Important notice

When reading these suggested answers, please note that the answers are intended as an indication of what is required rather than a definitive “right” answer. In many cases, there are several possible answers/approaches to a question. Please be aware also that the length of the suggested answers given here may be somewhat exaggerated compared with what might be achieved in the reality of an unseen, time-constrained examination.

Examiner’s general comments

Advice for future candidates:

- Read the instructions of each question carefully and answer the question asked.
- Attempt the required number of questions (otherwise you are restricting your chances of success).
- Use the examiner's comments and suggested answers as key parts of the examination preparation process.
- Do not neglect key areas of the syllabus.
- Make sure you know the content of the core text. Do not focus your revision too narrowly.
Section A

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

1. (i) When should a contingent asset be recognised as income in a company’s financial statements?
   A. Never.
   B. When the income is probable.
   C. When the income is possible.
   D. When it is virtually certain that the income will be received.

(ii) A company has 1,000,000 shares with a nominal value of 50p each. The company makes a further issue of 50,000 shares and receives 70p per share. What is the amount of the share premium?
   A. £10,000
   B. £20,000
   C. £25,000
   D. £35,000

(iii) Section 174 of the Companies Act 2006 states the minimum standard expected of a director. What is this standard?
   A. To exercise basic due care.
   B. To carry out duties in accordance with the knowledge they have obtained over their working life.
   C. To exercise reasonable care, skill and diligence.
   D. To exercise the standard of care expected of a member of the Institute of Directors.

(iv) In the USA, which entity oversees firms providing audit services?
   A. The International Accounting Standards Board.
   B. The Auditing Standards Board.
   D. The Public Company Accounting Oversight Board.
(v) In terms of interest rate contracts, what is a floor?

A. The maximum rate that will be paid.

B. The minimum rate that will be paid.

C. The average rate that will be paid.

D. The rate payable in relation to the going market rate.

(vi) FRS 18 ‘Accounting Policies’ explains the accounting policies that a company must follow. When is it permissible for a company not to follow FRS 18?

A. When following FRS 18 is very costly and takes too much time.

B. When the directors cannot decide how to apply FRS 18.

C. When complying with FRS 18 means the financial statements do not show a true and fair view.

D. When the company has going concern problems but is still trading.

(vii) The EU ‘white list’ is a list of:

A. Jurisdictions which are considered to have equivalent anti-money laundering legislation to the EU.

B. Jurisdictions to which EU countries are not allowed to transfer personal data.

C. EU members using the Euro as their national currency.

D. Companies that are seen as potential money laundering vehicles.

(viii) After a bank obtains a banking licence, there are various types of supervision and checking undertaken by the relevant regulatory authority. In this context, regulatory activity which includes review of a wide range of the bank’s activities, including risk management systems and internal controls is:

A. Offsite supervision.

B. Themed examination.

C. Focused examination.

D. Discovery examination.

(ix) In terms of UK Corporate Governance, what was the main focus of the Turnbull report?

A. Internal control systems in companies.

B. Directors’ remuneration.

C. Good practice in company reporting.

D. Dialogue with institutional shareholders.
There are four main quantitative characteristics which apply to a set of financial statements. Which of the following best describes the characteristic of ‘reliability’?

A. They are not unduly complex.
B. They can be used by anyone in their financial decision making.
C. They are free from bias and are materially correct.
D. They are based on the same accounting policies and estimates as the previous year.

(Total: 10 marks)

Suggested answers

(i) D. When it is virtually certain that the income will be received.

Examiner’s explanation:

Income can only be recognised when it is virtually certain to be received.

(ii) A. £10,000

Examiner’s explanation:

Share premium is the excess consideration over the nominal value. Consideration per share is 70p with the nominal value being 50p; the excess consideration is therefore 20p. With 50,000 shares being issued, the total share premium is thus £10,000.

(iii) C. To exercise reasonable care, skill and diligence.

Examiner’s explanation:

The Act uses the specific term “reasonable care, skill and diligence” as the standard expected of directors.

(iv) D. The Public Company Accounting Oversight Board.

Examiner’s explanation:

By definition. Note that the answer B relates to UK requirements, not USA.

(v) B. The minimum rate that will be paid.

Examiner’s explanation:

A floor is simply the minimum rate that is payable.

