CERTIFIED PUBLIC ACCOUNTANT

STAGE 3 EXAMINATION

S3.5 CREDIT MANAGEMENT

DATE: THURSDAY, 01 DECEMBER 2022

MARKING GUIDE AND MODEL ANSWER

SECTION A

Answer Grid

1. D
2. A
3. B
4. B
5. D
6. C
7. B
8. C
9. A
10. B

MARKING GUIDE

2 Marks for each correct answer	2
Total marks for this section	20

Model Answer

1. D Suppose initially current assets = RWF 1.5m, and current liabilities = RWF 1m. This gives the initial current ratio of 1.5m / 1m = 1.5.

   When the customer pays, this reduces current assets (receivables) and reduces current liabilities (as the company has an overdraft) by RWF 500,000. So, the current ratio becomes (1.5 – 0.5) / (1 – 0.5) = 2. The current ratio has therefore increased.

   As everyone else pays on time, removing this overdue debt from the receivable's ledger will reduce receivables days. Therefore, receivables days will decrease.

   As the current ratio will increase, and receivables days will decrease, the correct answer is D – all other answers are incorrect.

2. A To set up a new credit account, a record is needed of the customer's credit limit and agreed period of credit (so (i) and (ii) are required). Customer contact details are also required to enable queries to be raised and dealt with efficiently and effectively (so (iv) is required). However, customers pay money to the company, not the other way around, so (iii) customer bank details are not required.

3. B The revised offer constitutes a counteroffer. A counteroffer acts as a rejection of the initial offer so the original offer comes to an end once a counteroffer is made. Option A is therefore false.

   The 'live' offer is therefore the counteroffer, which has been accepted by Company A. It is therefore the revised terms that are binding. Option B is therefore true.

   Option C is false as the counteroffer has been accepted.

   Option D is false as both parties are clearly and explicitly negotiating a contract, hence there is an intention to create legal relations.

4. B When a debt is written off, it is removed from the receivables ledger. However, if it is only provided for, the amount remains on the ledger, and a separate provision is raised in the accounts. Statement (i) is therefore true.

   Company B's debts are merely doubtful, so there is some point of recovery. The amount will still be showing on the receivables ledger as outstanding so it should be chased. If it is recovered, the provision can be reversed. Statement (ii) is therefore false.

   Particularly as Company A's debt will be removed and is overdue, receivables days will reduce as a result. Statement (iii) is therefore true

5. D RWF 3.6m over 18 months equates to 3.6 / 18 = RWF 200,000 per month.

   So, the initial credit limit should be 200,000 × 1.18 = RWF 236,000 to include VAT, which forms part of the balance owed. Option D is therefore correct.

   Option A excludes VAT. This is incorrect as VAT forms a part of the balance owed.

Option B builds in 6 months of 10% per month growth as the customer has been a cash customer for 18 months ie 236,000 × $(1.1)^6$ = RWF 418,088. This is incorrect as the company policy states the initial terms should only be one month's sales.

Option C also includes 10% per month growth for 6 months but is based on the net-of-VAT sales (200,000 × $(1.1)^6$ = RWF 354,312) and is therefore similarly incorrect.

6. C Statement (i) is **not** appropriate – trading on a cash basis should be encouraged to build relationships. Statement (ii) **is** appropriate as it encourages an ongoing relationship.

Statement (iii) is generally **not** appropriate as it encourages disagreement with established policies. It is more appropriate to be available to discuss the reasoning, but not with a view to changing the decision.

7. B Company B, whilst within its 60-day limit, owes more than their credit limit hence this should be reported internally.

Company A is an already known dispute that will have been reported already.

Company C is within its agreed extended credit terms in general. The small amount owing over 90 days is not 'significant' as required by the policy for internal reporting.

8. C A negative working capital cycle means (receivables days + inventory days) are less than payables days. This means cash is coming in from customers before it is leaving the company to pay suppliers. Option C is therefore correct.

Statement A is incorrect: the length of the working capital cycle doesn't relate to the size of the balances, just how long they are outstanding for.

Statement B is incorrect – this refers to making sales at a cash loss.

Statement D is incorrect – the working capital cycle relates to current assets and liabilities, not equity.

9. A Option A is correct – a garnishee order is appropriate as it requires the debtor's customers to pay directly to KFL. As NARL has receivables but no other tangible assets or cash, this is likely to be the most beneficial option.

Option B is incorrect – an attachment of earnings order relates to the wages or salary of an individual so is not appropriate for recovering amounts owed from a limited company.

Option C is incorrect – a warrant of execution authorises a court bailiff to seize assets in settlement, but as NARL has no physical assets, this is not appropriate.

Option D is incorrect – a charging order involves attaching a charge to assets so they can then be sold in settlement directly for the amounts owed. NARL has no tangible assets, so this method is not available.

