

# AF2

## Advanced Diploma in Financial Planning

### Unit AF2 – Business financial planning

April 2011 examination

#### SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2010/2011, unless stated otherwise in the question, and should be answered accordingly.

Assume all individuals are domiciled, resident and ordinarily resident in the UK unless stated otherwise.

Candidates should answer based on the legislative position immediately BEFORE the 2011 budget.

#### Instructions

- Three hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**



# Unit AF2 – Business financial planning

## Instructions to candidates

### Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 160 marks as follows:
  - Section A: 80 marks
  - Section B: 80 marks
- You are advised to spend approximately 90 minutes on Section A and 90 minutes on Section B
- You are strongly advised to attempt **all** questions to gain maximum possible marks. The number of marks allocated to each question is given next to the question and you should spend your time in accordance with that allocation.
- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.
- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.
- It is important to show all steps in a calculation, even if you have used a calculator.
- If you bring a calculator into the examination room, it must be a silent battery or solar-powered non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.
- Tax tables are provided at the back of this question paper.
- Answer each question on a new page and leave six lines blank after each question part.

**Subject to providing sufficient detail you are advised to be as brief and concise as possible, using note format and short sentences on separate lines wherever possible.**

## SECTION A

**This question is compulsory and carries 80 marks.**

### Question 1

Peter London and his wife Mary, aged 58 and 57 respectively, purchased PML Plastics Ltd as a going concern on 1 October 2010. By the end of March 2011, PML Plastics Ltd was running into cash flow difficulties and its bankers are refusing to extend the company's overdraft facilities. Peter is the managing director of the company and has asked you to attend a meeting to discuss his business problems.

The issued share capital of PML Plastics Ltd is 40,000 £1.00 shares owned equally by Peter and Mary. The nominal capital stated in the memorandum is £250,000. In addition, both have provided directors' loans. The factory site is rented by the company. An adjacent office was purchased by the company at a cost of £150,000. This is owned and used outright by the company and its value is unchanged.

PML Plastics Ltd has an overdraft facility of £20,000 secured against Peter and Mary's home. Due to trading difficulties, the overdraft facility has proved inadequate and is fully utilised. A further £30,000 is being sought to meet immediate requirements.

Peter and Mary have already committed most of their free capital to this venture and do not wish to risk raising further finance secured on their home. Peter has a personal pension currently valued at £120,000 and he is prepared to take any reasonable action with it in order to safeguard PML Plastics Ltd.

The company produces moulded plastic products which is labour intensive, but for the most part does not require skilled staff. The company continues to employ the eight full-time staff who were employees at the time of purchase, and a further five full-time staff were employed from 1 November 2010. The total number of staff, including Peter and Mary, is 15.

Peter has advised you that the company operates a 'last in first out' staffing policy, although since he took control of the company, no one has been made redundant. In view of the company's current financial difficulties, he is now considering making five staff redundant to reduce costs and to replace them with other staff on part-time contracts. The staff contract of employment provides for the statutory notice period. Tom, the longest serving member of staff, has been continuously employed for 15 years. He has worked for the company since he was 40 years old and earns a salary of £400 gross for a basic weeks work.

Peter has told you that to date, sales have been lower than expected with significant variations from month to month and that he has reconciled his budget and expenditure at the end of each quarter. He further states that, during some weeks, his staff have had little to do, while at other times, they work a substantial level of overtime to meet the production levels required.

**Table 1 - PML Plastics Ltd Annual Profit & Loss Budget Projections  
1 October 2010 to 30 September 2011**

	£
<b>Sales revenue</b>	720,000
<b>Cost of goods sold</b>	168,000
<b>Sales and marketing expenses</b>	36,000
<b>Labour expenses</b>	240,000
<b>General administration expenses</b>	36,000
<b>Other overhead expenses</b>	120,000
<b>Operating income</b>	120,000