(vi) C. When complying with FRS 18 means the financial statements do not show a true and fair view.

Examiner’s explanation:

True and fair override is the only reason the FRS 18 does not have to be followed. Clear disclosure of the reason for non-compliance must be given.
(vii) A. Jurisdictions which are considered to have equivalent anti-money laundering legislation to the EU.

   Examiner's explanation:

   Those countries which have AML regulations that meet EU standards.

(viii) D. Discovery examination.

   Examiner's explanation:

   A discovery examination is aimed at discovering material weaknesses if any and it therefore looks at many different attributes of the bank.

(ix) A. Internal control systems in companies.

   Examiner's explanation:

   The main focus of the Turnbull report was internal control systems in companies.

(x) C. They are free from bias and are materially correct.

   Examiner's explanation:

   By definition. The other terms relate to understandability, relevance and comparability.
Section B

Answer all ten questions.

2. State the situations in which a company must produce accounts on a break-up basis and explain what a break-up basis means for the assets and liabilities of a company. (4 marks)

Suggested answer

A company must produce accounts on a break-up basis when:

- It is being liquidated or has ceased trading,
- the directors have no realistic alternative but to liquidate the company or to cease trading.

In this case, the assets of the company will be valued a realisable value rather than cost or depreciated values.

All liabilities that the company still has to incur will still be included in the accounts including those of liquidating the company.

Examiner's comments

Most candidates were able to state the reasons for the break-up basis being used. However, the valuation of assets and liabilities was in most answers unclear, while the need to include all liabilities including those relating to any administration expenses was rarely commented on.

3. In respect of a private limited company in the UK, state the requirements of the Companies Act 2006 regarding the notice period for, and holding of, the AGMs and other general meetings. (4 marks)

Suggested answer

- The normal notice period for an AGM is 14 days.
- The company’s articles may vary this notice period to a different number.
- There is no requirement to hold an AGM although 10% of the shareholders can require such a meeting to be held.
- GM can be held at short notice if 90% or more shareholders give their consent.

Examiner's comments

There appeared to be some confusion on notice periods in many answers, with the requirements for public companies being incorrectly stated (21 days as compared to 14 days for private companies).

Many answers also dealt with the procedure to run meetings (such as the taking of minutes) rather than notice periods and changes to these. Comments on the running of meetings were not relevant to this question.
4. **In terms of trust accounting, define ‘capital’ and ‘income’. Explain why it is important to distinguish between capital and income.**

*(4 marks)*

**Suggested answer**

- Income is the amount earned from trust assets, normally investments such as cash on deposit, bonds which earn interest or dividends from shares.

- Capital is the cash and non-cash assets owned by the trust which are used to generate income for the trust.

- It is important to distinguish between capital and income because:
  - Capital is the amount placed into a trust to generate income. By the trust deed, capital cannot normally be spent so a separate record of this amount must be maintained.
  - The beneficiaries of income may be different from the beneficiaries of capital. So, again, clear recording of the two amounts is necessary in order that correct amounts can be paid to the right beneficiaries.

**Examiner’s comments**

Almost all candidates correctly defined trust capital and trust income.

However, the reason for keeping capital and income separate was not always clear.

A number of candidates explained that capital and income could be taxed differently and received credit for this.

5. **Define ‘a provision’ 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)*

**Suggested answer**

A provision is liability of uncertain timing or amount.

It can only be recognised in financial statements when there is a constructive or legal obligation to do so.

A legal obligation is derived from a contract in law such as a court order to pay fines or liabilities.

A constructive obligation is to a third party which has been construed due to a company having created a valid practice expectation; for example, a company will pay to replace damaged goods.

**Examiner’s comments**

This question was either answered very well or quite badly. Most candidates clearly stated what a provision is, with relevant examples and supporting details. In contrast, some candidates provided no definition while also appearing to confuse provisions with contingencies, particularly contingent assets.
6. **Define a cell company and explain three key features of unincorporated protected cells.**

**Suggested answer**

A cell company is private or public company which is able to split its assets and liabilities between different “cells” with each cell carrying on a separate and distinct business.

Key features of protected cells include the following:

- They normally have no separate legal personality but are treated as separate legal entities.
- Assets are “ring-fenced”, meaning they are protected from being used to pay the debts of other cells.
- Transactions are carried out through the cell company itself as the cell cannot make contracts in its own right.

