Osborne Books Tutor Zone

Credit Management

Answers to practice assessment 2

Task 1

(a) (b) Be of some value, but not necessarily the full value of the goods

(b) (a) A counter offer

(c) (c) Hire purchase and hire agreements

(d) (b) Must always be in writing or agreed orally

(e) (b) 'I agree to buy this picture from you and will pay the £1.2 million asking price'

(f) (b) Breach of contract

(g) 10 per cent

(h) £125.75 *Workings*: (£10,000 x 1.2) x (8% + 0.5%) + 45/365

(i) The Unfair Contract Terms Act protects individuals and businesses by restricting the **operation and legality** of **contract terms**. The Act covers most forms of contract and one of its most important functions is to restrict **disclaimers of liability**.

Task 2

(a)

Hurdle Limited	**20-2 Indicator**	**20-2 Rating**	**20-1 Indicator**	**20-1 Rating**
Operating profit margin %	3.04	0	38.27	20
Interest cover	0.46	–20	6.46	10
Current ratio	0.94	–20	2.17	10
Gearing %	37.2	10	39.06	10
Total credit rating		–30		50

Workings:

	Formula	**20-2**	**20-1**
Operating profit margin %	$\frac{\text{Profit from operations x 100}}{\text{Sales revenue}}$	$\frac{12 \times 100}{395} = 3.04\%$	$\frac{155 \times 100}{405} = 38.27\%$
Interest cover	$\frac{\text{Profit from operations}}{\text{Interest payable}}$	$\frac{12}{26} = 0.46$	$\frac{155}{24} = 6.46$
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{131}{48 + 91} = 0.94$	$\frac{139}{64} = 2.17$
Gearing %	$\frac{\text{Total debt x 100}}{\text{Total debt plus equity}}$	$\frac{298 \times 100}{298 + 503} = 37.2\%$	$\frac{300 \times 100}{300 + 468} = 39.06\%$

(b) 20-2 High risk; 20-1 Very low risk.

(c) (b) Reject

Task 3

(a) The risks associated with giving credit to an overseas customer are:

- where is the location of the business, who are the business owners, will their offices be open at the same time and is there a point of contact?
- actually obtaining the money, can it be paid directly into the supplier's bank account
- will the money be paid in a foreign currency and if so fluctuating exchange rates may mean the receiving business may gain or lose in exchange rate differences
- how to recover debts and the different laws that cover debt collection in other countries

Further credit control procedures that should be carried out are:

- consider the possibility of trading in pounds
- consider trading using cash terms until a credit history is established
- request accounts and references (trade, credit and bank) using the usual procedures

(b) **Profitability**

The turnover has increased by 57% or £3,242,000. Whether or not this is a good sign depends on other factors such as changes in profit margins, levels of current assets, changes in trade cycle days and cashflow.

There has been an increase in the level of gross profit by £250,000; however, it is very important to look at the change in the gross profit margin, which has decreased from 38% to 27%. This could indicate that the company is having to pay more for its supplies.

Profit from operations has fallen by £614,000, this is due to the fall in the gross profit margin as distribution costs have remained constant at 4% of turnover and administrative expenses at 23% of turnover.

Interest cover was over 20 times in the previous year and now the profit from operations is not enough to cover the interest commitments. There has been a big increase in both the long and short term borrowing, which is a worrying sign as the banks may ask for immediate repayment if the interest payments cannot be met.

Liquidity

The higher the current ratio the better from a credit risk point of view, in this case it has fallen from 3.79 to 1.59. Whether or not the ratio is good will depend on the type of industry, in the building trade suppliers often need to be paid much quicker than the company will receive money from its customers.

Trade receivables have more than doubled and an increase would be expected with an increase in turnover. The collection period has increased from 42 days to 63 days which is a bad sign and indicates that credit control procedures are poor.

An increase in trade payables would be expected with an increase in the cost of sales, in this case they have increased from £300,000 to £928,000. This increase has resulted in an increase in the trade payables payment period by over 20 days; this indicates that the company is struggling to pay its suppliers according to their terms.

The level of inventories has remained constant, but the inventory holding period has fallen from 56 to 30 days. This may be a sign that the company will run out of inventories and will be unable to complete jobs.

Gearing

Gearing has increased from 35% to 62%, which means that the company is placing a much heavier reliance on funding from the banks.

There has been no injection of capital from shareholders which means that the £1,500,000 increase in non-current assets has purely been financed by an increase in borrowing.

The bank overdraft has increased by £372,000 and as mentioned above at present the company is unable to meet its interest commitments.

Recommendation

It would appear that the company has expanded quickly and is struggling to pay suppliers and banks, therefore an increase in the credit limit should not be given.

