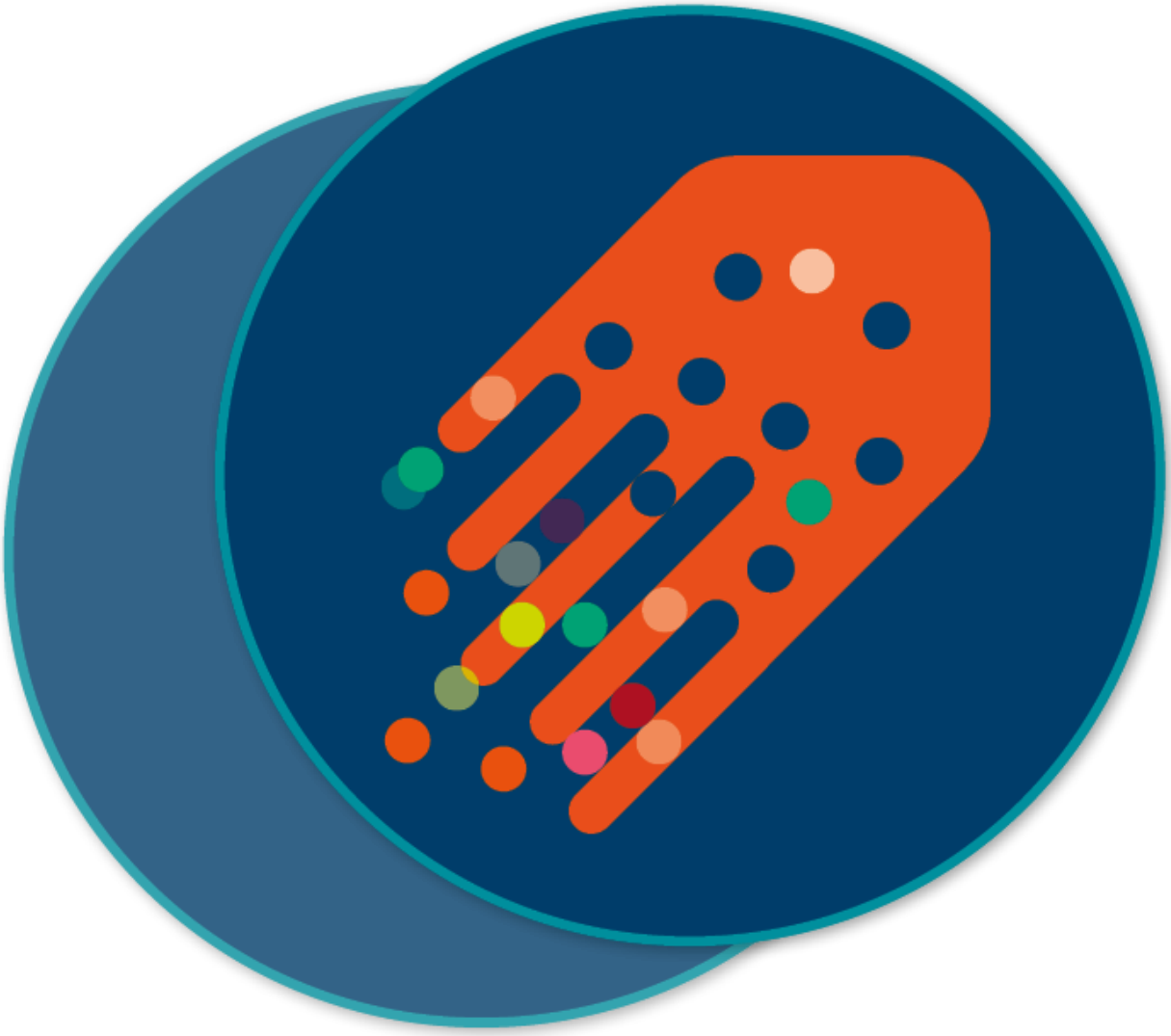
ACT Practice Paper

Diploma in Treasury Management (AMCT)

Unit 4a: Financial Reporting, Tax and Regulations



This is a practice paper for Unit 4a of the Diploma in Treasury Management (AMCT), based on the syllabus assessed from 1 August 2022.