**Examiner’s comments**

There were some good answers to this question. However, some candidates provided very brief answers indicating that perhaps they were not very familiar with cell companies.

7. **Explain four features of limited liability partnerships (LLPs).**

**Suggested answer**

- The partners in the partnership enjoy limited liability. Their loss is limited to money invested in the partnership.
- The partnership is a separate legal entity which means it can sue and be sued in its own name.
- The partners are liable to tax on the partnership profits – not the partnership itself.
- All LLPs must file accounts at Companies House, although, for smaller LLPs, those accounts may be in abbreviated form.

**Examiner’s comments**

Many comments made in answers to this question were technically not required. The examination is based on UK legislation and many comments were made regarding partnerships in other jurisdictions. Comments on general partners were not valid. There were therefore very few high scoring answers.

*Note: LLP agreements vary by jurisdiction. Hence the requirement to state UK LLP requirements [UK noted on the cover of the exam question paper].*
8. Define the term ‘whistleblowing’ and explain how the Dodd-Frank Act in the USA seeks to protect and encourage whistleblowing.

(4 marks)

Suggested answer

- A whistleblower is a person (who may or may not be employed by the company about which a disclosure is being made) who discloses information he or she reasonably believes evidences situations such as violations of law or dangers to public health or safety.

- In making a disclosure, whistleblowers are provided anonymity. In the USA, there is a free-phone number to make disclosures where whistleblowers do not need to leave their name.

- If the identity of a whistleblower does get into the public domain, the Act provides for that person to be entered into a protection programme meaning that they are given a new identity.

- Whistleblowing is encouraged under the Act by providing whistleblowers with a reward of up to 30% of fines imposed on a company (if those fines exceed $1million).

Examiner’s comments

The majority of answers were quite brief, indicating that perhaps the Dodd-Frank Act was not particularly well known. Some candidates explained other jurisdiction legislation, which was not required.

9. Each part of the financial statements of a company (such as the income statement) must display information required by accounting standards. Identify four of these items of information.

(4 marks)

Suggested answer

Any four of the following:

- The name of the reporting entity.
- The financial position date or the period covered by the statement.
- The presentation currency as defined by IAS 21.
- The level of rounding used in presenting amounts, e.g. £'000.
- The level of aggregation used in presenting amounts.
- In a group situation, whether the information relates to the individual entity or the group.

Examiner’s comments

Many candidates obtained full marks for stating the required information correctly. However, some candidates listed the individual pages of the financial statements and appeared to have misunderstood the requirement of the question.
10. Banking regulators and supervisors normally issue codes of best practice which licensee banks subject to regulation must follow. List four regulations which may be included in such a code. 

(4 marks)

Suggested answer

Any four of the following:

- The licensee’s business must be conducted with integrity.
- The licensee must have due regard for the interests of its customers.
- Affairs of the licensee must be organised for the proper performance of its business and to provide appropriate risk management systems.
- All business arrangements must be transparent.
- The licensee must maintain and be able to demonstrate the existence of adequate capital resources.
- The licensee must communicate with its regulator in an open and honest manner.
- The licensee must not make statements which are misleading or false.

Examiner’s comments

This question was generally well answered.

11. Define the term ‘gearing ratio’ and explain the effect of high and low gearing on a company. 

(4 marks)

Suggested answer

- The gearing ratio is the relationship of debt finance to equity finance in a company.
- Debt finance relates to capital raised from borrowing by way of loans or the issue of bonds, debentures and similar instruments, whereas equity finance relates to capital raised from selling shares.
- A low gearing ratio indicates that a company has relatively little debt compared to equity, and it may therefore find it relatively easy to raise more debt finance.
- A high gearing ratio means a company has a significant amount of debt compared to equity. This will limit the extent to which debt finance can be increased due to the perceived risk of non-repayment.

Examiner’s comments

Many candidates were able to explain the gearing ratio and the effects of high and low gearing.
Section C

Answer two questions only.

Examiner’s general comments

Performance in Section C of the examination paper was fair for all three Questions. Many candidates achieved a pass mark for the Questions they attempted. Question 13 was the least popular with 46% of candidates attempting it. This was surprising given that the written narrative of the question contained many “clues”.

