PRACTICE OF BANKING 11
QUESTION PAPER
MARCH 2017

SECTION A (COMPULSORY QUESTIONS)

QUESTION 1 (30 MARKS)

Brown Precision Engineering Limited has maintained an account at your bank since incorporation 10 years ago. The account has operated in credit throughout most of its history and there is little information on file, other than that the Directors, Mr. and Mrs. Brown, own their own house valued at $175 000, on which there is a mortgage of $45 000 outstanding, this property having been acquired five years ago with the help of a mortgage loan from your bank.

Mr. Brown calls regarding developments with his company which will necessitate a significant borrowing need for the first time. His largest customer has indicated that if he wishes to retain their business, he must up grade his machinery, their orders would then increase from $6 000 to $20 000 per month.

The machinery and associated equipment is immediately available and would cost $50 000. Mr. Brown, while wishing to go ahead is hesitant because of the need to borrow significantly, and seeks your advice.

You have been given the following information regarding the company's accounts in respect of the last 12 months, together with the audited accounts for the last two years (see below).

Balance	$ 8 200 credit
Debit turnover	$ 252 000
Range	$ 17 400 credit to $ 2 400 credit
Average balance	$ 8 600 credit

Brown Precision Engineering Limited
Balance Sheet as at 31 March 2016

	2015 $		31 March 2016 $	
Fixed Assets:				
Plant & Machinery	18 200		16 400	
Motor Vehicles	8 200		6 200	
	26 400		22 600	
Current Assets:				
Cash/bank	12 800		11 200	
Debtors	45 800		48 000	
Stock/ work in progress	9 200		8 200	
	67 800		67 400	
Current liabilities:				
Trade creditors	19 800		16 600	
Other creditors	18 800		14 800	
Directors' Loan	33 200		31 200	
	71 800		62 600	
Net current assets (liabilities):		(4 000)		4 800
Net tangible assets:		22 400		27 400
Financed by:				
Share Capital		200		200
Profit and Loss		22 200		27 200
		22 400		27 400

	2015	31 March 2016
Sales	218 800	223 200
Gross Profit	81 000	78 000
Net Profit	4 800	5 000
After directors remuneration	20 200	17 600
Depreciation	6 200	5 200

Required

The Bank is requested to set out in detail a response to Mr. Brown, indicating any further information that may be required.

QUESTION 2 (30 MARKS)

XYZ Limited is the parent company of three manufacturing subsidiaries X Ltd. Y Ltd and Z Ltd. They are embarking on a period of expansion which involves the purchase of additional buildings, plant and machinery by the subsidiaries. To assist with these acquisitions XYZ Limited seeks a loan of $400 000 with additional $100 000 to cover working capital needs. Two of the subsidiaries own their own premises while the third operates from rented accommodation. All three companies operate as separate entities but are financed by the parent company which in this way, keeps financial constraints over them.

The parent company offers a Notarial General Covering Bond over its own assets as security, repayment proposals are satisfactory and the balance sheet of XYZ Limited is as follows:

Assets		$	$
Investment in subsidiaries		1 000 000	
Owing by subsidiaries		500 000	
Cash at Bank		50 000	
			1, 550 000
Less			
Liabilities:			
Creditors	8 000		
Owing to subsidiaries	172 000		
Corporation tax	80 000		
Dividend	50 000		
			310 000
			$1 240 000
Issued Capital	900 000		
Reserves	260 000		
Profit and Loss account	80 000		
	$1 240 000		

Required

The bank is requested to consider how it could handle the request with comments on the security offered and whether some other arrangements would be preferred, at the same time setting out with reasons and discussing the advantages or otherwise of the various alternative security arrangements.

SECTION B (Answer any (2) Questions)

QUESTION 3 (20 MARKS)

A number of Banks have set up specialist units to support the development of lending to small and medium size enterprise (SMEs). Explain the purpose of these units, why the risks involved in lending to SMEs merit special treatment and the requirements of safe lending to SMEs.

(Total 20 marks)

QUESTION 4 (20 MARKS)

a) Briefly describe off-balance sheet financing and give examples to illustrate your answer. (5 marks)

b) List the factors that influence the degree of business risk. (5 marks)

c) What is the difference between a cash flow forecast and a cash flow statement? (5marks)

d) Briefly describe the following fundamental accounting concepts:
   1) The matching concept
   2) The going concern concept (5 marks)

(Total 20 marks)

QUESTION 5 (20 MARKS)

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

(Total 20 Marks)

QUESTION 6 (20 MARKS)

a) "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)

a) Before making credit available to **an individual** client the bank manager will assess the safety of the lending by considering the criteria which are commonly known as the five C's of Credit. Discuss these 5 C's in detail.

(10 marks)

(Total 20 Marks)

PRACTICE OF BANKING II
MARCH 2017
MODEL ANSWERS

SECTION A

QUESTION 1

1 At the outset, the Bank would wish to assist this established customer with an apparent good track record, if at all possible, and as a first step needs to assess the financial information available.