INTRODUCTION

This practice paper has been produced by the Awarding Body at the Association of Corporate Treasurers (ACT) to assist students in their preparation for the Diploma in Treasury Management assessments. It contains a practice exam for the specified unit as well as the answers. Ideally, students should have completed the majority of their Diploma in Treasury Management studies for Unit 4a before attempting this practice paper.

Students should allow themselves 180 minutes to complete the exam plus an additional 15 minutes reading time. They should then review their performance to identify areas of weakness on which to concentrate the remainder of their study time. Although the practice paper in this guide is typical of a Diploma in Treasury Management assessment, it should be noted that it is not possible to test every single aspect of the syllabus in any one exam.

To prepare properly for the examination, candidates should make full use of the tuition options where available and read as widely as possible to ensure that the whole syllabus has been covered.

ASSESSMENT TECHNIQUE

This is a professional paper that as well as testing theory expects application to practice at a managerial level.

The best way to approach written assessments is to work methodically through the questions. Candidates should not spend too much time on any one question if you are struggling to think of an adequate answer. Remember you can flag any question to come back to later should you want to continue your way through the exam.

When all the questions have been answered, it is prudent to use any remaining time to go through each question again, carefully, to double-check that nothing has been missed. Altering just one response could make the difference between passing and failing.

Please ensure you show your workings within your answer when prompted as this means there are marks available for the workings out. You will be able to make rough workings on a piece of paper during the exam and on screen should you wish to, however these will not count towards your final mark.

ASSESSMENT INFORMATION AND TEST SPECIFICATION

The Diploma in Treasury Management assessments for Units 4a and 4b each have three written questions, all of which are mandatory. They will also involve a pre-seen case study workbook for Section A that is released no later than two weeks prior to the assessment date. The papers will be split into Sections A and B and each unit exam is worth a total of 100 marks. For the purpose of this practice paper the questions follow each case study.

Diploma in Treasury Management assessment test specification:

Section	Amount of questions	Marks available
Section A	1 case study-based question	50
Section B	2 shorter case study-based questions, of which both are mandatory	50
Total	3	100

Under exam conditions, 3 hours (180 minutes) is allowed for each of the Diploma in Treasury Management assessments plus an additional 15 minutes reading time.

When you take your actual exam, you will be sitting online using your own PC/Laptop. You have access to an online scientific calculator, but for the purpose of this practice paper, you may use a non-programmable scientific calculator.

In order for you to determine how well you have performed, exemplar answers are listed at the end of this paper. There are also references to the relevant Learning Outcomes if you need to revisit the associated material.

SECTION A – 50 marks

Answer ALL questions in Section A. This questions tests knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level. You are required to present your answers in a report format.

Total available for Section A: 50 marks

Background

Greenfield Toys Ltd (GT) is a UK-based eco-friendly general children's merchandise retailer in the UK. Their products include toys, clothes, furniture and equipment such as pushchairs etc. GT designs its own products which it sells via its own websites across the UK, US, Canada and 12 countries in Europe, including Switzerland, Sweden and Denmark. GT also sells to wholesale customers across these countries. GT group consists of a UK-based parent company and subsidiaries in most of the countries where it sells directly through its websites. It was launched in 2002 and has since become an established business with an average annual revenue of GBP100m across the group. It is a family run privately-owned company.

Business Strategy

GT's core mission is to produce eco-friendly and innovative products for children of all ages. GT is able to maintain competitive profit margins through cost efficiencies arising from a lack of physical stores or office spaces. Most employees work remotely, except for the production and testing staff. The main costs incurred by the business are employee costs, quality, eco-friendly raw materials and designing and manufacturing costs. GT sources its raw materials from certified sustainable suppliers. Around 60% of raw materials are purchased from suppliers in Sweden and Denmark. Manufacturing occurs mostly in the UK. The group has recently also established manufacturing facilities in the US to reduce transport and storage costs of finished products.

To maintain an image of an exclusive high-end retailer, GT sells its products only through its own websites and select high-end stores. GT constantly refreshes its range of products, keeping up with the latest trends and customer preferences. This culture of innovation helps GT maintain a competitive advantage against other similar retailers. During the COVID-19 pandemic, GT experienced a surge in demand of its products as customers looked for ways to entertain their children while confined to their homes. Individual customers pay in their local currency at the point-of-sale. Wholesale customers pay within three months of the order placed in their own local currency. Credit checks are performed before extending credit to wholesale customers.