10. B Appeals of Provincial Court decisions are heard in the High Court.

Option A is incorrect – the judgment of the Provincial court is not necessarily final.

Options C is incorrect – appeals are always to a higher court.

SECTION B

QUESTION 11

Marking Guide	**Marks**
Personal information: relates to living individuals	1
Personal information: allows for direct or indirect identification of the individual	1
Principles: knowledge. ½ for each of the 8 principles, maximum	4
Principles: application to NSL: 1 per application, maximum	4
Total Marks	**10**

Model Answer

MEMORANDUM

To: Finance team, Nyanza Sugar Ltd (NSL)

From: Finance manager

Subject: **GDPR**

Date: XX/XX/XXXX

Following the recent cyber-attack, one of our major customers has expressed concern that some of their personal information may have been stolen. We agreed contractually with the customer concerned a while ago that we would maintain compliance with the European General Data Protection Regulation (GDPR). To this end, in our next meeting, we will review GDPR as a team. This memo seeks to preface that meeting by clarifying the definition of personal information as far as the GDPR is concerned, and what constitutes good practice in how we should treat customer data.

Personal data

Personal data as far as GDPR is concerned relates to **living natural persons** – companies are therefore not included, nor are deceased people.

Personal data means information which **identifies a specific individual,** or **directly allows for their identification**. It also includes any information that **indirectly allows for their identification** when used in conjunction with other data.

Some data is deemed by GDPR to be more sensitive than others – such as criminal or medical records.

For example, in NSL, a customer's company director's name and contact details are personal data, but information relating to the company they work for is not.

Principles of good practice

The following principles can be applied to NSL:

- **Information should be fairly and lawfully processed, in line with the data subject's rights:** customer contact details should be kept in formal records and held securely. Customers should be made aware we are storing their contact details and the reason we are storing them. We can explain this when the information is gathered (for example on credit account application forms).

- **Information should be adequate, relevant and not excessive, and should be processed for limited purposes:** only the bare minimum of personal information should be kept. A data audit could be undertaken to cleanse NSL of any superfluous personal data.

- **Information should be accurate and up to date and should not be kept for longer than is strictly necessary:** customer details should be kept up to date. When they change, all records should change with old information being deleted. This also includes deleting old emails that are out of date and no longer need to be kept.

- **Information should be kept securely and not transferred to countries elsewhere unless such data is adequately protected in those countries:** Rwanda is developing its own data protection legislation, but this is a work in progress. It may be we seek to store and manage our information overseas in a country that has a GDPR compliant environment for the time being.

QUESTION 12

Marking Guide	**Marks**
Difference between bankruptcy and insolvency	2
Legal courses of action: up to 1 for each method	5
Reasoned recommendation, detailing other alternatives	3
Total marks for this section	**10**

Model Answer

Both bankruptcy and insolvency relate to a situation where a debtor cannot or has refused to pay what they owe. Bankruptcy relates to individuals, and insolvency relates to companies.

Gitarama Engineering Ltd (GEL) is a limited company, hence insolvency is relevant in this case.

Assuming we have already asked the company exhaustively for payment, there are several courses of action that could be taken by the courts:

Garnishee order – this is where the court would insist that GEL's customers pay us directly. This may be appropriate if GEL has sufficient receivables.

Warrant of execution – this is where court bailiffs are appointed to seize assets in settlement of the debt. This might be appropriate if there are sufficient assets that can be sold in a reasonable timeframe.

A receiver could be appointed to enforce payments of amounts owing by GEL.

An administrative order could be actioned requirement regular payments to us until the debt is cleared.

Insolvency – petition the court to either appoint a liquidator or an administrative receiver. A liquidator is appropriate if there is no hope of GEL continuing to trade. An administrative receiver on the other hand would try to turn the company around.

Recommendation

The best course of legal action would be to petition the courts for recovery of the debt, and the court case would decide via a court order the most appropriate method of recovery. If there is no cash or assets, either an administrative order or insolvency proceedings may be preferred (to liquidate the company if it has no future or to turn it around if it has a viable future).

