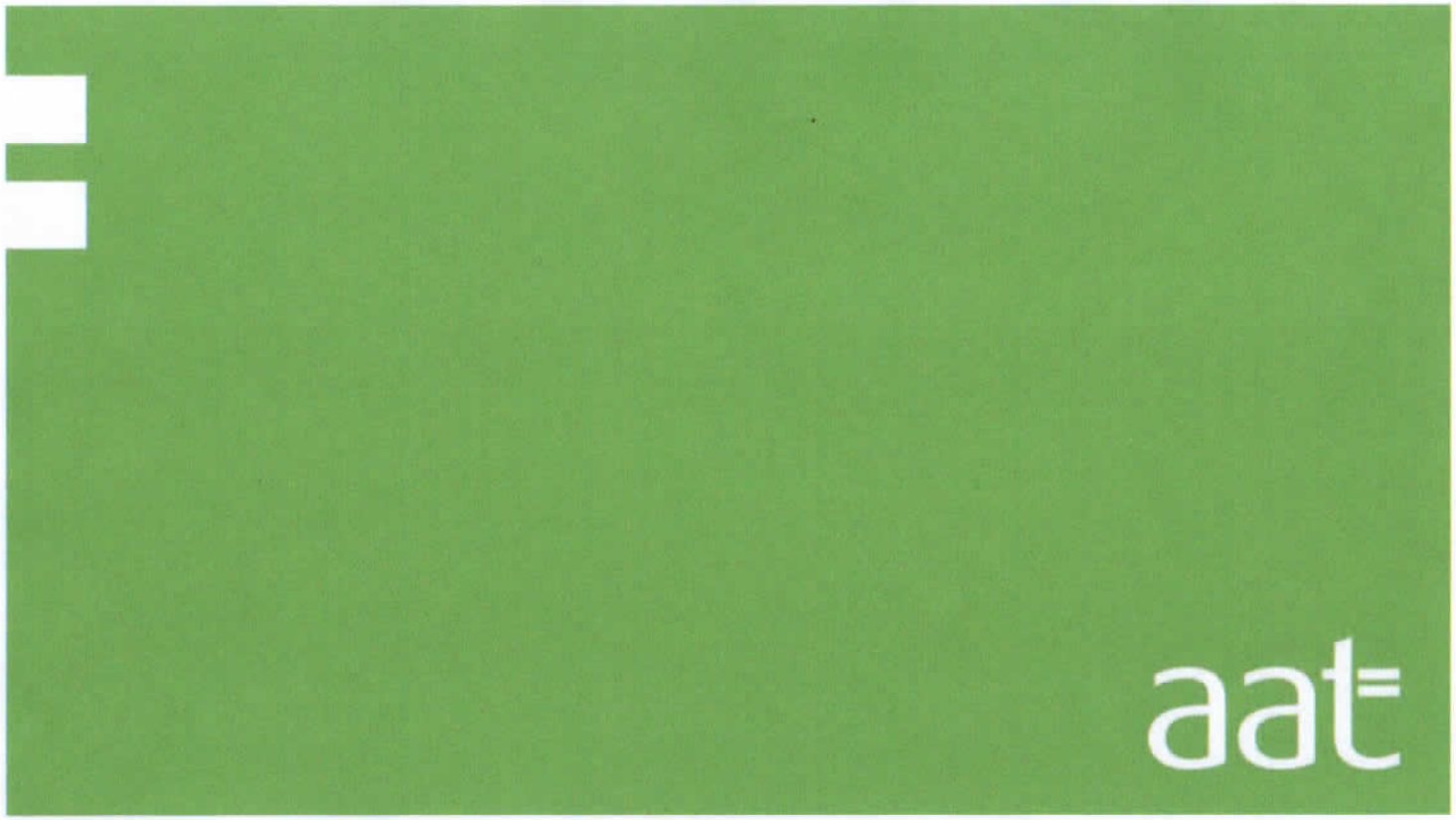
P. ROBBINS



CBT Sample assessment model answers

Credit Management (CDMT)
Sample assessment 1

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Task 1 (18 marks)

(a) Drag and drop the correct words into the following statement. (4 marks)

Terms specifically stated in a contract are known as express terms, which are binding for both parties. Terms that are fundamental to a contract are known as conditions. If they are broken, the party breaking them will be in breach of contract and can be sued for damages.

guarantees

warranties

termination

optional

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GUSTAV OWES HOLST £25,000 EXCLUDING VAT, WHICH IS CHARGED AT THE STANDARD RATE. THE DEBT HAS BEEN OVERDUE FOR 90 DAYS. THE CURRENT BANK OF ENGLAND BASE RATE IS 0.5%

Task 1 (continued)

(b) What is the amount of interest that Holst may charge Gustav under the Late Payment of Commercial Debts (Interest) Act? Calculate your answer to the nearest penny. (2 marks)

CAN CHARGE BASE RATE + 8% = 8.5% INTEREST.