Following its strong financial performance, GT is now looking to expand its business to certain parts of Asia by forming a partnership with a local high-end department store. GT will sell its products at the department store only, as market research shows a preference for in-person shopping in these countries.

GT has a central treasury for all entities within the group. GT uses foreign currency forwards to manage its foreign currency risk arising from operating across many countries. GT does not use hedge accounting. GT maintains cash low forecasts in each of the major required currencies to determine its foreign currency requirements.

Financial Performance

Group gross profit has been increasing steadily over the years, with strong growth in almost all regions that it operates in. However, foreign exchange gains/losses fluctuate year on year. The table below shows excerpts from the group Income Statement. The financial statements are presented in GBP.

GBP(m)	FY2020	FY2019
Revenue	114.0	98.5
Cost of Sales	(79.8)	(67.0)
Gross Profit	**34.2**	**31.5**
Administrative Expenses	(11.7)	(10.5)
Finance costs	(3.6)	(3.4)
Foreign Exchange losses	(5.0)	(3.6)
Other costs	(3.5)	(3.1)
Profit before tax	**10.4**	**10.9**
Tax	(1.86)	(1.90)
Profit for the period	**8.5**	**9.0**

Administrative expenses includes depreciation of GBP4.2m in FY2020 and GBP3.8m in FY2019.

GT is exposed to foreign exchange risks in two ways. Firstly, it obtains the bulk of its raw materials from Sweden and Denmark which exposes GT to foreign exchange risk through purchase of these materials in foreign currencies. Secondly, it consolidates the financial statements of its foreign subsidiaries that are presented in their own presentation currencies. These subsidiaries have borrowings on their balance sheets in their transaction currency.

GT's trade receivables consist of amounts owed by wholesale customers, since individual customers pay at the point-of-sale. Around 80% of sales are made to wholesale customers. Most of GT's liabilities include amounts owed to suppliers for raw materials and bank borrowings.

GBP(m)	FY2020	FY2019
Current assets		
Trade and other receivables	73.0	47.3
Inventory	25.1	18.7
Other current assets	2.2	1.9
	100.2	**67.9**
Current liabilities		
Trade and other payables	23.95	16.7
Bank and other loans	3.4	3.1
Other current liabilities	11.2	10.3
	38.6	**30.1**
Non-current liabilities		
Bank and other loans	34.1	36.5

The total equity on balance sheet was GBP35.1m in FY2020 and GBP28.7m in FY2019.

Joint venture in Asia

To expand its business in Asia, GT is considering entering a joint venture (JV) with a high-end department store. Due to uncertainty over popularity of its products in these Asian countries, GT is considering entering a JV arrangement with a 49% stake. GT will need to borrow an additional GBP10m to fund this joint venture. GT will extend a long-term loan to the JV. The amount is yet to be determined.

GT must adhere to covenants as part of the borrowing arrangements. Financial covenants in the agreement are as follows:

1. current ratio: current assets/current liabilities. A ratio of 1.8 is required
2. debt to equity ratio: total liabilities/total equity. A ratio of 2.0 is required
3. interest coverage ratio: EBITDA/Interest Expense. A ratio of 4.5 required
4. inventory turnover: cost of goods sold/average inventory. A turnover of 4 is required
5. operating profit (EBIT) margin: operating profit/revenue. A margin of 9.5% is required.

Q1	(a) Analyse the key issues faced by GT in relation to its currency exposures and recommend solutions to address these issues. You are required to make specific reference within your answer to the currency exposures relating to the proposed JV.	15 marks
	(b) Examine the financial performance of GT against each of its financial covenants. Include in your answers any risks of breaching the covenants and recommendations for improvements.	10 marks
	(c) Analyse the key risks and opportunities for GT relating to the proposed JV. Consider in your answer, the ownership structure, any financial reporting and tax implications and impact on financial covenants.	10 marks
	(d) Discuss the items that GT must disclose for financial reporting purposes in relation to the following: - IFRS 7 - use of derivatives.	15 marks
	Syllabus refs: LO16, LO17, LO18 & LO19	
		Total: 50 marks