The numeric element of Question 12 was well attempted; but, as noted further below, the cash flow statement in Question 14 presented some difficulties.

12. Walter Ltd (‘Walter’) manufactures hairstyling products such as brushes, combs and hair dryers. The company sells these items exclusively to wholesalers. During the financial year to 31 December 2012, the directors of Walter noted that sales were initially falling. Actions taken included broadening the customer base as well as amending the price charged for the products to increase sales. Sales recovered during the year, although the gross profit fell.

The statement of financial position of Walter for the two years 2011 and 2012 are shown below.

<table>
<thead>
<tr>
<th></th>
<th>2011 £’000</th>
<th>2011 £’000</th>
<th>2012 £’000</th>
<th>2012 £’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>4,029</td>
<td>4,089</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening inventory</td>
<td>115</td>
<td>125</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>2,579</td>
<td>2,746</td>
<td>2,694</td>
<td>2,871</td>
</tr>
<tr>
<td>Closing inventory</td>
<td>125</td>
<td>155</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>2,569</td>
<td>2,716</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,460</td>
<td>1,373</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling and distribution costs</td>
<td>334</td>
<td>401</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administration costs</td>
<td>451</td>
<td>503</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit before taxation</td>
<td>675</td>
<td>469</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxation</td>
<td>135</td>
<td>94</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit after taxation</td>
<td>540</td>
<td>375</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>125</td>
<td>125</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained profit</td>
<td>440</td>
<td>275</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Other relevant financial information:

Shares in issue: 50,000 ordinary shares of 50p. Shares were valued at £99.36 on 31 December 2011 and £85.50 on 31 December 2012.

Receivables at 31 December 2011 were £763,000 and receivables at 31 December 2012 were £894,000.

(continued)
Required

(a)  (i) Explain the meaning of the terms price/earnings ratio and dividend cover.  
     (2 marks)

     (ii) List two weaknesses of each term.  
          (4 marks)

(b)  (i) For the two years 2011 and 2012, calculate for Walter:

          • Earnings per share;  
          • Price/earnings ratio; and  
          • Dividend cover.  
          (6 marks)

     (ii) Explain the results of each calculation for Walter.  
          (3 marks)

(c)  (i) Calculate the gross profit percentage for the two years 2011 and 2012.  
       (2 marks)

     (ii) Suggest two reasons for the change in gross profit percentage calculated above.  
          (2 marks)

(d)  (i) Explain the meaning of the ratio ‘receivables days’.  
       (2 marks)

     (ii) Calculate the receivables days for the two years 2011 and 2012.  
          (2 marks)

     (iii) Suggest two reasons for the change in receivables days identified in the calculation above.  
           (2 marks)

          (Total: 25 marks)

Suggested answer

(a)  (i)  

Price earnings ratio

The price earnings (p/e) ratio is a measure of the value of a company being the market price of the share divided by the earnings for that share. In general terms, a higher p/e ratio indicates that the earnings of a company are more stable (there is lower risk of earnings falling).

A lower p/e ratio therefore indicates, in general terms, higher risk because earnings may be more volatile, and investors will want their investment (in terms of share value) to be repaid more quickly.
**Dividend cover**

The dividend cover shows the number of times the proposed dividend for a year can be paid out of retained earnings for that year.

A low dividend cover (normally below 1.5) may indicate that a company is struggling to make sufficient profit to pay the “normal” dividend expected by shareholders. Conversely a higher dividend cover may indicate the company is profitable or that dividend payments are relatively low compared to profits being made.

(ii)

Weaknesses of the price earnings (p/e) ratio include:

- It is calculated on the earnings figure of a company which is subject to a certain amount of manipulation by management.
- The value depends on share price which is set partly based on market perception of a company, which may be incorrect.
- The measure can only be used where there is a market for company shares. It is therefore of little use for unquoted companies where a p/e ratio has to be based on judgement.

Weaknesses of dividend cover include:

- May not have a direct link to profitability and health of the company, especially where directors strive to maintain the same absolute amount of dividends no matter the profits being made.
- As with any ratio based on profits, dividend cover can be manipulated by changing the profit figure.
- Other ratios such as earnings per share (EpS) tend to give investors a more accurate figure of their return from a company.