SECTION C

QUESTION 13

Marking Guide **Marks**

(a)	Ratio calculations: ½ per calculation up to a maximum of	4	
	Issues: bank statement	1	
	Issues: trade reference	1	
	Issues: financial statement – 1 per point up to a maximum of	4	
			10
(b)	Basic recommendation if reasonable, up to	2	
	Review in the future and/or conditions, up to	2	
	Reasoning: 1 per valid point up to	6	
			10
	Total		**20**

Model Answer

(a)

	2021	**2020**
Gross profit margin %: gross profit / sales revenue	19.9	22.0
Operating profit margin %: operating profit / sales revenue	7.6	10.3
Interest cover: operating profit / finance costs	4.6	4.8
Current ratio: current assets / current liabilities	0.79	0.58
Trade receivables collection period in days: (Trade receivables / sales revenue) × 365	21.9	23.5
Trade payables outstanding in days: (Trade payables / costs of sales) × 365	30.4	35.1
Inventory holding period in days: (inventory / costs of sales) × 365	9.1	15.0
Length of working capital cycle: receivables days + inventory days – payables days	0.6	3.4
Gearing % (non-current debt / non-current debt + equity)	36.3	34.9

Key issues and concerns with the information provided:

Bank reference

Although 'should prove good for your figures' sounds like a positive reference (and it could be much worse) it is not the best possible reference. Typically, 'considered good for your purposes' would be better, and 'undoubted' better still. The reason for this less-than-perfect bank reference needs to be determined.

Trade reference

The amount of credit granted by the trade referee is RWF 10 million less than has been applied for from UTL, and KCL occasionally pay late ie over the 30-day terms they have with this supplier. This is a concern given KCL have asked for 60 days credit from UTL and that the reference was put forward by KCL themselves, one would expect it to be 'clean' in this case.

Financial statements

Gross margin: this has reduced despite an increase in turnover. This is a concern if it is a trend as it may indicate costs are spiralling out of control.

Operating margin: distribution costs have increased proportionately more than revenues. Again, this may indicate costs are out of control.

Liquidity and gearing: liquidity has improved, and the average payables days is 30.4 in 2019, which is half the period of credit they have applied for, prompting the question why they wish to apply for 60 days. Gearing has increased only marginally.

(b) **Dear manager Kananza Clothing Ltd (KCL) – credit application**

The above customer has applied for credit of RWF 50 million on 60-day terms. KCL have only been a cash customer of ours for a relatively short period – six months – albeit trading with us has increased consistently over that time.

However, the amount of credit applied for is more than twice the current level of monthly purchases, and they have applied for a period of 60 days rather than our standard terms of 30 days.

The bank and trade references, whilst not poor, are not perfect, and there are some indications when reviewing recent financial statements that despite the business growing, profitability has declined lately.

Recommendation

In light of the above, I recommend the credit application on the grounds requested be refused. However, we could counter-offer more restricted terms of:

Credit limit of RWF 20 million on standard 30-day terms for a period of **six months**, and if there are no issues in that time, we could look to increase the limit over the next 12 months to the requested limit of RWF 50 million if the volume of trade continues to increase.

During the initial six-month period we should also undertake further research:

- Investigate why the bank reference may be less than perfect
- Obtain further trade references of our choosing
- Obtain a credit report from a rating agency to assist our decision in six months' time

I look forward to receiving either your questions or authorisation for me to action the above.

Kind regards,

Credit team member

QUESTION 14

Marking Guide

			Marks
(a)	Debt collection agencies: advantages 1 per point up to	2	
	Debt collection agencies: disadvantages 1 per point up to	2	
	Debt factoring: advantages 1 per point up to	2	
	Debt factoring: disadvantages 1 per point up to	2	
	Early settlement discounts: advantages 1 per point up to	2	
	Early settlement discounts: disadvantages 1 per point up to	2	
			12
(b)	Clear recommendation	1	
	Justification: 1 per point up to	2	
			3
			Marks
(c)	Email format and tone – up to	2	
	Communication of effect – up to	2	
	Justification	1	
			5
	Total		**20**

Model Answer

(a) **Debt collection agencies**

These simply administer the collection of debts. The debts would still remain on HRL's receivables ledger.

Advantages: they are experts in their role and are likely to be effective in collecting debts. They can also be used simply to chase specific problematic customers.

Disadvantages: They charge a fee for their services. Customers may not like the official approach of a debt collection agency which could be detrimental to HRL's relationship with that customer.

Debt factoring:

A debt factor provides a combination of services that may include administration of the receivables ledger, finance, and bad debt insurance.

Advantages: like debt collection agencies they are experts in their field so will probably be very effective in collecting debts. The provision of finance can improve liquidity for HRL, and bad debt insurance removes the risk of travel agency groups who may cease trading.

Disadvantages: each of the services cost money so this could be an expensive option for HRL. Customers may not appreciate a third-party collecting money from them which could erode customer goodwill. In addition, HRL may lose the ability to collect money themselves. This may create problems should, for example, the debt factor themselves fail as a business, or when it comes to renegotiating terms with the factor HRL may be in a disadvantageous position.

Early settlement discounts:

This would involve HRL offering, for example, a 1% discount for settlement in say 14 days.

Advantages: this would improve liquidity for HRL if customers take advantage of the early settlement discount. This discount may also attract new business.

Disadvantages: early settlement discounts are often very expensive. For example, 1% for settlement in 14 days as opposed to 30 days is a simple annualised rate of (very) approximately $24 \times 1\% = 24\%$.