Q1 answer	a) Currency exposures (including any issues related to the proposed JV). *Please note that candidates are not to be penalised for not specifically stating the terms "transaction risk" nor "translational risk" listed below.* FX rates are difficult to predict and can adversely affect a multinational business such as GT. Transaction risk - sell in various local currencies. 80% are to wholesale customers who are given three months to pay. There is a risk of FX moving adversely in that time. Transaction risk - purchase from suppliers in various local currencies. 60% of raw materials are purchased from Sweden and Denmark. There is a risk of FX moving adversely in that time. GT sells in many countries in their local currencies - sales may fall if price changes due to FX rates. If prices are not changed to reflect changes in FX rate, it may eat into profits. Need to maintain foreign currency bank account for JV. There will be additional costs associated. Translational risk - Translation does not affect cashflow but affects shareholder confidence and borrowing capacity (credit rating is affected based on financial statements). GT is exposed to following translation risks: Translation of foreign currency liabilities, especially trade payables. Especially as raw materials are purchased from Sweden and Denmark. There is economic risk here as well of GBP weakening against these currencies. Translation of foreign currency trade receivables, as wholesale customers purchase in their local currency from various countries. There is economic risk here as well of foreign currencies weakening against GBP. Translation risk - GT's share of JV's profit/loss will need to be translated to be included in GT's income statement.	15 marks

Translation risk - foreign subsidiaries financial statements will need to be translated for consolidation.

Despite higher revenues and gross profit in FY2020 compared to FY2019, PBT for FY2020 is lower than FY2019. part of this is driven by increases FX losses by almost 40%.

If FX translation or other differences have an adverse effect on the financial statements this may, in turn, adversely affect the credit rating.

GT should review FX hedging to reduce the transaction risk associated with trade receivables/payables.

GT should monitor EBITDA and the total equity by currency, and match them to the currency of debt if possible to manage FX translation risks.

An appropriate carve-out should be negotiated in respect of FX translation. A suitable carve-out would be that covenant compliance should be measured on an appropriate basis so that the FX difference does not cause a breach of covenant e.g. for operating profit (EBITDA) margin.

b) Financial Covenants -

10 marks

5 marks each of correct calculation of each ratio and appropriate commentary

Current ratio: current assets/current liabilities
FY2020: 100.2/38.6 = 2.6
FY2019: 67.9/30.1 = 2.3

Debt to equity ratio: [current liabilities + non-current liabilities]/equity
FY2020: (38.6+34.1)/36 = 2.1
FY2019: (30.1+36.5)/28.7 = 2.3

Interest coverage ratio: EBITDA/Finance costs
EBITDA: Profit before tax + finance costs + depreciation
FY2020: (10.4 +3.6 +4.2)/3.6 = 5.0
FY2019: (9 +3.4 +3.8)/3.4 = 5.3

Inventory Turnover: Cost of goods sold/average inventory
FY2020: 79.8/[(25.1+18.7)/2] = 3.6
FY2019: cannot be calculated as inventory for 2019 is not known.

EBITDA margin:
EBITDA: Profit before tax + finance costs + depreciation
FY2020: (10.4 +3.6 +4.2)/114.0 = 15.9%
FY2019: (9 +3.4 +3.8)/98.5 = 18.4%

With the additional GBP15m debt, there is a risk of breaching the debt/equity ratio. GT should take this into account along with the change in equity to ensure the ratio is not breached.

There is uncertainty over whether GT's products will be popular in Asia. If products don't sell quickly enough, the inventory turnover ratio may fall below the requirement.

Interest coverage ratio needs to be recalculated based on the new interest amounts for the additional loan. Further information is needed to determine if the interest coverage ratio will be sufficient with the additional loan.

Mitigation:

Negotiate FX translation carve out or sufficient headroom to absorb changes in FX that affect operating profit

Consider converting some debt into equity to prevent breaching the debt/equity ratio for the loan for the JV

Negotiate interest rate to maintain the required interest coverage ratio.

c) Proposed JV

10 marks

Opportunity to expand into a new market and generate further operating cashflows for GT.

If the JV fails, the risk will be shared with the other investor.

Additional financial reporting burden - JV will need to be accounted for correctly. There will also be an FX impact related to including JV's profit/loss into GT. Any FX impact on the P&L will in turn impact financial ratios, with a risk of breaching the covenants.

Tax - GT will not be able to use group relief for any losses incurred as JV is not a subsidiary.