£ 628.77

WORKING: £25,000 × 1.2 = £30,000 GROSS
£30,000 × 8.5% × 90/365 = £628.77

(c) Identify whether the following statements about the Data Protection Act are true or false. (4 marks)

	True	False
Companies are able to find out what information is held about them on computer-based records.	☐	☑
Individuals have a right to object to decisions taken where there is no human involvement.	☑	☐
Individuals cannot request that data relating to them will not be used for direct marketing purposes.	☐	☑
Data cannot be kept for more than six months.	☐	☑

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Task 1 (continued)

Sanjay orders 500 sweaters from an online fashion supplier. The sweaters are described as 100% wool. When the sweaters arrive, Sanjay checks the labels and sees that the material is described as 50% wool, 50% man-made fibres.

(d) The contract between Sanjay and the fashion supplier is voidable due to: (2 marks)

- [ ] Unfair Contract
- [ ] Fraud
- [x] Misrepresentation
- [ ] Consumer Credit

(e) Identify whether the following statements about consideration in contract law are true or false. (6 marks)

Consideration has to be in the form of goods or money.	False
Consideration can be in the form of agreeing to perform an existing public duty.	False
Consideration can be a promise to do something in the future.	True

End of Task

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Task 2

Floortiles Ltd uses a credit rating system to assess the credit status of new customers. The credit rating (scoring) system below is used to assess the risk of default by calculating key indicators (ratios), comparing them to the table and calculating an aggregate score.

Credit rating (scoring) system	Score
Operating profit margin	
Losses	-5
Less than 5%	0
5% and above but less than 10%	5
10% and above but less than 20%	10
20% or more	20
Interest cover	
No cover	-30
Less than 1	-20
1 and above but less than 2	-10
2 and above but less than 4	0
4 or more	10

Credit rating (scoring) system	Score
Current ratio	
Less than 1	-20
1 and above but less than 1.25	-10
1.25 and above but less than 1.5	0
1.5 or more	10
Gearing (total debt/total debt plus equit	
Less than 25%	20
25% and above but less than 50%	10
50% and above but less than 65%	0
65% and above but less than 75%	-20
75% and above but less than 80%	-40
80% or more	-100

Risk	Aggregate score
Very low risk	Between 60 and 21
Low risk	Between 20 and 1
Medium risk	Between 0 and -24
High risk	Between -25 and -50
Very high risk	Between -51 and -160

The sales department has asked for a credit limit of £45,000 to be given to Bathrooms Ltd, a potential new customer. The financial information below has been supplied by Bathrooms Ltd.

Bathrooms Ltd Statement of Profit or Loss	20X5	20X4
	£'000	£'000
Sales revenue	9,870	8,624
Cost of sales	7,405	6,900
Gross profit	**2,465**	**1,724**
Distribution costs	982	850
Administration expenses	1,000	1,000
Operating profit/(loss)	**483**	**(126)**
Finance costs	200	105
Profit/(loss) before taxation	**283**	**(231)**
Taxation	60	0
Profit/(loss) for the year	**223**	**(231)**

Bathrooms Ltd Statement of Financial Position	20X5	20X4
	£'000	£'000
Assets		
Non-current assets		
Property, plant and equipment	3,869	2,700
Current assets		
Inventories	364	350
Trade and other receivables	192	177
Cash	5	9
	561	**536**
Total assets	**4,430**	**3,236**
Equity and liabilities		
Equity		
Share capital	1,500	1,500
Retained earnings	464	241
Total Equity	**1,964**	**1,741**
Non-current liabilities		
Borrowing	2,000	1,050
Current liabilities		
Borrowing	110	0
Trade and other payables	356	445
Total liabilities	**2,466**	**1,495**
Total equity and liabilities	**4,430**	**3,236**

Rating	Decision
Very low or low risk current year and very low or low risk previous year	Accept
Very low or low risk current year and medium risk previous year	Accept
Very low or low risk current year and high or very high risk previous year	Request latest management accounts and defer decision
Very high risk or high risk current year	Reject
Medium risk current year and medium, low or very low risk previous year	Accept
Medium risk current year and high or very high risk previous year	Request latest management accounts and defer decision

TASK 2 - WORKINGS

OPERATING PROFIT MARGIN

FORMULA	20x5	20x4
$\frac{\text{OPERATING PROFIT}}{\text{SALES REVENUE}} \times 100$	$\frac{483}{9,870} \times 100$	$\frac{-126}{8,624} \times 100$
	= 4.89%	= -1.46%

INTEREST COVER

FORMULA	20x5	20x4
$\frac{\text{OPERATING PROFIT}}{\text{FINANCE COSTS}}$	$\frac{483}{200}$	$\frac{-126}{105}$
	= 2.42 TIMES	= -1.20 TIMES

CURRENT RATIO

FORMULA	20x5	20x4
$\frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$	$\frac{561}{466}$	$\frac{536}{445}$
	= 1.20:1	= 1.20:1

