PRACTICE OF BANKING II

OCTOBER 2018

QUESTION PAPER

SECTION A - COMPULSORY
QUESTION 1 (30 Marks)

Mr. Sean Patterson and his business associate Mr. Sam Gazi are the promoters of Sean Sam Joinery (Pvt) Limited, a company they established 18 years ago and whose patronage with your Bank back dates to the company's formation stages when they sought your advice on how to form a company.

The directors, who initially were fitters, subcontracted their services to construction companies and expanded their services to incorporate the supply of wood materials, wood flooring, wall fittings and fixtures. As a result of their growth, tenders for contracts of value less than $1.5 million are not submitted. Initially the company employed 600 employees and now most employees are engaged on contract basis and the permanent employees now number approximately 50 at any one time.

The company enjoys an overdraft and bid bond/guarantees facilities of $1, 5 million and $2, 5 million respectively against the following securities.

a) First mortgage bond over business premises valued at $1 250 000.
b) Directors personal guarantees supported by mortgage bonds on their houses for $900 000 and $400 000 respectively.

During the last six years following the economic deregulation, the company expanded its markets into the SADC region and opened an office in Angola. Despite the anticipated advantages of the move, the decision was not a success due to the local employee trade union's manipulations and as a result the office was closed down and the initial investment was written off.

Following the above developments, the company directors intend to see you now because their audited accounts are out and now desirous to discuss their following 12 months' financial requirements.

Due to its size, the company in its history has never produced management accounts or formal forecasts although internal management's assessments have been relied upon with reasonable accuracy.

The company has contracts on hand worth $8 million with an anticipated net profit of
$1.25 million during the current financial year. Prospects are that they will win a contract of $5 million for a twelve month period as a subcontractor to one of the International mining investing company in the country which will sustain its operations. All things being equal the company has an equal opportunity to win a contract worth $5 million in the next 12 months as a contractor to one of the SADC Building Developments.

The said contract will require a performance bid of 15% of the contract value. The company is currently using the existing facilities to the upper limit. The company request you to increase the same to $3 000 000 and the bonds and guarantee to $2 250 000 (no claims have ever been received

under the performance guarantees).

REQUIRED

Below is an analysis of the current position of the company. Give your response to the request with reasons.

Total (30 marks)

SEAN SAM JOINERY (PVT) LTD

STATEMENT OF COMPREHENSIVE SUMMARY

Turnover	10 514 245	11 065 355	18 187 575
Gross Profit	1 839 250	2 033 530	3 789 940
Depreciation	137 100	189 510	237 345
Directors Remuneration	**Year to 30 Sept 2015**	**2016**	**2017**
Interest Paid	256 600	319 075	1 457 970
Profit before tax	649 205	600 080	
Extra-ordinary item (write-off the Angola Investment)	-	-	1 797 090
Tax paid	177 750	247 970	810 770
Retained profit (Loss)	471 455	352 355	(1 149 890)

STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER

Current Assets

	2015		2016		2017	
Cash	785		5 000		2 505	
Debtors	1 707 425		2 811 430		3 982 230	
Work in Progress	660 250	2 368 460	943 120	3 759 550	2 059 565	6 044 300

Current Liabilities

	2015		2016		2017	
Creditors	1 134 010		1 161 615		2 286 330	
Hire Purchase	110 040		89 050		123 740	
Bank overdraft	1 128 390		2 222 630		2 697 705	
Current taxation	413 430	2 785 870	503 610	3 976 905	588 295	5 696 070
Net Current Assets		(417 410)		(217 355)		348 230

(Liabilities)						

Fixed Assets

Land & Buildings	673 820		674 655		622 930	
Plant & Machinery	675 045		550 580		653 880	
Investment in subsidiary	1 450 825	2 799 690	1 647 355	2 872 590	-	1 276 810

Long-Term Liability

Hire Purchase	(499 030)		(416 145)			(575 840)
Net Assets	1 883 250		2 239 090			1 049 200

Financed by:

Share Capital	500		500			500
Profit & Loss a/c	1 882 750		2 238 590			1 048 700
	1 883 250		2 239 090			1 049 200

Accounting Ratios

	2015	2016	2017
Gross margin (%)	17,5	18,4	20,4
Net margin (%)	6,2	5,4	8,0
Interest cover (times)	3,5	2,9	4,7
Net gearing (%)	92	122	312
Current ratio	0,85:1	0,95:1	1,06:1
Acid Test	0,61:1	0,71:1	0,70:1
Credit given (days)	59	93	80
Credit taken (days)	48	47	50
Work-in-progress turnover days	28	38	52

QUESTION 2 (30 Marks)

Grant Anderson is a 35 year old qualified accountant who has banked with you for 18 years. He practices in partnership with another accountant, Arthur Thornton, aged 34, as Anderson & Thornton Chartered Accountants. The partnership banks with you, maintaining useful credit balances on both office and clients' accounts.