Additional loan - GT will have additional expenditure in terms of interest and capital repayments.

Consider impact on covenants of the additional loan. This will affect debt/equity ratio and interest coverage ratio. (Additional marks for any calculations shown).

GT has a central treasury - loan extended to JV may have an FX impact on the P&L, if the loan does not qualify as an investment in entity despite settlement not being planned.

Project - 49% ownership in Asia. Lack of control in making strategic and operational decisions e.g. banking relationships, hedging strategy, dividends policy etc.

Dividends will need to be repatriated to GT. There will be FX transaction costs and withholding tax implications to consider. These will adversely impact cash.

As a JV instead of a subsidiary, the JV will have limited access to GT's capital. It will require careful CF forecasting and management.

Opportunity for net hedging cash and receipts in the local currency.

d) IFRS 7

15 marks

Includes quantitative and qualitative disclosures. Quantitative disclosures include showing the carrying amounts of financial instruments per category.

Under IFRS 7, certain risks being faced by the organisation must be disclosed along with how these are

managed. This includes credit risk, liquidity risk and market risk. There is a risk that GT does not disclose these in an appropriate manner. Examples of risks and mitigations to be awarded 1 mark each up to 6. Examples could include the following:

- credit risk - corporate suppliers are not able to pay, adversely impacting GT's cash operating inflows. This is mitigated by performing credit checks before extending credit
- liquidity risk - GT is not able to pay its suppliers on time due to not having sufficient cash in the required currencies. This is mitigated by maintaining cashflow forecasts for the currencies required and ensuring sufficient cash is available for each currency
- market risk - prices of raw materials could increase overtime due to changes in supply & demand/inflation/increase in general cost of living. FX rates could move adversely. FX rate risk is mitigated to a certain extent by hedging using instruments such as forwards.

Sensitivity analysis must also be performed on the above.

Use of derivatives

Any transaction costs must be charged to the profit & loss account.

GT uses FX forwards. GT must ensure that these are recorded appropriately as financial assets per IAS 32.

Derivatives are classified as Fair Value through Profit and Loss (FVTPL) per IAS 32. The FV must be determined appropriately as per IFRS13.

IFRS 13 sets out a fair value hierarchy under which the inputs to valuation techniques used to measure fair value are categorised into three levels. Over-the-counter (OTC) are usually categorised as level 2.

FV must be remeasured at each month-end.

	Since GT does not use hedge accounting, gains and losses at remeasurement should be charged to the profit and loss account. This mark scheme is not exhaustive – all valid points within answers will be awarded marks.	
		Total: 50 marks

SECTION B – 50 marks

TWO mandatory questions. Questions test knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level. Candidates are expected to be able to synthesise knowledge from different elements of the syllabus rather than be tested on discrete areas.

Total available for Section B: 50 marks

Section B, Question 1 Case Study

Background

BlueWater Group Limited (BW) is a US-based financial technology company that provides electronic money services to personal and business customers. Some of its services includes bank accounts, debit cards, prepaid cards, peer-to-peer transfers, currency-exchange and stock trading. Unlike traditional banks, BW does not have physical branches and does not deal with cash or cheques. Founded in 2012, BW has grown rapidly and now operates in 30 countries across Europe and Asia. It has most recently expanded to Australia. The group's global annual revenue is around USD300m. BW Group Limited is the umbrella parent company and has subsidiaries in 35 countries. BW has a central treasury function based in the US.

Business Strategy

BW has around 25 million retail customers and one million business customers globally. BW aims to enable its customers to manage their banking requirements through its app and website. As such, continued investment in its IT infrastructure is a core part of BW's strategy. BW spends a significant amount on intangibles and research and development (R&D).

BW earns revenue through various streams. Its main revenue streams are as follows:

1. interchange fees - earned by charging merchants a fee every time a customer pays with a BW card

2. bank account fees - BW charges a monthly fee for its business accounts and premium account for retail customers

3. international money transfers - customers are charged a fee for international payments above USD5,000

4. stock trading fees - customers are charged a flat fee of GBP5 per transaction for trading stock

5. interest income - customers are charged fees on unarranged overdrafts and loans.

Recently, BW has experienced issues with many retail and business customers being unable to pay back their loans and keep up with their interest charges. This could be because during the COVID-19 pandemic, businesses and individuals may have lost income as a result of government mandated lockdowns.