(b) (i)

**Ratio calculations for Walter**

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares in issue</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Profit after taxation</td>
<td>£540,000</td>
<td>£375,000</td>
</tr>
<tr>
<td>Earnings per share (PAT / shares in issue)</td>
<td>£10.80</td>
<td>£7.50</td>
</tr>
<tr>
<td>Value per share</td>
<td>£99.36</td>
<td>£85.50</td>
</tr>
<tr>
<td>P/E ratio (value per share / EpS)</td>
<td>9.2</td>
<td>11.4</td>
</tr>
<tr>
<td>Dividend cover (PAT / dividend)</td>
<td>4.32</td>
<td>3</td>
</tr>
</tbody>
</table>
(ii)

**Explanation of ratios**

The earnings per share (EpS) is also falling as Walter is making less profit with the same number of shares in issue. If shareholders consider that earnings are becoming too low, they may want to sell their shares and invest in a higher-earning company.

The price earnings (p/e) ratio is increasing. This indicates that, although earnings are falling, shareholders still have confidence that the company will continue to be profitable in the future.

The dividend cover is falling. This indicates, at least in the short term, that there is an increased risk that dividends cannot be paid from retained profit. However a cover of 3 still indicates dividends can be paid 3 times from profits, which is probably an acceptable risk for shareholders.

(c) (i)

**Calculation of gross profit percentage**

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>£4,029,000</td>
<td>£4,089,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>£1,460,000</td>
<td>£1,373,000</td>
</tr>
<tr>
<td>Gross profit percent (gross profit/sales * 100)</td>
<td>36.2%</td>
<td>33.6%</td>
</tr>
</tbody>
</table>

(ii)

**Reasons for the fall in gross profit include:**

- Purchase cost increasing more rapidly than sales (which they have in Walter Ltd).
- Deliberate decision by the directors to decrease selling prices to try and increase the volume of items being sold.

(d) (i)

**Explanation**

Receivables days show on average how long customers are taking to pay a company for the goods or services that they have received. A higher figure simply indicates that receivables are taking longer to pay their debts, whereas a lower figure is indicative of a company managing its receivables (and therefore its cash-flow) effectively.
(ii)

**Receivables days calculation**

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>£4,029,000</td>
<td>£4,089,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>£763,000</td>
<td>£894,000</td>
</tr>
<tr>
<td>Receivables days</td>
<td>(receivables / sales * 365)</td>
<td>69 days</td>
</tr>
</tbody>
</table>

(iii)

In the case of Walter Ltd, an increase from 69 to 80 days is concerning. Possible reasons for this change include:

- The company has allowed extended payment terms to its receivables in an attempt to increase sales.
- The credit control department in Walter Ltd is not doing its job properly and is not chasing receivables for payment efficiently.
- New customers have not been checked for credit-worthiness and now are potentially bad debts.
- The country is in recession and receivables overall are taking extended credit periods in an attempt to maintain their cash-flows.

**Examiner's comments**

This was a very popular question in Section C with most candidates attempting it.

In many answers, the calculations were accurate, although there were a few errors such as using cost of sales (COS) to calculate gross profit rather than sales.

With the interpretation of the actual calculations performed, many candidates simply explained that a ratio had fallen or increased by a certain amount rather than trying to explain why that change had taken place.
Broyles plc (‘Broyles’) is a listed company based in the United Kingdom. The company provides investment advice, private banking and aggressive taxation planning services to clients ranging from private individuals to large limited companies. For example, Broyles regularly recommends individuals to purchase their houses via limited companies to avoid payment of inheritance tax at a later date. This activity has attracted significant adverse publicity both for Broyles and the individuals concerned. Taxation authorities are currently considering the legality of this and other taxation avoidance schemes.

The board of Broyles comprises five executive and five non-executive directors. Non-executive directors are only required to attend board meetings. The non-executive directors are appointed based on their ability to work with other board members to ensure board meetings are not too long.

The Chairman was appointed this year from Watcher Ltd, a company specialising in production of telescopes and other vision-enhancing equipment. The chairman had been the marketing director for two years; he had no other board appointments prior to this.

Shareholders of Broyles are a mixture of clients of the company and other private individuals; there are no institutional shareholders. Shareholders are content to let the directors run their company and insist on not disclosing their voting intentions at general meetings.