Five years ago the partners established a property company called Anderson & Thornton Properties Limited, each holding 50% of the shares. This company owns two freehold retail units

in one of the better quality Harare suburbs. These were purchased at a cost of $426, 000 with the assistance of a $300,000 25 year mortgage loan from Building Society. Both units are let on 30 – year leases, which have 24 years to run and, following a five – yearly rent review last year, gross rental income amounts to $76, 000 per annum.

The property company also banks at your branch but there is little activity on the account as it is used mainly for the receipt of rentals and to make the mortgage payments to the Building Society.

Anderson calls to see you. The property company wishes to buy two more freehold retail units which will cost $200,000 each. One has an annual rental income of $16,000 and the other $20,000. The leases on the properties both have over 30 years to run and contain provisions for seven year rent reviews. The next reviews are due in 15 months and 18 months' time respectively. Anderson gives you a copy of the latest audited accounts. He asks you to grant the company a bridging loan of $400 000 for two years, after which he will refinance the properties on a long term mortgage.

Set out your response to Anderson, giving the reasons for your decision and indicating what further information you would require from him.

(30 marks).

ANDERSON & THRONTON PROPERTIES PVT LIMITED

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	2016 $	2016 $	2017 $	2017 $
Current Assets				
Cash	13, 860		7,008	
Debtors & prepayments	11, 004	24, 864	19,496	26,504
Current Liabilities				
Creditors	3, 556		5,230	
Tax	2, 166	(5, 722)	2,166	(7,396)
		19,142		19,108
Fixed Assets				
Freehold Property	426,000		760,000	
Plant & Equipment	546	426, 546	464	760,464
Total Assets:-		445,688		779,572
Financed by:				283,538
Long term loan		291,276	126,000	
Issued share capital	126,000		334,000	
Capital Reserve	--------		36,034	496,034
Profit & loss account	28,412	154,412		779,572
		445,688		

STATEMENT OF COMPREHENSIVE SUMMARY:

12 months to 31 December	*2016* $	*2017* $
Gross Income	42,600	61,500
Interest	35,280	34,320
Directors' remuneration	3,080	19,900
Profit before tax	3,060	4,440

Accounting Ratios

	2016	2017
Net gearing %	180	56
Interest cover (times)	1.09	1.13
Net Margin %	7.2	7.2

SECTION B

QUESTION 3 (20 Marks)

a) List and discuss the elements of overtrading. In your own opinion what effect if any will overtrading have on the cash flow of business?

(10 marks)

b) Factoring and Invoice Discounting are tools that Bankers can use to enhance both their customers' growth and the Banks' own risk management".

Describe the advantages and disadvantages of these methods of Working Capital Finance when compared to traditional bank lending, from both the customer and Banks' point of view.

(10 Marks).

(Total 20 Marks)

QUESTION 4

a) It is often said "profit is not the same as cash" explain this statement with specific reference to some of the fundamental accounting concepts. In your opinion, what effect will this have on a lending manager's decision when considering a loan application?

(10 marks)

b) "Shareholders loans should not be considered as part of shareholders equity". Evaluate this statement in the context of the "Business Entity Concept" and loan capital repayment. Under what circumstances would it be acceptable to consider Shareholders Loans as equity?

(10 marks)

(Total 20 Marks)

QUESTION 5

(i) Describe briefly how the following ratios are calculated and how they are used to assist in the lending decisions: -

Acid Test ratio
Debtor's turnover ratio
Gearing ratio
Interest cover ratio
Return on Capital employed.

(10 Marks)

(ii) What is meant by qualified accounts? (2)
Give an example of qualified accounts that would be of concern to a Banker (2)
Why would your example above give concern to the Bank? (1)

(iii) Briefly describe the following fundamental accounting concepts:
(a) The matching concept
(b) The going concern concept

(5 marks)

(Total 20 marks)

PRACTICE OF BANKING 11

OCTOBER 2018

MODELANSWERS

QUESTION 1

Background

1 Long-standing customer, we would like to help

1 Management expertise is undoubted

1 But do not have an unblemished track record

1 The core business has performed well recently

1 The continuous increase in sales suggests the directors can get business from major builders hence their reputation is good.