GEARING RATIO

FORMULA	20x5	20x4
$\frac{\text{TOTAL DEBT}}{(\text{TOTAL DEBT + EQUITY})} \times 100$	$\frac{2,110}{(2,110+1,964)} \times 100$	$\frac{1,050}{(1,050+1,741)} \times 100$
	= 51.79%	= 37.62%

Task 2 (24 marks)

(a) Complete the table below by calculating the key indicators (to two decimal places) for 20X5 and 20X4 for Bathrooms Ltd, and rate the company using the credit rating scoring system. (22 marks)

Bathrooms Ltd	20X5	20X5	20X4	20X4
	Indicator	Rating	Indicator	Rating
Operating profit margin %	4.89	0	-1.46	-5
Interest cover	2.42	0	-1.20	-30
Current ratio	1.20	-10	1.20	-10
Gearing %	51.79	0	37.62	10
Total credit rating		-10		-35

Indicators

This model answer uses the appropriate negative figures to indicate **negative** operating profit margin percentages, and zeros to indicate **negative** interest cover figures. This reflects industry preference.

However, for the purposes of this assessment, students may enter zero or the appropriate negative figure for both negative operating profit margins and negative interest cover.

(b) Based on the results of your credit rating and using the table above, recommend whether the requested credit limit should be given to Bathrooms Ltd. (2 marks)

Customer	Decision
Bathrooms Ltd	Request latest management accounts and defer decision ▼

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Task 3 (30 marks)

BERLIN LTD IS A POTENTIAL NEW CUSTOMER AND HAS APPROACHED MILAN LTD TO ASK FOR A CREDIT LIMIT OF £50,000. MILAN LTD HAS STANDARD TERMS OF TRADE OF 30 DAYS. THE SALES DIRECTOR HAS ADVISED YOU THAT SHE HAS INVITED THE DIRECTORS OF BERLIN LTD TO PLAY GOLF NEXT MONTH, AS SHE IS KEEN TO GAIN BERLIN'S BUSINESS. THE SALES DIRECTOR RECEIVES A BONUS BASED ON THE AMOUNT OF NEW BUSINESS SHE BRINGS IN.

(a) Write notes to brief a new member of the credit control team explaining three sources of external information you will use (other than financial statements) when assessing whether to grant credit to a new customer. Comment on the role of the sales director in the credit assessment process. (8 marks)

There are a wide variety of sources which can be used when assessing the granting of credit, both internal and external. We will usually try to use a combination of sources in order to try to get the fullest picture of whether a new customer is an acceptable credit risk.

External sources of information include bank references, trade references, credit rating agencies, credit circles, and industry/trade publications. Bank references must be interpreted carefully, as banks have a duty of confidentiality. Their first regard is to their own customer and references are therefore usually worded in fairly standard ways – and we must try to interpret the "real" meaning behind this. Banks will only give an opinion on the overall soundness of the customer and will not be able to tell us how quickly they might pay their debts.

Trade references are responses from other companies who have dealt with the prospective customer and may be able to tell us something about the payment profile. However, it is important to bear in mind that the customer themselves has nominated these references and may have selected only those who might reply favourably.

Credit rating/reference agencies are organisations who maintain databases of information about individuals and businesses. The amount of information can be detailed (e.g. payment history, bankruptcy proceedings, court judgements etc) but can be out of date.

Credit Circles are groups of businesses in the same type of industry who have customers in common with each other and who meet on a regular basis. The sharing of information (often on an informal basis) can give useful and timely information on any possible problems with customers.

Trade publications and the media can sometimes be useful when considering the type of business a potential customer is in, and can help to see what overall trade views are on specific businesses, although it is important to check the facts behind any opinions provided in articles.

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Task 3

Berlin has supplied the following information based on the last two years of trading

Berlin Limited Statement of Financial Position	20X5	20X4
	£'000	£'000
ASSETS		
Non-current assets		
Property, plant and equipment	8,399	15,473
Current assets		
Inventories	858	1,145
Trade and other receivables	2,407	2,655
Cash	5	5
	3,270	**3,805**
Total assets	**11,669**	**19,278**
EQUITY AND LIABILITIES		
Equity		
Share capital	2,500	2,500
Retained earnings	2,324	1,135
Total Equity	**4,824**	**3,635**
Non-current liabilities		
Borrowing	3,825	10,200
Current liabilities		
Trade and other payables	2,144	2,671
Taxation	376	272
Borrowing	500	2,500
	3,020	**5,443**
Total liabilities	**6,845**	**15,643**
Total equity and liabilities	**11,669**	**19,278**

Berlin Limited Statement of Profit or Loss	20X5	20X4
	£'000	£'000
Sales revenue	28,340	29,380
Cost of sales	22,360	23,210
Gross profit	**5,980**	**6,170**
Distribution costs	2,580	2,100
Administration expenses	1,350	1,250
Operating profit	**2,050**	**2,820**
Finance costs	485	1,525
Profit before taxation	**1,565**	**1,295**
Taxation	376	272
Profit for the year	**1,189**	**1,023**

Berlin Limited	20X5	20X4
Gross profit margin %	21.1	21.0
Operating profit margin %	7.23	9.60
Interest cover	4.23	1.85
Current ratio	1.08	0.70
Trade payables payment period in days	35.0	42.0
Trade receivables collection period in days	31.0	32.98
Inventory holding period in days	14.01	18.01
Gearing %	47.27	77.75

The following additional information has also been provided.

