44%
B  56%
C  59%
D  79%

(vii) The EU maintains a list of countries which have anti-money laundering regulations which are equivalent to the EU’s. What is this list called?

A  The AML compliance list.
B  The FATF list.
C  The white list.
D  The anti-money laundering and counter terrorism list.

(viii) Regarding banking supervision, which of the following is not part of offsite supervision?

A  Review of financial statements.
B  Monitoring capital requirements and ensuring requirements are maintained.
C  Processing of data and systems changes to reflect changes in connection with a regulated activity or the notification of significant events.
D  Discovery examination.

(ix) In terms of trust accounting, how are profits on the sale of investments treated?

A  As an increase in the capital account.
B  As an increase in the life tenant’s account.
C  As an immediate distribution to the beneficiaries of the trust.
D  Offset against administration expenses of the trust.

(x) There are four main quantitative characteristics which apply to a set of financial statements. The characteristic of ‘comparability’ means that the statements:

A  Are not unduly complex.
B  Can be used by anyone in their financial decision making.
C  Are free from bias and are materially correct.
D  Are based on the same accounting policies and estimates as the previous year.
Section B
Answer all ten questions.

2 State four requirements of the UK Companies Act 2006 which are specific to public companies. (4 marks)

3 Explain the fundamental accounting concept of accruals and the terms ‘asset’ and ‘liability’ as defined in the Accounting Standards Board (ASB) statement of principles. (4 marks)

4 Explain what a trustee is and outline a trustee’s duties in relation to the trust. (4 marks)

5 Define ‘a contingent asset’ and explain when it can be recognised in a company’s financial statements according to IAS 37, ‘Provisions, contingent liabilities and contingent assets’. (4 marks)

6 In the context of offshore financial centres, define the meaning of a foundation and outline three disadvantages of foundations for an investor. (4 marks)

7 Explain four ways in which a company can demonstrate its corporate social responsibility (CSR). (4 marks)

8 Section 302 of the Sarbanes Oxley Act sets out aspects of the annual report that require certification by the CEO and CFO. List four of these. (4 marks)

9 With regard to IAS1, explain the differences between the Income Statement and the Statement of Comprehensive Income and list four examples of items that can be included in the Statement of Comprehensive Income. (4 marks)

10 Explain four main activities of a country’s central bank. (4 marks)

11 Define the term ‘earnings per share’, state how it is used, and explain the problems of using this as a comparative measure between different companies. (4 marks)

(Total: 40 marks)
Section C

Answer two questions only.

12 Freddie Ltd (Freddie) is a cruise company. It owns nine cruise ships which provide entertainment for families on board while the ships sail between different ports around Europe and the Caribbean. The following events took place over the last year.

Event 1

Due to falling demand for cruises in Europe, the company decided to take one ship out of service. All staff were transferred to other ships; there were no redundancies. The ship is now kept permanently at a port and the directors of Freddie have no plans to use it for the foreseeable future.

The net book value of the ship is £3.5 million; similar used ships are available for £2.75 million.

Event 2

Due to falling demand, a provision for the closure costs of one of Freddie’s three administration centres was included in the 31 March 2015 accounts. The directors of Freddie agreed to the closure at the board meeting in March and the announcement was made to the employees in April.

Event 3

Freddie sells cruises in different countries and so receives income in many different currencies. Any receivables at the year-end and all income for the year are translated at the year-end currency conversion rates. Translation differences on income are taken direct to retained earnings.

Event 4

One method of advertising used by Freddie is to send promotional catalogues to holiday agents. Agents use these catalogues to advertise Freddie cruises to potential customers. Only catalogues actually used are paid for by the agents; unsold catalogues can be returned up to the end of the calendar year. Freddie distributed the catalogues in March and included the sales income for these catalogues in the Income Statement.

Required

(a) For each of the events above, explain any accounting entries required for the year ended 31 March 2015, referring to the relevant accounting standards to justify your comments. (20 marks)

(b) Explain how auditors can provide confidence to shareholders that the published financial statements are free from accounting errors. (5 marks)

(Total: 25 marks)
Stella Ltd (‘Stella’) is an offshore financial services company providing investment and other advice to individuals and companies in its jurisdiction. There are fifteen employees and five directors (two executive, two non-executive and an independent chairman). The directors attempt to follow corporate governance best practice.

All directors and employees own shares in Stella, and the directors are considering entry to the country’s equivalent of the UK’s AIM in three years.

Elements of the company’s remuneration scheme have recently been discussed at the main board meeting (there is no remuneration committee due to the relatively small size of the company). There was some disagreement concerning elements of remuneration but the main decisions at the board meeting were:

Employee / director remuneration – common elements:

- Basic salary to be set at roughly 50% of the employee’s expected pay for the year.
- A bonus to be payable depending on the overall profit of Stella – this bonus will vary between 25% and 200% of basic salary.

Employee remuneration only:

- A share incentive will be started for all employees, with vesting of shares dependent on the profits attained over the next three years. The scheme will be recognised in the financial statements as the options become available to employees.

Director remuneration only:

- Basic pay will increase at 20% p.a. This is required to retain the services of the directors in the company.
- Details of directors’ remuneration will be disclosed to the board only.
- New service contracts to be introduced, giving the directors two years’ notice of termination.

Required

Write a report to the directors of Stella which:

(i) Discusses the extent to which the board decisions on remuneration policy meet the requirements of corporate governance best practice; and

(ii) where necessary, recommends and justifies changes to the remuneration policy. 

(25 marks)
Ernest Ltd ('Ernest') is an offshore company offering investment advice to individuals. It is incorporated as a limited company, enjoying a tax-exempt status in its jurisdiction. The company's year-end is 31 December.

Summary financial information for the company is shown below.

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£'000</td>
<td>£'000</td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advisory fees</td>
<td>3,000</td>
<td>2,610</td>
</tr>
<tr>
<td>Interest received</td>
<td>250</td>
<td>235</td>
</tr>
<tr>
<td>Total income</td>
<td>3,250</td>
<td>2,845</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advisory and management fees</td>
<td>1,512</td>
<td>1,462</td>
</tr>
<tr>
<td>Administration including salaries</td>
<td>538</td>
<td>497</td>
</tr>
<tr>
<td>Establishment costs</td>
<td>482</td>
<td>452</td>
</tr>
<tr>
<td>Depreciation</td>
<td>30</td>
<td>27</td>
</tr>
<tr>
<td>Total expenses</td>
<td>2,562</td>
<td>2,438</td>
</tr>
<tr>
<td>Net profit for the year</td>
<td>688</td>
<td>407</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>200</td>
<td>180</td>
</tr>
<tr>
<td>Retained profit</td>
<td>488</td>
<td>227</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£'000</td>
<td>£'000</td>
</tr>
<tr>
<td>Non-current assets – tangible assets</td>
<td>390</td>
<td>420</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>790</td>
<td>645</td>
</tr>
<tr>
<td>Receivables</td>
<td>230</td>
<td>210</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>834</td>
<td>432</td>
</tr>
<tr>
<td>Total assets</td>
<td>2,244</td>
<td>1,707</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>165</td>
<td>116</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,004</td>
<td>1,516</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>2,244</td>
<td>1,707</td>
</tr>
</tbody>
</table>

Required

(a) Explain the difference between operating activities, investing activities and financing activities in a cash flow statement.  

(b) Prepare the cash flow statement for Ernest for the year ended 31 December 2014. Clearly distinguish between operating activities, investing activities and financing activities.  

(c) Explain the implication of Ernest having a large cash balance at the end of the year.  

(Total: 25 marks)
The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.