1 The absence of any claim on bond indicates a high degree of technical competence.

1 The directors are financially doubtful - as discerned from lack of financial management accounts and forecasts.

FINANCIAL ANALYSIS

1 The capital structure of the business has weakened significantly

1 It must be appreciated that the company has been living without capital invested outside.

1 The current liquidity pressure is more to do with the rapid expansion in turnover rather than write- offs.

1 There is a hidden reserve in the property if the old valuation still holds good.

1 The directors have been taking too much out of the business of late

1 Can a reinvestment of some of the cash taken be made into the business?

1 Given the nature of debtors - large builders, the company may not have a great deal of control over credit given

1 There is likely to be a significant element of "Retentions" in the debtors figure.

1 Which will increase the locked up cash as turnover expands

1 Need to see a detailed break-down of debtors including retentions.

1 Probably some scope to squeeze creditors i.e. company's own sub-contractors.

1 But also need to recognize we cannot stretch them too far

1 Fundamentally in this business there is limited scope to improve their liquidity if they want to undertake their desired level of turnover without capital injection

1 Need to see a good detailed cash forecast

1 Also a detailed forecast of bond movements - some bonds must be due to run off soon.

1 Underlying profitability is excellent as shown in the impressive trend in gross margin

1 The performance at the PBT level is solid

1 Especially in 2010 if exceptional director's remuneration is discontinued.

1 Fundamentally this is a very good business which has made one serious error

Security

1 The freehold deeds need revaluing
1 But assuming title change the main security is:

Free Hold Business premises- value	**$ 3 500 000**
Bonds over Director's properties- value	**$ 850 000**
	$ 4 350 000

To cover **$5, 250 million** worth of facilities

1 The personal guarantees must be of high net-worth

1 The banks receiver would almost certainly need to trade on to complete contracts with risks. This involves potential further losses to the bank

1 Need Key man Insurance cover for directors

Decision

1 This is a very finely balanced decision with the strength of the business being matched against the thin security

1 The directors have already committed all their personal assets

1 Although they should re-inject any cash they have available from their large drawings

1 A detailed financial plan needs to be drawn up and a good monitoring

system put in place - probably with the help of a good firm of accountants.

1 Provided this is done and is satisfactory, the previous good track record of the business and the good track record with previous performance bonds make the decision a positive one.

1 A good fee, say $125 000 should be charged as well as good rates on the overdraft.

3 Up to 3 discretionary marks should be awarded for relevant points not covered above.

43

(Max. 30 marks)

QUESTION 2

Marks

Background

1 Good long standing relationship with a pair of young professionals – would wish to help.

1 The 100% amount and 2 year period of the loan are uncomfortable.

2 They are needed to carry the facility past the next rent reviews and the partners are hoping for increases in rentals to raise the investment value of the property to enable re-financing.

Financial Analysis

1 The present properties appear to have been re-valued, presumably on the back of the increased rental income.

1 The business has limited cash with surplus rental income siphoned off as increased directors' remuneration.

1 The balance sheet is relatively simple with current assets and liabilities presumably linked to delayed rental payments, etc.

1 There appears to be a small amount of cash but this may not be enough to meet the legal costs etc. of the new property purchases.

2 However with the surplus rentals, the business is cash generative and cash from debtor collection etc. should be sufficient to meet these costs, given the current assets surplus over current liabilities.

1 Gearing has reduced directly as a result of the property revaluation.

1 But will increase to circa 136% if the new facility is agreed.

The Proposition

2 Can the borrowing be serviced? Interest on $400,000 at say 11% p.a.

2 Base would be $48,000 against rental income of only $36,000.

1 But there are surplus rentals from the current properties available.

2 Repayments there at say 11% over 25 years on $300,000 = $35,028, compared to rental income of $76,000, so over $40,000 p.a. Spare cash.

2 This looks enough on paper but need to establish what expenses have to be met out of gross rentals – need a detailed budget.

1 Also need to examine the quality of tenants – void period would be a big problem.

1 Status enquiries on tenants necessary.

1 Sources of repayment – can be no guarantee that the rental income on the new properties will rise to increase their value to allow re-financing.

2 A long term lender would only lend say 70% of value and would want at least once times (and probably more) interest cover by rents.

Security

1 Would need first charge on new properties with valuation.

1 Also second charge over existing properties with new valuation.

1 A debenture – to give control of the rental income if an administrator was appointed by another creditor.

1 Consider directors guarantees.

1 Life cover over directors.

Decision

1 Re-financing is too uncertain to make proposition viable.

1 Might consider re-engineering subject to an element of amortization from surplus rents – approximately $70, 00 reduction over 2 years looks possible.

1 But re-financing is still probably too tight and directors would need to put in cash up front this might be available of around $20,000.

3 Up to 3 discretionary marks may be awarded for relevant points not covered above.

37

(Max. 30 marks)

QUESTION 3

1 **Overtrading** simply stated is a matter of trying to maintain a level of operations with insufficient reserves. (Graphically described as "over-blowing the balloon :)

1 Overtrading involves impressive size; increasingly thin margin of safety; a sense of strain and the danger of sudden collapse.

Causes of overtrading fall into two (2) categories:

(i) General causes which affect all kinds of business i.e.

1 inflation and the general rise in prices and wages and taxation.