**Table 2 - PML Plastics Ltd actual Profit & Loss figures  
1 October 2010 to 30 March 2011**

	Oct £	Nov £	Dec £	Jan £	Feb £	March £
<b>Sales revenue</b>	70,000	40,000	30,000	75,000	35,000	55,000
<b>Cost of goods sold</b>	20,000	12,000	9,000	18,000	11,500	15,000
<b>Sales and marketing expenses</b>	3,000	3,000	3,000	3,000	3,000	3,000
<b>Fixed labour expenses</b>	14,000	20,000	20,000	20,000	20,000	20,000
<b>Variable labour expenses</b>	15,000	-	-	10,000	-	3,000
<b>General administration expenses</b>	3,500	3,000	2,500	3,000	2,500	3,500
<b>Other overhead expenses</b>	10,000	10,000	10,000	10,000	10,000	10,000
<b>Operating income</b>	4,500	-8,000	-14,500	11,000	-12,000	500

### Questions

- (a) You are concerned that Peter's budgetary control is not to the standard you would expect.
- (i) Recommend the actions that PML Plastics Ltd should implement in order to operate an effective budgetary control process. (6)
  - (ii) Explain, in the context of the budget and using the information provided, the problems with Peter's labour arrangements and how they have contributed to the company's current cash flow problem. (6)
  - (iii) Recommend, giving your reasons, the action Peter should take to resolve the problems you have identified in part (a)(ii) above. (4)
- (b)
- (i) Explain to Peter why applying his policy of 'last in first out' may be an unsound business practice for making five staff redundant. (4)
  - (ii) Explain to Peter the criteria staff members would have to meet to qualify for redundancy pay. (5)
  - (iii) State, giving your reasons, the notice period that the company would have to provide to Tom if he was to be made redundant. (5)

Questions continue over the page

**Question parts (c), (d), (e) and (f) can be found on page 7**

- (c) Having read about a recent case in the newspaper, Peter is concerned that, if the bank does not extend the company's overdraft facilities and the company continues to trade, he may be liable for wrongful trading.
- Explain briefly to Peter:
- (i) the circumstances in which this could arise; (4)
  - (ii) the consequences should this arise. (7)
- (d) An increased overdraft is one way of financing the company's working capital requirements.
- State **five** alternative options for the company, explaining any drawbacks. *Ignore any options that make use of pension arrangements.* (15)
- (e) Peter would like to use his personal pension fund to help refinance the company.
- (i) Explain to Peter how he can use a self-invested personal pension (SIPP) to purchase the company office property. (4)
  - (ii) Explain how this would benefit the company. (5)
  - (iii) Calculate, **showing all your workings**, the amount he can raise and state whether this will be sufficient to meet the £150,000 purchase price. *Disregard any ancillary costs associated with the purchase.* (5)
- (f) In relation to the company's existing financial needs, explain the **drawbacks** to Peter and the company of raising cash by:
- (i) taking the pension commencement lump sum from his existing personal pension and introducing it to the company as a further director's loan; (5)
  - (ii) using the existing pension fund to purchase the company offices through a SIPP. (5)

**Total marks available for this question: 80**

**Questions continue over the page**

## SECTION B

**Both questions in this section are compulsory and carry an overall total of 80 marks.**

### Question 2

You have had a preliminary discussion with Brian Rodgers, personnel director of Whizz Games plc about a range of staff incentives he is considering for the company and have outlined to him some possibilities. He now requires more detailed information from you.

Whizz Games plc is an independent computer games software development company with 100 full-time staff and assets of £15,000,000. Whizz Games plc recently launched a very successful new game which is generating considerable revenue and it wants to provide a range of incentives to retain and reward 20 full-time key staff and is prepared to grant them share options equally up to the maximum allowed. Whizz Games plc also wants to provide a share incentive scheme for all staff. The market price of the Whizz Games 50p ordinary share is currently listed on the London Stock Exchange at £5.00 each.

Whizz Games plc has decided to implement a group income protection scheme so that it can make proper provision for its employees' ill health, rather than the ad hoc system it currently operates.

The head of the team that developed the new game, Peter Johnson, was given a new company car on 1 April 2011. It runs on diesel and has a list price of £135,000. In addition, he was allowed to specify a range of 'extras' costing £15,000. The CO<sub>2</sub> emissions are 190g/km.