1. Berlin Ltd sells catering supplies, but also hires out larger equipment and machinery. Up to 20X4, much of Berlin's plant and equipment was acquired by means of finance leases. From 20X5 onwards, most of the equipment is acquired by using operating leases.

2. Non-current assets acquired under finance leases are shown in the statement of financial position with the corresponding liability shown as part of borrowing.

3. Interest charges on the finance leases are included as part of the finance costs in the income statement.

4. Non-current assets acquired under operating leases are not shown in the statement of financial position. Payments relating to operating leases are included in the cost of sales. Commitments under operating leases are disclosed by way of a note. The operating lease note to the financial statements is shown below.

Operating lease note	20X5 £000	20X4 £000
Annual commitments under non-cancellable operating leases which expire:		
within one year	2,110	200
in the second to fifth year inclusive	9,350	800
over five years	430	0

Task 3 (continued)

The sales director should have minimal input when assessing whether to grant credit. Whilst she may be knowledgeable about the industry, her role is to increase sales and undertake marketing activities and she may not be knowledgeable about the process of credit control and the importance of liquidity and credit management.

In any event, the sales director's role is primarily sales driven, and she may be influenced by the fact that she receives a bonus based on the amount of new business.

(b) Write a note analysing the information and recommending whether credit should be granted. (22 marks)

Profitability

The turnover has decreased by a small amount (3.5%).
There is no real explanation for this – perhaps just a small downturn in the market, which can be monitored.
The gross profit has fallen by a similar amount (3.1%) and £190,000 in absolute terms.
The operating profit margin has fallen by 25% or £770,000 in absolute terms.
This fall in profitability may be because Berlin has changed its method of acquiring non-current assets and it may initially be more expensive to deal with the operating leases.
This may be a concern in the future if the admin and distribution expenses have a large fixed element.
Interest cover appears to be healthy and has improved, but this is due to the reduction in finance lease costs not due to an increase in operating profit. The business is less reliant on finance leases but is relying on operating leases.

Liquidity

The current ratio is higher than the previous year meaning liquidity appears to have improved.
The receivables collection period has decreased by nearly 2 days and is around an average of 30 days, which is a standard term of trade for many companies.
This gives some assurance that Berlin is managing its debt collection as well as in prior years.
Inventory also appears to be being managed adequately as the amount has fallen both in absolute terms and in inventory holding days.
A similar comment may be made about trade payables, so it seems that working capital is being managed relatively efficiently.

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Task 3 (continued)

Gearing and risk

The gearing has decreased from 77.75% to 47.27%, which would seem to give great comfort.
The absolute level of borrowing has reduced substantially from £12.7 million to £4.325 million. This is a good sign.
However, the commitments under operating leases need to be considered as this is similar to debt.
The annual operating lease commitments are almost £12 million which must be considered as financing.
The operating leases are non-cancellable, which means that the risk attached to this is quite high, particularly if the equipment is not hired out on a regular basis.
If this were included as borrowing in the balance sheet, the gearing would be deemed to be extremely high.

Conclusion

In general the performance indicators seem acceptable. Although there has been a decline in profitability, the business is still making a profit and manages its working capital well. The main issue is assessing the impact of the operating leases, and whether this is sustainable if Berlin faces a fall in equipment hire or other sales.
This might require an understanding of future forecasts for the industry, but it would certainly be appropriate to ask Berlin about future cash flow projections.
A decision on granting credit should therefore be deferred until after suitable discussions with Berlin and the provision of further up to date management information.
If credit is to be granted, further comfort in the way of retention of title clauses, credit insurance or directors' guarantees might be considered.

End of Task

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Task 4

The sales department of Rosemary Limited has asked for a credit limit of £55,000 to be given to Thyme Limited who is a potential new customer. The financial information below has been supplied by Thyme Limited in respect of the last two years. Rosemary Ltd trades on 30 day terms.