The directors of Broyles are concerned about the findings of the Walker Review (on corporate governance in the banking sector) and are considering making changes to the company’s governance structure based on those findings.

The remuneration committee of Broyles decides the remuneration package of all directors. Key staff remuneration is set by the human resources department. Bonuses are paid by Broyles although the method of calculation is specific to each member of staff and this information is not available to anyone apart from the staff member and the human resources department.

Required

(a) Identify six areas in which Broyles might not presently be adhering to the findings of the Walker Review. For each area identified, explain how Broyles will need to change to comply with the Walker Review findings and why this will benefit the company.

(19 marks)

(b) Another criticism of Broyles may be that it does not report on its corporate social responsibility. Define the term ‘corporate social responsibility' and explain four key principles underlying this concept.

(6 marks)

(Total: 25 marks)
Suggested answer

(a)

<table>
<thead>
<tr>
<th>Weakness in Broyles plc</th>
<th>Action to comply with the Walker Review and benefit of that action</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-executive directors (NEDs) are only required to attend board meetings.</strong></td>
<td>This means that NEDs have minimal knowledge of the workings of Broyles. The Walker Review requires a greater time commitment from NEDs as this will help them understand the company and be able to make more informed decisions on the board.</td>
</tr>
<tr>
<td><strong>NEDs are appointed on their ability to work with other board members.</strong></td>
<td>This means that the actual experience of NEDs in working in the industry of Broyles is not considered on appointment. The Walker Review requires a more robust interview process for NEDs. Having criteria for Broyles plc to consider NEDs experience in the company’s activities will again help them make better decisions on the board.</td>
</tr>
<tr>
<td><strong>The newly-appointed chairman comes from a company of vision-enhancing equipment.</strong></td>
<td>This means that the chairman has no experience in the financial services sector. The Walker Review requires that chairmen are appropriately qualified for their role in terms of knowledge of financial services. Having appropriate knowledge adds credibility to the role, and shows that the chairman understands the issues involved in financial services.</td>
</tr>
<tr>
<td><strong>The chairman has had limited board experience prior to joining Broyles plc. The chairman was only on a board for two years and then as marketing director.</strong></td>
<td>This means that the chairman is actually not used to leading boards, and does not have the experience to do this anyway. The Walker Review requires chairmen to have past leadership ability. Having this ability will help provide clear direction to board meetings.</td>
</tr>
<tr>
<td><strong>Shareholders are content to let the directors run their company.</strong></td>
<td>This means that directors are not necessarily aware of the view of shareholders, and may fail to run the company as shareholders required. The Walker Review requires that shareholders are more involved in the running of the company. The directors of Broyles must contact shareholders on a regular basis to ensure the company is run according to wishes of shareholders.</td>
</tr>
<tr>
<td><strong>The results of votes at general meetings remain secret.</strong></td>
<td>This is in compliance with legislation, but not explaining how shareholders vote means that again directors cannot respond to their wishes. The Walker Review requires institutional shareholders to disclose their voting intentions, but extending this to all shareholders in this case will benefit the directors.</td>
</tr>
</tbody>
</table>
The remuneration committee sets remuneration of the board only, not key staff members. This means that remuneration of key staff may not be well aligned to that of the board. The Walker Review suggests remuneration of key staff is the remit of the remuneration committee to try and ensure that any remuneration disparities are minimised.

The incentive packages of key staff are only known to the human resources department. This means that the remuneration package of key staff is not transparent. The Walker Review suggests that the bonus-setting process is transparent which will help all staff understand how bonuses are calculated and ensure the bonuses are “fair”.

(b)

Corporate social responsibility (CSR) can be defined as: “the responsibility of enterprises for their impact on society” – according to the European Commission.

In other words, this relates to the responsibility of companies over and above any legal obligation that they have to society.

Key concepts in CSR include:

- Transparency: it should be clear why decisions are made.
- Accountability: companies recognise that they are accountable for their actions e.g. pollution involves a social cost which companies could pay.
- Integrity: companies are honest and truthful, and do not cover up wrongdoing.
- Respect: companies generate a positive image from their actions so individuals respect them.

Note: any other relevant remarks were awarded marks.