1. Historic assessment

(a) Net worth/surplus resources

		2015	31 March 2016
2	Capital profit & loss account	$ 22 400	$ 27 400
	Plus director's loans	$ 33 200	$ 31 200
	Total	**$ 55 600**	**$ 58 600**

1 On the basis that the directors loans can be regarded as quasi – capital and will be retained in the business (see below- security), there is an improving net worth in the business and presently, with no borrowing, nil gearing.

(a) Liquidity

		2015	31 March 2016
2	Current ratio	1.76	2.15
	Liquidity ratio	1.52	1.90

1 Liquidity appears satisfactory and is improving as a result of retained profits being utilized for working capital needs. A simple calculation of retained cash flow in the year just ended is as follows:

	Net Profit	$5 000
	Plus Depreciation	$5 200
		$10 200
	Which has been applied as follows:	
	Purchase of fixed assets	$1 400
2	Repayment of directors loans	$2 000
	Surplus – working capital	$6 800
		$10 200

1 Credit given 79 days (previous year 76 days) and credit Taken 27 days (previous year 33 days).

1 Both appear satisfactory, although comparison of debtor period as against industry norm would provide additional comfort and,

1 In addition, production of a list of debtors by amount and period would confirm no problems with large overdue debts.

1 Further, Mr. Brown should be questioned about "preferential" creditors to ensure that there are no large amounts in arrears.

1 Although from the evidence of the account there should be no problem in this regard.

1 Stock turnover 15 days (previous year 15 days) appears satisfactory.

(c) Profitability

1 Sales have increased by only 2 percent, less than the probable inflation rate, and with a decline in gross margins from 37 percent to 35 per cent, there could be problems in finding real sales at past levels, and this may be due to increasing competition.

1 However, net profits at 2.2 per cent have been maintained, indicating overheads have been kept well in check.

1 Overall, this is a soundly based concern with adequate resources, although sales in the last year have fallen in real terms slightly and recent management figures to show current trends should be sought.

2. Proposition

1 Whilst there is cash available of some $8 000, some of this may be needed for future working capital purposes.

1 However, it would be sensible for the business to operate partly on overdraft in future to gain benefit from account fluctuations seen in the past, and therefore from a practical angle, a loan at $40, 000 should be sought over, say, five years plus an overdraft facility based on the cash flow forecast.

1 If interest was assessed at say, 15 per cent then a projected profit forecast would be as follows, assuming existing turnover $252 000 of which $72 000 relates to the major company, increasing to $240 000.

		$	$
	New turnover, say,		420 000
	Gross Profit (35%)		147 000
	Less directors remuneration	26 000	
2	Other expenses	60 000	
	Finance costs – 15% on $40 000	6 000	
	Depreciation	16 000	108 000
	Net Profit		**$39 000**

This return should enable all repayment to be effected at $8 000 per annum
1 but there is likely to be a need for an overdraft to finance increased net working assets arising from the expanded trading.

A projected sources and application of funds statement can be calculated as follows:

Working capital variations
(as a result of 66 2/3% increase in projected turnover).

			$
	Stock		(5 400)
	Debtors		(31 600)
	Creditors		11 000
	(A)	Working capital requirements	(26 000)
		Profit before tax	39 000
		Depreciation	16 000
	(B)	Funds generated by operations	55 000
2	(C)	True funds from operation (B – A)	29 000
	(D)	Capital Expenditure	50 000
	(E)	Funds required before external finance	21 000
	(F)	Term loan	40 000
		Less repayments (8 000)	32 000
	(G)	Net financial surplus	11 000

1 Taking into account the opening cash/bank position, there would appear to be more than adequate cash flow to service the term loan and while an overdraft may be needed at the outset on acquisition of the machinery, by the end of the period permanent creditor operation should be seen.

1 A monthly cash flow forecast is essential to show monthly peak overdraft requirements if any.

Other Issues

1 Security will be necessary here, bearing in mind the level of borrowing ($40 000 plus any overdraft requirements), is relatively full against net worth of $58 600 (regarding directors loans as quasi – capital).

1 It will therefore be necessary to look closely at these debtors and, in particular, in view of the fact that in future well over 50 per cent turnover is with one concern, references should be taken up on this company.

1 There is clearly an inherent danger in so much business being with one concern, but it would appear that Mr. Brown has little option than to proceed, for if this business was lost the remaining turnover of $180 000 producing gross profit $63 00 (35%) would be inadequate to cover likely overheads, and losses would therefore, in all probability, be incurred.

1 Thus in addition to the security, postponement of the director's loans and/or capitalization of part thereof, should be obtained and the personal joint and several guarantee of the directors should be taken to tie in their personal responsibility.

1 A second mortgage over their home should be sought, although this may not be absolutely essential with the overall background here.