Thyme Limited Statement of Profit or Loss	20X5	20X4
	£'000	£'000
Sales revenue	17,500	12,400
Cost of sales	12,450	7,875
Gross profit	**5,050**	**4,525**
Distribution costs	1,150	1,105
Administration expenses	1,541	1,655
Operating profit	**2,359**	**1,765**
Finance costs	390	280
Profit before taxation	**1,969**	**1,485**
Taxation	395	300
Profit for the year	**1,574**	**1,185**

Thyme Limited Statement of Financial Position	20X5	20X4
	£'000	£'000
Assets		
Non-current assets		
Property, plant and equipment	6,996	6,313
Current assets		
Inventories	2,608	1,295
Trade and other receivables	3,803	1,992
Cash	0	5
	6,411	**3,292**
Total assets	**13,407**	**9,605**
Equity and liabilities		
Equity		
Share capital	3,500	3,500
Retained earnings	2,889	1,520
Total Equity	**6,389**	**5,020**
Non-current liabilities		
Borrowing	2,500	2,500
Current liabilities		
Bank overdraft	1,200	200
Trade and other payables	3,318	1,885
Total liabilities	**7,018**	**4,585**
Total equity and liabilities	**13,407**	**9,605**

TASK 4 - WORKINGS

INCREASE IN TURNOVER

£17,500,000 - £12,400,000 = £5,100,000

$$\frac{£5,100,000}{£12,400,000} \times 100 = 41.13\% \text{ INCREASE}$$

GROSS PROFIT MARGIN

FORMULA	20x5	20x4
$\frac{\text{GROSS PROFIT}}{\text{SALES REVENUE}} \times 100$	$\frac{5,050}{17,500} \times 100$	$\frac{4,525}{12,400} \times 100$
	= 28.86%	= 36.49%

INCREASE IN OPERATING PROFIT

£2,359,000 - £1,765,000 = £594,000

$$\frac{£594,000}{£1,765,000} \times 100 = 33.65\% \text{ INCREASE}$$

OPERATING PROFIT MARGIN

FORMULA	20x5	20x4
$\frac{\text{OPERATING PROFIT}}{\text{SALES REVENUE}} \times 100$	$\frac{2,359}{17,500} \times 100$	$\frac{1,765}{12,400} \times 100$
	= 13.48%	= 14.23%

INTEREST COVER

FORMULA	20x5	20x4
$\frac{\text{OPERATING PROFIT}}{\text{FINANCE COSTS}}$	$\frac{2,359}{390}$	$\frac{1,765}{280}$
	= 6.05 TIMES	= 6.30 TIMES

TASK 4 – WORKINGS

CURRENT RATIO

FORMULA	20x5	20x4
CURRENT ASSETS	6,411	3,292
CURRENT LIABILITIES	4,518	2,085
	= 1.42 TIMES	= 1.58 TIMES

QUICK (ACID TEST) RATIO

FORMULA	20x5	20x4
CURRENT ASSETS – INVENTORY	6,411 – 2,608	3,292 – 1,295
CURRENT LIABILITIES	4,518	2,085
	= 0.84 TIMES	0.96 TIMES

INCREASE IN INVENTORY

£2,608,000 – £1,295,000 = £1,313,000

$$\frac{£1,313,000}{£1,295,000} \times 100 = 101.39\%$$

INVENTORY HOLDING PERIOD

FORMULA	20x5	20x4
INVENTORY x 365	2,608 x 365	1,295 x 365
COST OF SALES	12,450	7,875
	= 76.46 DAYS	= 60.02 DAYS

TRADE RECEIVABLES COLLECTION PERIOD

FORMULA	20x5	20x4
TRADE RECEIVABLES x 365	3,803 x 365	1,992 x 365
SALES REVENUE	17,500	12,400
	= 79.32 DAYS	= 58.64 DAYS

TASK 4 - WORKINGS

INCREASE IN TRADE RECEIVABLES

£3,803,000 - £1,992,000 = £1,811,000

$$\frac{£1,811,000}{£1,992,000} \times 100 = 90.91\%$$

TRADE PAYABLES PAYMENT PERIOD

FORMULA	20X5	20X4
$\frac{\text{TRADE PAYABLES}}{\text{COST OF SALES}} \times 365$	$\frac{3,318}{12,450} \times 365$	$\frac{1,885}{7,875} \times 365$
	= 97.27 DAYS	= 87.37 DAYS

Task 4 (20 marks)

Complete the email to the chief credit controller, calculating and commenting on key ratios, and conclude by recommending whether or not credit should be extended. All calculations should be given to to two decimal places.

Email

To: Credit Controller **Date:** Today

From: AAT Technician **Subject:** New Customer Thyme Ltd

Please find below my calculations, observations and recommendation for new customer Thyme Ltd.

Profitability

Turnover has increased by [41.13%] . Gross profit margin in 20X4 was [36.49] % and [28.86] % in 20X5.

Operating profit itself has increased by [33.65%] , however the operating profit margin in 20X5 was [13.48] % as compared to [14.23] % in 20X4. This means that [expenses have been well controlled] although there might be some signs of possible [overtrading] which need to be investigated further.

Interest can be covered [over 6 times] in both years.

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Task 4 (continued)

Liquidity

Both the current ratio and the quick (acid test) ratio have [deteriorated]. In order to understand the liquidity position further it is important to review the trade cycles and the individual components making up the ratios.