Cashflow Forecasting

The central treasury department of BW has prepared the following consolidated cashflow forecast for the next three years.

USD(m)	**FY2022**	**FY2023**	**FY2024**
Profit for the financial year	1,968.10	2,558.53	3,326.09
Adjustments:			
Depreciation	1,200.60	1,320.66	1,452.73
Amortisation	16.10	78.00	92.00
Interest Income	(0.70)	(0.90)	(1.10)
Interest expense	1.80	4.20	6.50
Net fair value losses on derivative financial instruments	2.40	2.00	2.00
Other	2,304.30	3,000.00	3,000.00
Working capital movements:			
Increase in trade receivables	(7,614.30)	(8,375.73)	(9,213.30)
Increase/ (Decrease) in trade payables (including customer liabilities e.g., customer deposits)	4,190.00	(2,300.00)	(3,440.00)
	(1,804.20)	(750.00)	(400.00)
Net cashflow from operating activities	**264.10**	**(4,463.24)**	**(5,175.09)**
Purchase of intangible assets	(98.60)	(200.00)	(20.00)
Purchase of tangible assets	(4,200.10)	(3,500.00)	(3,200.00)
Net cash from investing activities	**(4,298.70)**	**(3,700.00)**	**(3,220.00)**
Interest paid	(652.60)	(1,200.00)	(1,600.00)
Interest received	2.10	2.90	3.40
Borrowings	30,000.00		
Loans repaid	(5,000.00)	(4,000.00)	(4,000.00)
Net cash from financing activities	24,349.50	(5,197.10)	(5,596.60)
Net increase/(decrease) in cash and cash equivalents	20,314.90	(13,360.34)	(13,991.69)
Cash and cash equivalents at beginning of year	3,996.20	24,317.20	10,960.36
Foreign exchange gains and losses	6.10	3.50	3.50
Cash and cash equivalents at the end of year	24,317.20	10,960.36	(3,027.83)

Q1	(a) Using the cashflow forecast prepared by central treasury, analyse the key risks faced by BW in relation to its cash management. Within your answer you are required to recommend actions to manage these risks. (b) Recommend improvements that could be made to the presentation of BW's cashflow forecast. **Syllabus refs: LO16**	17 marks 8 marks
		Total: 25 marks
Q1 answer	a) Cashflow from operating activities is decreasing rapidly in the next three years. This is because working cash management seems to be poor. Trade receivables are increasing year on year. This may be due to BW's customers struggling to pay off their loans and interest. Alternatively, increase trade receivables could be due to overtrading. BW should review its credit policy, perform thorough credit checks before extending credit and implementing a policy for following up with customers and interest charged on late payments, if there isn't already one. GT should enforce better payment terms with customers. To tackle overtrading, if it is an issue, GT should consider scaling back the pace of revenue growth until reserves have improved. It may be worth separating trade receivables by revenue stream to identify where BW is struggling to recover cash from. This should then be used as a basis to strategically improve working cashflow. BW may also consider increasing its fee for some of its services (e.g. stock trading) or decreasing the threshold for free services (e.g. no charge for international payments under GBP5,000). Trade payables is expected to decrease in the next two years. This shows that BW pays it suppliers on a timely manner or too soon. This negatively impacts cash. BW should negotiate more favourable payment terms with its suppliers. It must be noted that trade payables include customer liabilities such as customer deposits. There is a risk that	17 marks

it is not always possible to predict customer deposit activity accurately. Hence, this could cause fluctuations in the balance.

As with trade receivables, a further breakdown of trade payables should be considered

Tax paid appears to be decreasing. The assumptions for these figures should be reviewed. Given the tax disputes, tax liabilities, penalties and charges may increase. BW must plan for these and include within the forecast.

Interest expense is increasing every year. BW should analyse the reasons for this and try negotiating better interest rates where possible.

Under financing activities, interest paid is also increasing, reducing operating cashflow.

This is likely to be relates to the GBP30m borrowings in FY2022. In addition, BW may need to make further borrowings by FY2024 to prevent a negative cash balance.

BW is planning on repaying around GBP5m in FY2022 and GBP4m each in FY2022 and FY2023 each. This could help reduce interest expense.

However, given that cash is likely to decrease in the next three years, BW should reconsider repaying the loans unless BW is able to get more favourable rates on new loans.