### Questions

- (a) (i) Explain to Brian whether Whizz Games plc would qualify to offer its 20 key staff shares under an Enterprise Management Incentive Scheme. (6)
- (ii) Explain to Brian any restrictions relating to the amount of options that Whizz Games plc can offer as a whole, or to individual members of staff and explain whether the 20 key staff will each be able to receive the maximum grant. (4)
- (iii) Explain to Brian the tax implications to the employees if the company issues them options with an exercise price of £1.00 instead of the market price of £5.00. (3)
- (b) Explain to Brian the main features of an approved share incentive scheme. (12)
- (c) Explain to Brian the tax treatment of a group income protection scheme to both Whizz Games plc and its employees. (5)
- (d) Calculate, **showing all your workings**, the benefit-in kind value of Peter's new company car. (6)

**Total marks available for this question: 36**

### Question 3

ZYX Technology Ltd is an unquoted trading company involved in the development and sale of productivity software for legal practices. The company was founded four years ago by its two directors, John Smith and his sister, Sally, who hold equal shares in the company.

John and Sally wish to expand the company into Europe and have agreed to hire Tomas Mendes as their European business development manager. ZYX Technology Ltd's bank has agreed to lend a sum of £400,000 for a period of three years on an interest only basis to fund the expansion. The monies will be released to ZYX Technology Ltd in three months' time. Tomas, aged 40, is a non-smoker in excellent health and his salary will be £115,000 gross per annum and the costs associated with his recruitment will be £35,000. Tomas's skill set is highly specialised and the employment agent used by John and Sally took six months to recruit him. Tomas will require three months training on the company's products when he arrives before he is able to generate revenue.

ZYX Technology Ltd's business plan states that after the first year, it expects to earn revenues of around £1,000,000 per annum from the new European business at current exchange rates with gross profits of around £550,000 per annum.

John and Sally are both married with families who do not wish to be involved in ZYX Technology Ltd. They wish to ensure that, should one of them die unexpectedly, their families can receive fair value for the deceased's share and that the survivor can continue to run and control the business. Their Wills currently leave their shares in ZYX Technology Ltd to their respective children and their solicitor has advised them to put a suitable shareholder arrangement in place. John and Sally are looking for maximum flexibility in any arrangements to protect their shareholdings.

Neither ZYX Technology Ltd nor its directors have any current protection policies in place and they are keen to minimise any tax liabilities for the company and themselves, including any Inheritance Tax if one of them should die.

### Questions

- (a) (i) Identify **three** key person life protection needs relevant to protecting ZYX Technology Ltd's European venture. (3)
- (ii) State, giving your reasons, the amount and method for calculating, as appropriate, the sum assured you would recommend for **each** key person life protection need you have identified in part (a)(i) above. (12)
- (iii) Recommend, giving your reasons, the type of life policy, and sum assured you would recommend to cover the shareholder protection needs. (4)
- (iv) Explain the Income Tax treatment of both the premium and death benefit payments for the policy you recommended in part (a)(iii) above. (2)
- (b) Explain the Corporation Tax treatment of both the premium and death benefit payments, including any qualifying conditions, for a policy taken out by ZYX Technology Ltd on the life of Tomas to provide cover for loss of profits. (6)
- (c) If either John or Sally die, explain the Inheritance Tax treatment of the deceased's shares in ZYX Technology Ltd. (5)
- (d) Explain how a cross/double option agreement and associated life policies for John and Sally will enable them to achieve their requirements in respect of their shares in ZYX Technology Ltd and the tax savings they seek to achieve. (12)

**Total marks available for this question: 44**

**The tax tables can be found on pages 11 - 15**

# INCOME TAX

RATES OF TAX	2009/2010	2010/2011
Starting rate for savings*	10%	10%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	N/A	50%
Starting-rate limit	£2,440*	£2,440*
Threshold of taxable income above which higher rate applies	£37,400	£37,400
Threshold of taxable income above which additional rate applies	N/A	£150,000

*\*restricted to savings income only and not available if taxable non-savings income exceeds starting rate band.*

## MAIN PERSONAL RELIEFS

Income limit for Personal Allowance §	N/A	£100,000
Personal Allowance (basic) §	£6,475	£6,475
Personal Allowance (age 65-74) §	£9,490	£9,490
Personal Allowance (aged 75 and over) §	£9,640	£9,640
Married/civil partners (minimum) at 10% †	£2,670	£2,670
Married/civil partners (age 75 and over) at 10%	£6,965	£6,965
Income limit for age-related allowances	£22,900	£22,900
Blind person's allowance	£1,890	£1,890
Enterprise Investment Scheme relief limit at 20%	£500,000	£500,000
Venture Capital Trust relief limit at 30%	£200,000	£200,000