Inventory has increased by [101.39] %. When compared to the increase in turnover this might indicate that Thyme is planning further increases in sales. The inventory holding period has increased from [60.02] days in 20X4 to [76.46] days in 20X5.

This means that [funds are tied up in inventory].

The trade receivables collection period has [worsened by over 20 days]. Trade receivables have increased by [90.91%].

This might mean that [Thyme is offering more generous terms to encourage sales].

The payables payment period is [significantly more than] our standard terms of trade.

The company has no cash in 20X5 and is more reliant on [short-term borrowing].

Recommendation

I recommend that [we refuse any credit.]

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Task 5 (22 marks)

(a) Match each type of claim on the left to the appropriate type of court procedure on the right by clicking on the left box first then on the corresponding right box. You can remove a line by clicking on it. (6 marks)

Claim	Court procedure
Over £25,000	High Court or County Court under the Multi Track route
	Magistrates Court under the Fast Track
Under £10,000	County Court under the Fast Track
	High Court under the Small Claims Track
£10,000 - £25,000	County Court under the Small Claims Track

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Task 5 (continued)

(b) Which of the following statements are true if a retention of title claim is to be successfully enforced? (4 marks)

	True	False
The goods subject to the clause must be clearly identifiable.	✓	
Goods which have been altered cannot usually be repossessed.	✓	
The goods subject to the clause must be in the customer's warehouse.		✓
There must be a rentention of title clause shown on every invoice sent to the customer.		✓

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Task 5

XYZ Ltd is considering alternative ways of managing debt collection. XYZ's total receivables ledger balance as at 30 June 20X5 is £2,560,000, which includes £180,000 of debts that are over 90 days.

ABC Co. can provide XYZ with a facility whereby ABC manages the receivables ledger on behalf of XYZ. ABC will lend XYZ a maximum of £1,750,000, or 75% of the outstanding receivables balance, excluding debts over 90 days. ABC will not provide any protection against irrecoverable debts.

WITH RECOURSE FACTORING

WORKINGS:

TOTAL RECEIVABLES LEDGER BALANCE	£2,560,000
LESS DEBTS OVER 90 DAYS OLD	(£ 180,000)
	£2,380,000

£2,380,000 x 75 % = £1,785,000

XYZ LTD CAN BORROW £1,750,000

Task 5 (continued)

(c) Complete the following sentences. (4 marks)

ABC is offering a recourse factoring facility.

XYZ can borrow: £ 1750000

(d) Which of the following are stages in a company winding up procedure? (2 marks)

(i) Statutory demand
(ii) Petition to the Court
(iii) Bankruptcy order
(iv) Appointment of Administrator

- [ ] (i), (ii) and (iii)
- [x] (i) and (ii)
- [ ] All of the above
- [ ] (ii) and (iv)

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Task 5 (continued)

(e) Drag and drop the correct words into the following statement. (4 marks)

An aged receivables analysis is a management tool that can be used to highlight customers who are [slow to pay].

It analyses the balance due from each customer according to the [date] of each invoice outstanding.

Analysis of trade receivables can also be undertaken based on focusing attention on [20%] of customer accounts which make up [80%] of the total value of outstanding debts.

amount

a bad credit risk

50%

100%

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Task 5 (continued)

Christopher owes Jayne £7,500 for goods supplied.

(f) What is the normal remedy for Jayne as a result of non payment of the debt? (2 marks)

- [ ] Action for breach
- [x] Action for price
- [ ] Specific injunction
- [ ] Action for restitution

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Task 6 (16 marks)

DEF Ltd wishes to claim VAT bad debt relief on some unpaid customer invoices.

(a) Identify whether each statement below is true or false. (4 marks)

In order for DEF Ltd to be able to successfully reclaim VAT on an unpaid debt...

	True or False
...DEF Ltd must have already accounted for the VAT and paid it over to HMRC.	True
...the claim must be made within three years of the due date of payment of the debt.	False
...DEF Ltd must have made a provision for the unpaid debt.	False
...the debt must have remained unpaid for six months after the due date of payment.	True

4 1/2 YEARS.

MUST HAVE ACTUALLY BEEN WRITTEN OFF.

Meerkat Ltd wishes to offer a 2% discount to its customers for settlement of invoices within 21 days.
Meerkat's standard terms of trade are 45 days.