1 To maintain a constant level of business, a company is faced with a continually increasing line up of capital in fixed and circulating assets.

1 Costs increase at rates impossible to pass on to consumers resulting a drop in sales and/or a drop in margins and

1 depletion of the company's liquid resources.

(ii) Internal causes arising from mistakes of financial policy/ discipline of the proprietors themselves.

Most common errors in financial policy:-

1 (1) Starving a business of essential cash and endeavoring to maintain the turnover without it.

1 Due to the premature repayment of long term debt, excessive drawing dividend payments; investment of cash into other businesses by way of loans and or share purchases.

1 (ii) Attempting to expand the volume of business beyond what is justified by the resources available.

1 Historical accounting methods have not been able to make adjustments for inflation when making calculations for taxation so depreciation as written in Accounts will not be sufficient to provide for replacement machinery hence extra funds have to be provided at the time of replacement merely to keep the business at the same position.

1 Historical Accounts will then be misleading since large book profits have been shown whereas after taking inflation into account and the extra funds required to run the business, real profits have actually declined.

1 Also since the large historical profits will attract higher tax deductions combined

with the additional cash required to run the business, the additional tax will deprive the business of much needed liquidity thus putting a huge strain on the cash flow of the business.

Results of overtrading:-

1 - Difficulty in funding wages
1 - Difficulty in paying taxes
1 - Increased cost of purchase owning to:-
1 - in ability to accept special offers
1 - Hand to mouth buying (Bulk buying is cheaper)
1 - Selecting sources of supply because credit is obtainable not necessary on quality price or value
1 - loss of discounts

Reduction in effective sales figures by:-

1 - placing stock for sale to get much needed liquidity (cash)

1 - Discounts allowed

Expedients to raise money:-

1 - charges over plant and equipment
1 - sales of Book debts/factoring
1 - Unsecured loans at punitive interest rates.
- General difficulties with creditors.
1 - Pressure on debtors to settle accounts sooner.
1 - Obsolete plant & equipment resulting in constant breakdowns/hence loss of production.

(Max. 10 marks)

(b)

Factoring

Advantages

1 Improve payment performance of debtor's Ledger.
1 Immediate liquidity/cash provided by Bank
1 Credit protection granted with definite recourse

Disadvantages

1 Admin of debtors taken over by Bank
1 Only a certain percentage taken at very high cost.
1 Facility not offered to all & Sundry (selective)

Invoice Discounting

Advantages

1 Whole Debtors Ledger not taken
1 It can be a once off transaction
1 Advance is of self-liquidating nature

Disadvantages

1 Risk of non-payment
1 Customer retains control of payment performance
1 Only certain identified debts can be taken over

(Max. 10 marks)

QUESTION 4

a)

- Profit is an accounting concept which measures the efficiency with which funds are being used in an organization (2)
- The higher the profit figure the more efficient the organization is operating (2)
- Profit cannot be the same as cash because certain of the elements used to calculate profit do not involve movement of money e.g. depreciation (2)
- In a lending decision the Banker has to be concerned with the cash generating capacity of the business (2)
- For this reason there is need to monitor/check the cash conversion cycle of the business i.e. Debtors – stock-creditors-cash receipt (2)
- A business can be profitable but/without generating cash to fund its operations (2)
- Remember that Bank loans are repaid from cash and not profit, therefore cash flow is important in a business and is not necessarily the same as cash (2)

b)

- Shareholders should not be part of equity because these are just like any other loan to the business (2)
- In the event of liquidation shareholders loans are treated in exactly the same as any other loan owed by the company (2)
- Shareholders can make a claim against the company in the event of default since the business has separate legal status from the individual shareholders (2)
- Shareholders loans can only be considered as equity if they are subordinated i.e. shareholders pledge that they will not withdraw the loans from the business (2)
- Shareholders loans are liabilities to the company and cannot be treated as capital (2)

(Max.20 marks)

QUESTION 5

i) Describe briefly how the following ratios are calculated and how they are used to assist in the lending decision:-

Acid Test ratio
Debtor's turnover ratio
Gearing
Interest cover ratio
Return on Capital employed

Marking 1 point for correct formulae and 1 point for correctly identifying use of ratio.

(Total 10 marks)

ii) What is meant by qualified accounts? (2)
Accounts that the auditors are not prepared to sign as showing a true and fair view without mention of a problem. (2)

Give an example of qualified accounts that would be of concern to a Banker. (2)
Unable to verify stocks etc.! (2) Or not complying with IAS (1)
Why would your example above give concern to the Bank? (1)
If stocks are not verified profit would be inflated (1).

Matching concept
States that expenses incurred in a particular period are matched against revenues earned during that same period.

(5 marks)

Going concern concept
States that a company is assumed to continue to operate indefinitely and will not go out of business or into liquidation in the foreseeable future.

(5 marks)

(Max. 20 marks)