*§ the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age from 2010/2011.*

*† where at least one spouse/civil partner was born before 6 April 1935.*

Child Tax Credit (CTC)		
- family element	£545	£545
- family element baby addition	£545	£545
CTC usually reduced by 6.67% of joint income over	£50,000	£50,000

## NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	Weekly	Monthly	Yearly
Lower Earnings Limit (LEL)	£97	£421	£5,044
Primary threshold	£110	£477	£5,715
Upper Earnings Limit (UEL)	£844	£3,656	£43,875
Upper Accruals Point	£770	£3,337	£40,040

Total earnings £ per week	CLASS 1 EMPLOYEE CONTRIBUTIONS	
	Contracted-in rate	Contracted-out rate
Up to 110.00*	Nil	Nil
110.01 – 770.00	11%	9.4%
770.01 – 844.00	11%	11%
Above 844.00	1%	1%

Total earnings £ per week	CLASS 1 EMPLOYER CONTRIBUTIONS		
	Contracted-in rate	Contracted-out rate	
		<i>Final salary</i>	<i>Money purchase</i>
Below 110.00**	Nil	Nil	Nil
110.01 – 770.00	12.8%	9.1%	11.4%
770.01 – 844.00	12.8%	12.8%	12.8%
Excess over 844.00	12.8%	12.8%	12.8%

\* This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £97 per week. This £97 to £110 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.

\*\* Secondary earnings threshold.

<b>Class 2 (self-employed)</b>	Flat rate per week £2.40 where earnings exceed £5,075 per annum.
<b>Class 3 (voluntary)</b>	Flat rate per week £12.05
<b>Class 4 (self-employed)</b>	8% on profits between £5,715 - £43,875 plus 1% on profits above £43,875

## PENSIONS

TAX YEAR	LIFETIME ALLOWANCE	ANNUAL ALLOWANCE
2006/2007	£1,500,000	£215,000
2007/2008	£1,600,000	£225,000
2008/2009	£1,650,000	£235,000
2009/2010	£1,750,000	£245,000
2010/2011	£1,800,000	£255,000

### NOTIONAL EARNINGS CAP

£123,600 – (For schemes that require post-1989 benefits to be still subject to a cap).

### ANNUAL ALLOWANCE CHARGE

40% member's tax charge on the amount of total pension input in excess of the annual allowance.

### LIFETIME ALLOWANCE CHARGE

55% of excess over lifetime allowance if taken as a lump sum.

25% of excess over lifetime allowance if taken in the form of income, which is subsequently taxed under PAYE.

# INHERITANCE TAX

## RATES OF TAX ON DEATH 2009/2010    2010/2011

Transfers made after 5 April 2010			
- Up to £325,000		Nil	Nil
- Excess over £325,000		40%	40%
- Lifetime transfers to and from certain trusts		20%	20%

## MAIN EXEMPTIONS

Transfers to			
- UK-domiciled spouse/civil partner		No limit	No limit
- non-UK-domiciled spouse/civil partner (from UK domiciled spouse)		£55,000	£55,000
- UK-registered charities		No limit	No limit
Lifetime transfers			
- annual exemption per donor		£3,000	£3,000
- small gifts to same person		£250	£250
Wedding/civil partnership gifts by			
- parent		£5,000	£5,000
- grandparent/party to marriage/civil partnership		£2,500	£2,500
- other person		£1,000	£1,000

100% relief: businesses, unlisted/AIM companies, certain farmland/building  
 50% relief: certain other business assets

Reduced tax charge on gifts within 7 years of death:

- Years before death	0-3	3-4	4-5	5-6	6-7
- Inheritance Tax payable	100%	80%	60%	40%	20%

# CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO<sub>2</sub>) emissions. There is no reduction for high business mileage users.

### For 2010/2011:

The percentage charge is 15% of the car's list price for CO<sub>2</sub> emissions at or below the qualifying level of 130g/km.

The base percentage charge of 15% increases in 1% steps for every additional full 5g/km over the 130g/km threshold, up to a maximum of 35% of the car's list price.