Interest received under financing activities seems very low. BW should look for opportunities to improve this by investing in money market deposits and money market funds. This should help improve cash from financing activities.

BW appears to be investing in tangible assets each year. For an organisation without physical banks, BW should consider if these costs can be cut down.

Changes in foreign exchange gains and losses could adversely impact cash. The basis of these figures is not known.

	BW should implement FX hedging through purchasing forwards, if BW doesn't already do so. BW should arrange for alternative sources of funding e.g., a credit facility in case of need for cash during a shortfall. **b) Improvements for cashflow** A split by currency requirements would help determine any FX hedging requirements. BW should consider preparing short, medium and long-term forecasts separately. Short-term is useful for daily cash management while medium- and long-terms forecasts are more useful for strategic decisions. Long-term cashflow should extend beyond three years to actively manage long-term planning. Sensitivity analysis should be performed on FX and interest rates to understand the impact of changing interest and FX rates. Additionally, all assumptions should be justified and explained appropriately. For example, profit for financial year has been forecasted to grow year-on-year. If this turns out to be a poor estimate, it will have a significant impact on its cashflows. The other category in operating cashflows section should be further explained and justified. This mark scheme is not exhaustive – all valid points within answers will be awarded marks.	8 marks
		Total: 25 marks

Section B, Question 2 Case Study

Background

Transfer Clear (TC) is a German-based financial services company, headquartered in Berlin. It provides wire transfer services whereby money can be sent online to any person based in any of the countries in which it operates. Money can be transferred either directly to a bank account or it can be sent to a TC location where cash is collected by the receiver on providing identification. Money can be transferred to over 150 countries in the world. TC has subsidiaries in almost every country in which it operates. TC reported global revenue of EUR2.1bn in financial year-ended 2021.

Business Strategy

TC's services are mostly used by individual customers and small business owners in transferring money internationally. Foreign exchange rates are applied at the point of transaction. The receiver receives the money in the currency of the country in which they are based. TC earns revenue by charging a fee for each transaction. The fee depends on the country of origin and the country of receipt. Cash collections incur a higher fee compared with transfers directly to receiver's bank accounts. Fees vary but are generally in the range of 0.02% - 2.5%. TC relies heavily on its technological platforms to make transfers available almost instantly.

Tax

TC is facing disputes with local tax authorities in many of the jurisdictions within which it operates. Given the cross-border nature of its operations, TC faces additional scrutiny from tax authorities as location of taxable profits is not always clear due to lack of a physical presence. TC may be facing fines, penalties and interest charges if these are not resolved in a timely manner.

TC is in dispute with various tax authorities over attempts to evade tax by profit shifting. BW provides certain services centrally to all subsidiaries, such as IT support and infrastructure, payroll processing and certain human resources activities. Further, TC has significant intellectual property (IP) on its balance sheet due to its innovative nature. Subsidiaries are charged for using central services and IP. The service providing entities are based in jurisdictions with lower tax rates.

Further, TC has been accused by tax authorities of placing its third-party borrowings in jurisdictions with high tax rates to benefit from interest expense tax deductions. Intercompany loan arrangements are in place to further reduce the taxable income. Interest is charged on intercompany loan and paid monthly. Tax authorities have also expressed that TC may be further reducing its tax burden by gearing certain subsidiaries so they can benefit from tax deductions.

Conversely, some borrowing entities are in tax jurisdictions with lower tax rates compared to the lending entity. Senior management have expressed concerns over potential tax inefficiencies in these scenarios. Furthermore, the funding structure has been questioned in some jurisdictions. Tax authorities have expressed concerns that TC has placed large amounts of debt in certain subsidiaries to reduce taxable profit through deductible interest payments.

As TC undertakes R&D to continually improve its services, it can benefit from R&D tax credits. Due to the digital nature of its research, it is difficult to estimate the costs accurately. BW has faced disputes regarding its R&D tax credit claims in many jurisdictions.

It has come to the treasury manager's attention that TC has often been late in filing its monthly VAT returns in the UK. This has led to delays in receiving the VAT amounts from the tax authority and caused inaccuracies in the cashflow forecast maintained for daily cash management.