(PCM 3.2)

(b) I recommend utilising the services of a debt collection agency, but only for problematic accounts.

Justification:

A settlement discount would have to be offered to all customers, it is expensive and generally unnecessary.

Liquidity is not an issue for HRL. Cash is received generally before payments are made to suppliers, so up-front finance provided by a debt factor is unnecessary.

The occasional use of a debt collection agency means that personal relationships can be maintained with the majority of HRL's customers.

(PCM 3.2)

(c) **To:** Purchasing manager, Rwandan Paradise Ltd

From: Credit manager, Highlife Resorts Ltd

Subject: Credit terms

Date: XX/XX/XXXX

Dear purchasing manager,

I trust you are well, and that business is good.

Historically, as you know, our Financial Controller has contacted you for payment. As HighLife Resorts Ltd continues to grow, we are finding this approach a little impractical, and we have recently decided to formalise our approach to collections.

This doesn't change our standard terms with you of 30 days, but it does mean collection is more likely to be via a debt collection agency, Kigali Customer Services Ltd, who are being tasked to collect in accordance with our standard 30-day terms.

Your account at present is approximately four months overdue, and as a gesture of goodwill we are prepared to allow a grace period of three months to bring the account back within the

30-day limit before we switch over to Kigali Customer Services Limited. I do hope you find this agreeable.

I hope you understand this new approach is to manage the time of our financial controller, and to manage our working capital requirements in the future to ensure we can all continue to grow profitably.

If you have any questions at all, please do not hesitate to ask.

Kind regards,

Credit manager

HighLife Resorts Ltd

QUESTION 15

Marking Guide			Marks
(a)	Kimenyi builders – 1 for recommendation, 1 for justification	2	
	Kicukiro Housing – 1 for recommendation, 1 for justification	2	
	Manzi and Son Ltd – 1 for recommendation, 1 for justification	2	
	Gicumbi Construction – 1 for recommendation, 1 for justification	2	
	Rulindo Civil Engineering – 1 for recommendation, 1 for justification	2	
			10
(b)	Cost – flat fee	1	
	Cost – relating to size of debt (one for total debt size, 1 for applying %)	2	
	Benefit (one for incremental %, 1 for applying to debt)	2	
			5
(c)	Up to 1 per customer, justified	5	
			5
	Total		**20**

Model Answer

(a) **Kimenyi Builders**

Although there are some overdue amounts on the account, the net amount owing is zero. The RWF 5,000 million credit may well need applying to the aged debts. It could be unallocated cash, or a recently raised credit note. This needs clarification before any further action is taken.

Kicukiro Housing

Kicukiro Housing is operating within its agreed credit terms. However, KCL are aware there may be problems with this customer. Further trading should cease while rumours are investigated. If the rumours prove to be founded, it is recommended that this account is passed to the debt collection agency as soon as it is due for payment.

Manzi and Son Ltd

RWF 1,000 million is overdue by more than two months. However, there is a credit of RWF 1,000 million in the 1–2-month column. It may be unallocated cash or a credit note relating to the old amount. This should be investigated before taking any further action.

Gicumbi Construction

Gicumbi construction owe RWF 4,000 which is more than two months overdue. Despite the promise they have made to pay, this should be passed to the debt collection agency in line with policy to ensure payment is received.

Rulindo Civil Engineering

The balance of RWF 5,500 million is clearly overdue. However, the company is in the process of liquidation. There is little point in incurring the fees of a debt collection agency as it is unlikely to increase the chances of recovery. Assuming KCL has already been contacted by the liquidator, no further collection procedures are necessary at this time.

(b) Assuming a debt collection agency is used to collect the Gicumbi Construction (RWF 4,000 million 2 months + overdue) and Kicukiro Housing (RWF 7,000 owed):

	RWF million
Cost: flat fee: 2 × RWF 75m	(150)
Cost: Fee relating to size of debt: 5% × (4,000 + 7,000) =	(550)
Benefit: Average increased recovery: (75% – 60%) × (4,000 + 7,000) =	1650
Net benefit of using the debt collection agency	**950**

(c) Assuming the debt collection agency is not to be used, the following doubtful debt allowance is recommended:

Customer	*Reason*	*Amount* RWF million
Kimenyi Builders	Appears to be an allocation issue on the ledger	0
Kicukiro Housing	Rumours indicate issues with recovery	7,000
Manzi and Son Ltd	Older amounts net to zero	0

Gicumbi Construction	100% of 2–3 months, 50% of 1–2 months So, 4000 + (50% × 11,000)	9,500
Rulindo Civil Engineering	Pending further information from the liquidator – 100%	5,500
Total		**22,000**

END OF MODEL ANSWER AND MARKING GUIDE