Task 4

(a)

Ultra Ltd	**20-3 Indicator**	**20-2 Indicator**
Gross profit margin %	41.51	54.06
Operating profit margin %	3.22	6.81
Trade payables payment period in days	98.46	89.43
Inventory holding period in days	25.71	42.64
Current ratio	0.87	2.5
Quick ratio	0.61	2.02

Workings:

	Formula	**20-3**	**20-2**
Gross profit margin %	$\frac{\text{Gross profit x 100}}{\text{Sales revenue}}$	$\frac{413 \text{ x } 100}{995}$ = 41.51%	$\frac{413 \text{ x } 100}{764}$ = 54.06%
Operating profit margin %	$\frac{\text{Profit from operations x 100}}{\text{Sales revenue}}$	$\frac{32 \text{ x } 100}{995}$ = 3.22%	$\frac{52 \text{ x } 100}{764}$ = 6.81%
Trade payables pmt period in days	$\frac{\text{Trade payables x 365}}{\text{Cost of sales}}$	$\frac{157 \text{ x } 365}{582}$ = 98.46	$\frac{86 \text{ x } 365}{351}$ = 89.43
Inventory holding period in days	$\frac{\text{Inventories x 365}}{\text{Cost of sales}}$	$\frac{41 \text{ x } 365}{582}$ = 25.71	$\frac{41 \text{ x } 365}{351}$ = 42.64
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{136}{157}$ = 0.87	$\frac{215}{86}$ = 2.5
Quick ratio	$\frac{\text{Current assets less inventories}}{\text{Current liabilities}}$	$\frac{136 - 41}{157}$ = 0.61	$\frac{215 - 41}{86}$ = 2.02

Profit from operations	20-3	£8,000 + £24,000 = £32,000
	20-2	£8,000 + £15,000 + £29,000 = £52,000
Cost of sales	20-3	£995,000 – £413,000 = £582,000
	20-2	£764,000 – £413,000 = £351,000

(b) Sales revenue has increased by £**231,000** or **30.24**%, this **is** a strong indicator that the company may be overtrading.

Despite the increase in sales, gross profit has remained the same, this **is not** a good sign. The gross profit margin has **decreased**.

The profit from operations has **fallen**. **This may be a problem depending on the cash flow of the business.**

The trade payables payment period indicates on average **how long a business takes to pay its suppliers.** In this case it has increased by **9.03** days, which may mean that the company **is** struggling to pay its suppliers.

The level of inventory has remained the same **but the holding period has decreased which means that inventory may run out.**

Both the current and quick ratios have fallen, which strongly indicates **poor liquidity, which is a major concern**.

I recommend that credit not be given.

Task 5

(a) (c) Multi Track

(b) (a) The buyer mixes the goods with other material in a manufacturing process

(c) Credit insurance

£2,580 *Workings:* (£750 x 12) – (£10,700 x 60%)

(d) (c) Invoice, statement, reminder letter, telephone call, solicitor's letter

(e) (b) A garnishee order

(f) (a) Be in breach of contract

Task 6

(a) (a) The VAT which can be claimed back from HMRC is £7,020 and the amount that can be claimed from the insurers is £15,825

(b) The simple annual interest rate of the discount is **66.19**%.

Workings:

$$\left(\frac{3.5}{96.5}\right) \times \left(\frac{365}{30-10}\right) \times 100 = 66.19\%$$

The compound annual rate of discount is **91.59**%.

Workings:

$$\left\{\left(1 + \frac{3.5}{96.5}\right)^{\wedge\left(\frac{365}{30-10}\right)} - 1\right\} \times 100 = 91.59\%$$

(c) **(a)** and **(d)** are False; **(b)** and **(c)** are True

(d) £302,500 *Workings:* (£110,000 x 95%) + (£120,000 x 90%) + (£100,000 x 90%)

(e) (c) 1, 3 and 4 only

(f) £318.24 *Workings:* £1,700 x 1.2 x 0.156

Task 7

(a) Tricky Ltd

(d) Tricky Ltd should be contacted to state that the problem was not notified within 48 hours of delivery

Meringue Ltd

(c) A credit note should be issued for the value of the goods and the correct invoice issued

Chocolate Supplies Ltd

(d) Chocolate Supplies Ltd should be telephoned and an immediate payment requested

Sugar Pie Ltd

Contact the credit insurer to make a claim for £**648**, make a provision for £**216** and claim VAT of £**172.80** from HMRC.

(b) Thomas Ltd

- Make sure the account is put on stop.
- Continue to send regular statements of account.
- Contact Thomas Ltd to establish why the account is not being paid in full.
- If Thomas Ltd is experiencing financial difficulties make a provision in the accounts.
- If Thomas Ltd is unable to pay the account in full consider offering a regular payment plan.

Tasty Desserts Ltd

- Contact Tasty Desserts Ltd and state that the invoice cannot be reissued as the contract was originally with Tasty Desserts Ltd.
- Consider taking legal advice to resolve the matter.