(b) Calculate the following to two decimal places: (4 marks)

The simple annual cost of the discount 31.04 %

The compound annual cost of the discount 35.97 %

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TASK 6b) - WORKINGS

SIMPLE ANNUAL INTEREST RATE

$$\left[\frac{d}{100-d}\right] \times \left[\frac{365}{N-D}\right] \times 100 = \underline{\text{ANNUAL COST OF DISCOUNT}}$$

d = PROMPT PAYMENT DISCOUNT % 2%

N = NORMAL SETTLEMENT PERIOD IN DAYS 45 DAYS

D = SETTLEMENT PERIOD FOR EARLY PAYMENT IN DAYS 21 DAYS

$$\left[\frac{2}{98}\right] \times \left[\frac{365}{24}\right] \times 100 = \underline{31.04\%}$$

COMPOUND ANNUAL INTEREST RATE

$$\left[\left[1+\frac{d}{100-d}\right]^{\wedge}\left[\frac{365}{N-D}\right]-1\right] \times 100 = \underline{\text{ANNUAL COST OF DISCOUNT}}$$

d = PROMPT PAYMENT DISCOUNT % 2%

N = NORMAL SETTLEMENT PERIOD IN DAYS 45 DAYS

D = SETTLEMENT PERIOD FOR EARLY PAYMENT IN DAYS 21 DAYS

$\wedge$ = TO THE POWER OF

$$\left[\left[1+\frac{2}{98}\right]^{\wedge}\left[\frac{365}{24}\right]-1\right] \times 100 = \underline{35.97\%}$$

Task 6 (continued)

(c) Which ONE of the following is an important aspect of liquidity management? (2 marks)

- [ ] Having enough assets to meet all obligations on a timely basis.
- [x] Being able to pay all suppliers and other operational costs as they fall due.
- [ ] Being profitable enough to settle amounts due when they become payable.
- [ ] Rescheduling loan repayments to ensure they are non-current liabilities.

Jonty's customers currently pay 30 days after the month end. He is introducing a 1% discount from month 2 if customers settle the invoice in the same month. It is expected that 80% of customers will take advantage of this. The expected sales revenue per month is as follows:

	Sales revenue
Month 1	£95,000
Month 2	£105,000
Month 3	£136,000

(d) Expected cash receipts in month 3 will be: (2 marks)

£ 128712

WORKING:

MONTH 2 : £105,000 × 20% = £ 21,000

MONTH 3 : £136,000 × 80% × 99% = £107,712

TOTAL £128,712

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(e) Which ONE of the following is NOT a type of credit insurance? (2 marks)

- [ ] Key account
- [ ] Catastrophe
- [x] Unlimited excess
- [ ] Whole turnover

Tom has received a letter from the liquidator of Jerry Ltd. The liquidator has indicated that all unsecured creditors of Jerry will receive a dividend of 2.5p in the pound (£) later in the year. Tom is owed £7,500 by Jerry.

(f) Calculate the amount that Tom should write off as an irrecoverable debt. Ignore VAT. Show your answer to the nearest penny. (2 marks)

£ 7312.50

WORKING:

WILL RECEIVE £7,500 x 2.5% = £187.50

NEED TO WRITE OFF £7,500 − £187.50 = £7,312.50

End of Task

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Task 7 (20 marks)

(a) Review the information provided for each customer below and prepare comments and an action plan for dealing with the outstanding amounts due to Softfruit. Your action plan should include a summary of the options available to Softfruit to pursue outstanding amounts, along with recommendations for provisions or write off of irrecoverable debts where appropriate.

FDP

FDP is a regular customer of Softfruit and always pays to terms. FDP is responsible for 15% of Softfruit's annual turnover. FDP had ordered 12 custom-built computers for use in a new software development project. The order had specified that all 12 computers were to be delivered by 16 April in time for the project to begin. Softfruit delivered six computers on 15 April. However, due to the extended illness of their computer engineer Softfruit could only deliver the remaining six computers on 25 April.

CONTRACTUAL TERM?

The total value of the invoice to FDP dated 25 April is £72,000 including VAT. FDP has complained about the late delivery, stating that this has significantly delayed their important project. They are withholding payment and asking for compensation.

DISPUTED DEBT RATHER THAN IRRECOVERABLE DEBT.

Care needs to be taken here as FDP seems to be a customer who places regular orders and provides Softfruit with a substantial part of their sales – a tactful approach is therefore required. The terms of the sale contract need to be reviewed carefully, as well as delivery documentation, as FDP are possibly in breach of contract if the delivery date was part of the agreed terms.

Even though part of the order was delivered on time, the remainder was 10 days late. If Softfruit were determined to be in breach of contract, they would be liable for damages. The amount of damages would be determined based on what FDP might have incurred by way of costs or lost revenue as a result of the delay.

It would therefore be preferable to meet with FDP and negotiate some kind of discount for the problems and inconvenience caused. This would avoid any legal costs, maintain customer goodwill and hopefully bring about payment of the outstanding amount less any discount. As FDP has always otherwise paid to terms, there is no reason to make any provision or take other action to collect the debt at this point.

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Task 7 (continued)

Gigabits

Softfruit has received notification that Gigabits is in receivership. The amount of the outstanding debt is £28,620 including VAT. The receiver has told Softfruit that she will not accept any retention of title claim as the goods in question are generic computer components that Gigabits has purchased from a number of suppliers. It will therefore not be possible to identify which had been supplied by Softfruit.

DO NOT AUTOMATICALLY ACCEPT THIS – NEEDS TO BE CHALLENGED.