1 However, term life cover for the fiver year loan period should be taken as a minimum on the life of Mr. Brown.

Conclusion

1 While this proposition could be financed, as an alternative, by Asset Finance or leasing, a medium term facility of $40 000 over five years should be agreed, subject to the security above and satisfaction on cash flow projections and latest management accounts.

1 Up to 2 discretionary marks may be awarded for relevant points not covered.
37 + 2

QUESTION 2

1 Clearly the bank would wish to assist XYZ Limited but as the holding company has no tangible assets of its own (the cash balance is needed to pay the dividend) and

1 any floating charge given by the parent company depends upon the value of the investments in subsidiary companies and amounts due therefrom, such a charge would not be an attractive banking security.

1 In fact while the parent company would rank along with other unsecured creditors for inter – company indebtedness.

1 The investments in subsidiaries would only be worth anything after all creditors of the subsidiaries have been settled.

1 Preferably the subsidiaries should borrow themselves against charge over their own tangible assets.

1 But as the parent company wishes to control the overall group finances.

1 The bank must endeavor to put itself in as favorable as position as possible by lending direct to the assets - owning companies.

1 To this end the subsidiaries could give their unlimited guarantees for the parent company.

1 But claims under such guarantees would rank only along with other unsecured creditors of the subsidiaries.

1 To overcome this draw back – and as the parent company has already offered a charge - such security should be taken from each subsidiary preferably incorporating specific charges over the freehold properties owned by two of the subsidiaries.

1 The charge will also pick up the assets to be purchased.

1 Although the interest in the new buildings will only be specific equitable charges if the debentures are taken before purchase.

1 Unless further legal mortgages are executed subsequently.

1 The ideal security would therefore be a full cross guaranteed linked group with mortgage bonds from all companies, although with the apparent strength of the group (Net worth $1 240 000) the directors of XYZ Limit may object to such requirements as being over cautious.

1 Insufficient information is available to comment on such a response and,

1 In any case, sight of the audited accounts of all companies is needed to ascertain, inter alia, whether the trading subsidiaries already resort to borrowing for a day to day working capital needs and level of profitability being earned.

1 Finally, if the subsidiaries are linked to the parent by means of guarantees, their individual borrowing powers will need to be checked to ensure that they cover overall borrowings.

2 * **Any <u>other forms of alternative security</u>**
- **Advantages (5 Marks)**
- **Disadvantages (5 Marks)**

1 Up to 2 discretionary marks may be awarded for relevant points not covered.

<u>30+2</u>

<u>SECTION B</u>

<u>QUESTION 3</u>

(i) Purpose of SME(S)

- This is a unique customer segment with special needs which are different from normal business/corporate clients.
- However if well managed they can create good returns for the Bank/Organisation hence:
- Give specialist attention to this sector of the economy/asset in bank's books.
- Give support and specialist knowledge on business management:-
- Good Book keeping.
- Good record keeping.
- Good monitoring and control of business activities.
- Providing coaching to management.
- Run seminars in any areas of interest/concern.

(ii) Risks involved are pretty much the same in business however SME(s) if not well managed have higher default, financial and management risk which need close monitoring. There is therefore need to pay particular attention at the following: -

- Business viability.
- How strong is competition in the market.
- Financial management and record keeping.
- Management control.
- Succession planning/Business continuity.

*** 1 mark for each point raised.**

(Total 20 Marks)

QUESTION 4

(a) Facility structure which doesn't entail / require the Bank to outlay any funds:-
Examples: -
- Bank guarantees
- Letters of guarantee
- Letters of credit (confirmed / unconfirmed)
- Performance bonds
- Bid bonds
- Shipping guarantees
- Self-liquidating structured finance.

* Two (2) marks for correctly describing what off balance sheet financing is and then give examples **[5 marks]**

(b) Business risk: viability of the business relative to others in the same industry sector. Essentially the question posed is "where is the business going and what the probability that it will get there is?"

Risk issues include:
- Falling markets
- Highly competitive sector especially with failing market.
- Static sales/turn over.
- Fragmented markets.
- Shrinking margins.
- Price controls.
- Reliance on specialised and/or single suppliers or buyers
- Vulnerability to labour/trade union action.
- Growth rate against say inflation/industry average

(Max 5 marks)

(c) Cash flow forecast / Cash flow statement:-

1. Cash flow forecast

The one sets out cash requirements of the coming period <u>whilst the other</u>

2. Cash flow statement

States what cash was earned in the previous accounting period, where it came from and what it was used for. **[5 marks]**

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

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]

QUESTION 5

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.

2 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/
1 discipline of the proprietors themselves.

Most common errors in financial policy:-
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 (iii) 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
1 - 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.
2 - Whether the condition of overtrading is due to lack of wisdom or external misfortune, the real cure is **MORE CASH.**

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QUESTION 6

(a)

- 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)

(b)

5C's
- Character
- Collateral
- Capacity
- Capital
- Conditions (4 marks each)

* 2 marks each for correctly identifying the 5C's
* 2 marks each for correct interpretation