A lower percentage charge of 10% of the car's list price applies for emissions at or below 120g/km and 5% for emissions at or below 75g/km.

If price of car exceeds £80,000 then its price for tax purposes will be fixed at £80,000.

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards or registered after 31 December 2005. However, the maximum charge remains 35% of the car's list price.

**Car fuel**      The benefit is calculated as the CO<sub>2</sub> emissions % relevant to the car and that % applied to a set figure (£18,000 for 2010/2011) e.g. car emission 160g/km = 21% on car benefit scale.  
 21% of £18,000 = £3,780.

1. **Accessories** are, in most cases, included in the list price on which the benefit is calculated.
2. **List price** is reduced for capital contributions made by the employee up to £5,000.
3. **Car benefit** is reduced by the amount of employee's contributions towards running costs.
4. **Fuel scale** is reduced only if the employee makes good **all** the fuel used for private journeys.
5. **All car and fuel benefits** are subject to employers National Insurance Contributions (Class 1A) of 12.8%.

## PRIVATE VEHICLES USED FOR WORK

2010/2011 Rates

### Cars

On the first 10,000 business miles in tax year 40p per mile  
 Each business mile above 10,000 business miles 25p per mile

### Motor Cycles

24p per mile

### Bicycles

20p per mile

## MAIN CAPITAL AND OTHER ALLOWANCES

2010/2011

Plant & machinery 100% annual investment allowance (first year)	£100,000
Plant & machinery (reducing balance) per annum	20%
Patent rights & know-how (reducing balance) per annum	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	10%
Industrial & agricultural buildings (straight line)	1%
Energy & water-efficient equipment	100%
Zero emission goods vehicles (new)	100%
Qualifying flat conversions, business premises & renovations	100%

### Motor cars: Expenditure on or after 01/04/09 (Corporation Tax) or 06/04/09 (Income Tax)

CO <sub>2</sub> emissions of g/km:	110 or less *	111-160	161 or more
Capital allowance:	100%	20%	10%
	first year	reducing balance	reducing balance

\* If new

Research & Development: Capital expenditure	100%
Revenue expenditure: Small/medium companies:	175%
Large companies:	130%

## MAIN SOCIAL SECURITY BENEFITS

		2009/2010	2010/2011
		£	£
Child Benefit	first child	20.00	20.30
	subsequent children	13.20	13.40
Incapacity Benefit	short-term lower rate*	67.75	68.95
	short-term higher rate*	80.15	81.60
	long-term rate	89.80	91.40
Attendance Allowance	lower rate	47.10	47.80
	higher rate	70.35	71.40
Retirement Pension	single	95.25	97.65
	married	152.30	156.15
Pension Credit	single person standard minimum guarantee	130.00	132.60
	married couple standard minimum guarantee	198.45	202.40
	maximum savings ignored in calculating income	6,000.00	10,000.00
Bereavement Benefit (lump sum)		2,000.00	2,000.00
Widowed Parent's allowance		95.25	97.65
Jobseekers Allowance		64.30	65.45

\* under State Pension Age

## CAPITAL GAINS TAX

### RATES OF TAX

Chargeable gains, less allowable losses, are charged to tax as follows from 23 June 2010:

- for individuals who are non-taxpayers or basic-rate taxpayers, the rate chargeable is 18%.
- for individuals who are higher-rate taxpayers or additional-rate taxpayers, the rate chargeable is 28%.
- for trustees of trusts and personal representatives the rate chargeable is 28%.
- Entrepreneurs' Relief reduces the rate to 10% on qualifying assets subject to a lifetime limit of £5,000,000.

### ANNUAL EXEMPTION

- The annual exemption is £10,100.
- Most trusts have an annual exemption of £5,050.

### CHATELS EXEMPTION

- Gains on chattels are exempt if proceeds do not exceed £6,000 per item.

## CORPORATION TAX

	2009/2010	2010/2011
Full rate	28%	28%
Small companies rate	21%	21%
Small companies limit	£300,000	£300,000
Effective marginal rate	29.75%	29.75%
Upper marginal limit	£1,500,000	£1,500,000

## VALUE ADDED TAX

Standard rate to 03/01/11	17.5%
Standard rate from 04/01/11	20%
Annual Registration limit	£70,000

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