Regulatory Challenges

In reviewing the costs incurred by TC during the year, senior management has noted significant onboarding costs for certain customers. These include costs incurred during the 'know your customer' procedures. Given the nature of TC's operations, these procedures cannot be avoided. Further, there have been delays in onboarding customers. In some instances, the delays have lasted several months and resulted in poor customer relationships and even loss of business.

Due to the Russian invasion of Ukraine, several countries have placed various economic sanctions against Russia as a punitive measure. These sanctions target Russian-based individuals and organisations. While TC does not operate in Russia anymore, it must still ensure that it complies with the recently announced sanctions which does not allow doing business with individuals and organisations listed on the sanction list.

Q2	(a) Analyse the tax issues faced by TC and propose mitigating actions. (b) Discuss the challenges TC faces due to anti-money laundering rules and recommend how it can address these challenges. **Syllabus refs: LO18 & LO20**	15 marks 10 marks
		Total: 25 marks
Q2 answer	a) TC risks facing reputational and financial damage through disputes with tax authorities. TC should comply with local tax rules. TC should cooperate with tax authorities and provide all the information requested in a timely manner. TC should seek external advice if needed to resolve the tax disputes as soon as possible. TC may be in breach of BEPS regulations with regards to its transfer pricing practices and its third party and intercompany loans arrangements. TC should provide commercial and strategic justifications for centrally provided services to tax authorities. TC should provide justification to tax authorities of its use of certain subsidiaries for external borrowings and also its intercompany loans structure. TC may be suffering withholding tax on interest paid on intercompany loan payments. This will have a negative impact on TC's cashflows. TC should reconsider the interest policy on the intercompany loans. Negative tax arbitrage leading to inefficiency - Intercompany loan arrangements are not the most tax effective. Borrowing subsidiaries are saving money as they are in jurisdictions with lower tax rates and are hence saving tax on interest expense while the parent company loses the amount. TC should consider equity funding in this scenario to avoid tax inefficiency.	15 marks

There is a risk that TC is breaching thin capitalisation rules. TC must comply with rules in individual jurisdictions. TC should consider converting some of the debt into equity. Alternatively, it should only claim deductions up to the allowable amount in the relevant jurisdiction.

TC may face penalties and fines for incorrect R&D credits claims. It may also experience delays in receiving the tax relief due to the disputes.

TC should provide justifications for its calculations and seek external advice for further reassurance that its calculations appear reasonable. TC should maintain records of all costs incurred which can be made readily available to tax authorities if required, including "reliefs, exemptions and special incentives to attract businesses into its market."

Due to the complex nature of R&D credits calculations, TC should ensure staff are appropriately trained to perform the calculations.

TC has been filing its VAT returns late and has received its payments late. This has an opportunity cost in terms of loss if interest income on the VAT amount.

TC should review its systems and processes and identify the reasons for delays in filing the VAT returns.

b) As a financial services organisation, TC is required to follow AML rules, such as the AMLD5 in EU countries. Given that nature of the services provided by BW, it is at risk of being targeted by criminals looking to disguise illegally obtained funds as legitimate income. As such, AML is crucial for TC. — 10 marks

One such requirement within AML rules are KYC procedures. This refers to the specific actions organisations are required to undertake to verify the identity of any potential customers prior to accepting work from them.

Any breaches could lead to penalties and criminal proceedings. This will also cause reputational damage.

	TC must therefore identify relevant regulations in all jurisdictions in which it operates and ensure compliance. Some of the challenges include costs associated with performing KYC, especially for large business customers. Further, the process can be quite long, which can damage relationships and delay start of business with these customers. TC should review its processes and use technological solutions where possible to speed up the process. Further, principles of KYC it allows organisations to take a risk-based approach to AML, as they can identify the level of risk of potential money-laundering activities a specific customer presents, and therefore treat customers with varying levels of caution depending on the risk posed. In using a risk-based approach, BW could speed up the onboarding process for lower risk customers. Given the new sanctions, TC is at risk of unknowingly entering into business with individuals or businesses on the sanctions list. TC must ensure it has access to the most updated database of list of sanctions that it can verify clients against. The monitoring should be continuous to prevent risk of missing updates. Also consider, where relevant, MiFID and Client Money Rules.	
		Total: 25 marks

Published in September 2022 by
ACT (Administration) Limited
150 Minories
London
EC3N 1LS

www.treasurers.org

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