Examiner’s comments

This was the least chosen question in Section C. However, candidates who attempted this question generally used the information in the scenario to make relevant points.
14. Denham Ltd (‘Denham’) is an offshore company offering investment advice to individuals. It is incorporated as a limited company, enjoying a tax-exempt status in its jurisdiction.

Summary financial information for the company is shown below.

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>£’000</td>
<td>£’000</td>
</tr>
<tr>
<td>Advisory fees</td>
<td>1,500</td>
<td>1,450</td>
</tr>
<tr>
<td>Interest received</td>
<td>125</td>
<td>130</td>
</tr>
<tr>
<td>Total income</td>
<td>1,625</td>
<td>1,580</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advisory and management fees</td>
<td>756</td>
<td>812</td>
</tr>
<tr>
<td>Administration</td>
<td>134</td>
<td>141</td>
</tr>
<tr>
<td>Operating costs</td>
<td>241</td>
<td>251</td>
</tr>
<tr>
<td>Directors’ fees</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Total expenses</td>
<td>1,281</td>
<td>1,354</td>
</tr>
<tr>
<td>Net profit for the year</td>
<td>344</td>
<td>226</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Retained profit</td>
<td>244</td>
<td>126</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets – intangible assets</td>
<td>175</td>
<td>175</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>790</td>
<td>958</td>
</tr>
<tr>
<td>Receivables</td>
<td>230</td>
<td>275</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>415</td>
<td>350</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,610</td>
<td>1,758</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>145</td>
<td>167</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>1,390</td>
<td>1,516</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>1,610</td>
<td>1,758</td>
</tr>
</tbody>
</table>

Required

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

(6 marks)

(b) Prepare the cash flow statement for Denham for the year ended 30 June 2013. Clearly distinguish between operating activities, investing activities and financing activities.

(15 marks)

(c) Explain how the purchase of a factory would be shown in the cash flow statement of a company.

(4 marks)

(Total: 25 marks)
Suggested answer

(a)

Operating activities

These are the main income-producing activities of a business. The cash flow statement will therefore show the net profit derived from those activities as well as changes in assets and liabilities relating to the day-to-day trading of the company.

Investing activities

These are activities relating to the acquisition and disposal of investments which are not part of the day-to-day trading of a company. For example, a company may have surplus cash which is invested in investments rather than kept in the bank to pay for current liabilities. Any interest received on these investments is also included in investing activities.

Financing activities

These relate to the raising of finance in the form of either debt or equity. Cash flow statements show the return due to debt-holders or equity-holders in terms of interest paid or dividends paid during the year. There may be a difference to the figures shown in the income statement because this shows dividends payable whereas the cash flow shows actual payments made.

(b)

FHG Trust – Cash flow statement for the year ended 30th June 2013

<table>
<thead>
<tr>
<th>Cash flows from operating activities</th>
<th>2013 £'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit for the year</td>
<td>226</td>
</tr>
<tr>
<td>Increase in receivables</td>
<td>-45</td>
</tr>
<tr>
<td>Increase in payables</td>
<td>22</td>
</tr>
<tr>
<td><strong>Net cash flow from operating activities</strong></td>
<td><strong>203</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from investing activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in current investments</td>
<td>-168</td>
</tr>
<tr>
<td>Interest received</td>
<td>130</td>
</tr>
<tr>
<td><strong>Net cash flows from investing activities</strong></td>
<td><strong>-38</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from financing activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid</td>
<td>-100</td>
</tr>
<tr>
<td><strong>Net cash flow from financing activities</strong></td>
<td><strong>-100</strong></td>
</tr>
</tbody>
</table>

| Net decrease in cash and cash equivalents | 65       |
| Cash and cash equivalents at beginning of year | 415     |
| Cash and cash equivalents at end of year | 350      |
(c)

The purchase of non-current assets is an investment for a company; the assets, in this case the factory, will be used over a number of years to generate income in terms of being a building to make the company’s goods in.

In terms of the cash flow statement:

- Depreciation charged on the factory will be added back to net profit as a non-cash expense.
- Purchase of the factory will be shown as a negative amount in investing activities as Charlie Ltd has spent money on the factory (cash outflow).

Examiner’s comments

Some candidates demonstrated their knowledge of producing a cash flow statement and scored highly.

However, a small number of candidates generally appeared unclear on how to produce the statement and therefore answered the question poorly.