The account is credit insured for a maximum of 75% of the net debt or £15,000, whichever is the lower.

(EXCL. VAT)

A receiver will often attempt to reject ROT claims in the first instance therefore Softfruit should check what sort of goods they have recently supplied to Gigabits. If the goods are small components then the receiver may be correct that it is not possible to identify which have been supplied by Softfruit, particularly if they had not been kept separate by Gigabits. However, it may be possible to identify Softfruit's components. Therefore if it is cost-effective to pay a visit to Gigabit's premises, Softfruit should send a representative immediately with all relevant documentation.

Softfruit has an "all monies" retention of title clause. This means that it would not be necessary to match any goods unpaid for to specific outstanding invoices. If the ROT clause turns out to be unenforceable, Softfruit will be an unsecured creditor of Gigabits, which means it is unlikely that Softfruit will receive much, if any, of the outstanding amount.

A claim should be made on the credit insurance for the amount of £15,000. (Net debt is £28,620/1.2 = £23,850. Maximum claim is lower of £15,000 or 75% x £23,850 = £17,887.50). A provision should be made for the balance of £8,850. VAT of £4,770 can be reclaimed from HMRC after six months and after the debt has been written off.

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Task 7 (continued)

Netintra

Netintra has an outstanding invoice for £15,000, including VAT. The invoice is dated 1 March. Netintra has often been slow to pay in the past, and has now given several excuses to delay payment, ranging from being unable to trace any of the original documentation to the authorised cheque signatory being away. Softfruit has supplied Netintra with copies of all relevant documentation and, in accordance with the credit control policy, is now about to instruct a debt collection agency or commence legal action.

NOW 3 MONTHS OVERDUE.

The HR director has asked you to refrain from sending the debt collectors or instructing solicitors because the Managing Director of Netintra is president of the local tennis club. She wishes to join this club, and she is concerned that any unpleasant tension will affect her application.

RAISES ETHICAL ISSUES E.G. SELF INTEREST THREAT TO HER OBJECTIVITY.

Netintra seem to have used a variety of excuses and delaying tactics, while Softfruit has done its best to prove the amount owed. The debt is now substantially overdue (payment was due by 31 March, it is now 30 June, so the debt is 90 days old) with no apparent reason, even though Netintra are normally slow payers.

A credit control policy is in place to ensure that Softfruit does not suffer any unnecessary liquidity problems or unnecessary bad debts. Because there is no business reason for not pursuing the debt in accordance with the credit control policy, Softfruit should proceed to instruct a debt collection agency or commence legal action.

Causing "unpleasantness" is not a sufficient reason for Softfruit not to protect its business position. The HR director's personal situation should have no bearing on Softfruit's business decisions and she should not use her position as a director to influence how a policy should be applied for her own personal gain.

(b) Megachips

	May	June
	£	£
Opening balance	65,000	37,600
Invoice	26,400	16,920
Credit note	(3,840)	(2,100)
Interest charge	250	0
Closing balance	37,600	(2,100)
Payments received	**50,210**	**54,520**

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Task 7

Softfruit Ltd manfactures and supplies computer components. It also assembles and supplies computers made to individual customer specifications. VAT is charged at the standard rate on all supplies.

Softfruit includes an all monies retention of title clause as part of its standard terms of trade. Computers that are custom made to a specific customer order carry a unique serial number for warranty purposes. Payment terms are 30 days from the invoice date.

Softfruit has credit insurance for certain named customer accounts.

You work in the credit control department of Softfruit. Your supervisor is away on holiday and is not contactable, however you have been provided with the information below. Today's date is 30 June.

Softfruit has had some problems with certain customer accounts following a computer virus. The accounts department has managed to recover the following details relating to the account of Megachips:

- balance at 1 May: £65,000 (debit) BALANCE B/D
- invoices raised: 5 May £22,000 net of VAT, 12 June £16,920 including VAT
- credit notes issued: 17 May £3,840 including VAT, 14 June £2,100 including VAT
- late payment charge processed in May relating to an overdue invoice from February: £250
- balance at 31 May: £37,600 (debit) BALANCE B/D
- balance at 30 June: £2,100 (credit). BALANCE B/D

INVOICE 5 MAY : £22,000 x 1.2 = £26,400 INCL. VAT

b) CALCULATE THE PAYMENTS RECEIVED FROM MEGACHIPS IN MAY AND IN JUNE.

TASK 7b) – WORKINGS

MEGACHIPS

BALANCE B/D	65,000	CREDIT NOTE	3,840
INVOICE	26,400	BANK	50,210
INTEREST CHARGE	250	BALANCE C/D	37,600
	91,650		91,650
BALANCE B/D	37,600		

MEGACHIPS

BALANCE B/D	37,600	CREDIT NOTE	2,100
INVOICE	16,920	BANK	54,520
BALANCE C/D	2,100		
	56,620		56,620
		BALANCE B/D	2,100