

EDI
 LCCI IQ ON DEMAND
 AWARD IN BUSINESS FINANCE AND BANKING OPERATIONS SAMPLE
 LEVEL 4
 MARKING SCHEME

DISTINCTION MARK 75%
CREDIT MARK 60%
PASS MARK 50%

TOTAL 100 MARKS

QUESTION 1

(a)

| | | | | | |
|-----------------------|------------------|------------------|---|------------------------------------|--|
| Inventory days | $\frac{1}{2}$ | $\frac{1}{2}$ | $36,500/72,500 \times 365 = 183.8$ days rounded to 184 days | | |
| Receivable days | $\frac{1}{2}$ | $\frac{1}{2}$ | $25,000/118,000 \times 365 = 77.3$ days rounded to 77 days | | |
| Payables days | $\frac{1}{2}$ | $\frac{1}{2}$ | $21,760/72,500 \times 365 = 109.6$ days rounded to 110 days | | |
| Working capital cycle | $\frac{1}{2}$ of | $\frac{1}{2}$ of | $\frac{1}{2}$ of | $\frac{1}{2}$ of + $\frac{1}{2}$ f | $= 184$ days + 77 days – 110 days = 151 days |

$\frac{1}{2}$ a mark for rounding up

(6 marks)

(b)

There are a number of costs to the business associated with holding inventory:

Holding costs – these are costs associated with holding the inventory for example

- the cost of a warehouse to house the inventory,
- handling costs, it is likely staff are required to manage the inventory,
- Insurance costs as the inventory needs to be insured.
- Opportunity costs – as the money is tied up in the inventory, the company may miss out on a opportunity for example they may be unable to take advantage of a early settlement discount being offered by their suppliers
- Deterioration/obsolete costs- the inventory may become damaged or no longer useable due to being stored for a long period of time
- Theft – inventory may be stolen

Re order costs – these are costs associated with ordering the inventory into the business, for example:

- Transport/delivery costs
- Ordering costs for example the administration costs required to place the orders
- Stores costs – costs related to staff required to deal with the delivery of inventory. The more deliveries being received in t to the business each day will require more staff to process the goods received.

Shortage costs – these are costs related to a business running out of inventory if the ordering of new materials hasn't been managed correctly.

- Production stoppage caused by running out of raw materials
- Emergency reorder costs – may have to buy raw material from another supplier and pay a higher purchase price compared to regular supplier.
- Loss of customer goodwill – if the business is unable to fulfil a customer order due to running out of inventory the business may not only lose the order in place but may also lose future orders from the customer

(Only two costs need to be identified, 1 mark for each cost and upto a maximum of 2 marks for the depth of explanation)

(6 marks)

(c)

(i) **Total cost of factoring the accounts receivables ledger**

The cost to factor the receivables balance is 5% of the total value factored, therefore Estuary will only receive 95% of the receivables that they factor.

$$\$25\text{m} \times 95\% = \$23,750\text{m}$$

$$\$23,750\text{m} - \$25\text{m} = \mathbf{\$1,250,000}$$

This means that \$1,250,000 will be an expense for factoring the receivables ledger.

The fee to factor the accounts receivables balance is 1% of the total amount factored:

$$\$25\text{m} \times 1\% = \mathbf{\$250,000}.$$

Therefore \$250,000 is the fee to factor the receivables ledger

| | | |
|--------------------------|-------------------|--------------|
| Total cost of factoring: | \$ million | |
| Cost | 1,250,000 | |
| Fee | 250,000 | |
| Total cost | 1,500,000 | (1of) |

(4 marks)

(ii) **Overdraft costs**

$$\$20,000,000 \times 8\% = \$1,600,000 \text{ per year}$$

(1 mark)

(iii)

The directors of Estuary should choose to factor their receivables ledger to pay off the overdraft.

The reason for opting to factor is that the overall cost of factoring the receivables is lower than the annual cost for the overdraft, thereby saving Estuary \$100,000

| | |
|---|-----------------------|
| Total cost for factoring the receivables ledger | \$1,500,000 |
| Total cost for annual overdraft | <u>(\$1,600,000)</u> |
| Total savings | <u>100,000</u> |

- 1 mark for stating that factoring costs are lower than overdraft costs
- 1 mark for recommending factoring the receivables ledger to pay off overdraft
- ½ mark for referring to previous calculations
- ½ mark for referring to the figure of \$100,000

(3 marks)

(Total 20 marks)

QUESTION 2

- (a)
- | | |
|--------------------------|--|
| Treasury bills | Treasury bills are issued by central banks, they are guaranteed by the government of the country of issue. No interest is paid as such, but they are issued at a discount and redeemed at par after a fixed period, for example, UK Treasury Bills are 91 days. They are negotiable, so the bills can be sold on the discount market at any time before their maturity date. There is an implied rate of interest in the price at which Treasury bills are traded. |
| Bank deposits | A wide range of interest-earning investment opportunities are available from the banks. A <i>term deposit</i> offers a fixed rate of interest for a fixed period, usually from 1 month to 6 years. For shorter periods, typically up to 3 months, the interest may be at a variable rate based on money-market rates. |
| Certificates of deposit | Certificates of deposit (CDs) are issued by the banks at a fixed interest rate for a fixed term (usually between 3 and 5 years). CDs are negotiable documents for which there is an active secondary market, meaning that the holder of a CD can realise the investment on the discount market at any time. |
| Money-market accounts | Most major financial institutions offer schemes for investment in the money market at variable rates of interest. There is a large money market in the UK for inter-bank borrowing and lending, with terms ranging from overnight to 12 months or more. Large entities will be able to lend surplus cash directly to a borrowing bank on the inter-bank market. |
| Local authority deposits | Local authorities have a requirement for short-term cash, with terms ranging from overnight to 12 months or more. Interest would be payable on these deposits |
| Commercial paper | Large entities may issue unsecured short-term loan notes, referred to as commercial paper. These loan notes will generally mature within 9 months, typically between a week and 3 months. Commercial paper is negotiable, so the bills can be sold on the discount market at any time before their maturity date. There is an implied rate of interest in the price at which the commercial paper is traded. |
| Local authority bonds | These bonds are issued by local authorities and may be purchased with their remaining maturity. They are tradable, but have a lower level of marketability than most marketable securities, although this is dependent upon the size of the particular local authority. |
| Corporate bonds | These are bonds issued by entities to raise debt finance. They are long term, but are tradable and thus can be sold in money markets at any time. The level of liquidity depends on the cumulative volume issued by the entity. The level of risk depends on the individual entity and on the terms of the bond, but a credit score is available from credit rating agencies. |
| Government bonds | These are bonds issued by a government. They normally have lower default risk than corporate bonds (depending upon the government that issued them). They are tradable in money markets and tend to be more liquid than corporate bonds as they are issued in higher volumes. |

1 mark for method **1 mark for explanation (maximum of 4 methods)**

(8 marks)

(b)

(i) Loan

$\$500,000 \times (1.075)^5 = \$717,815$ total cost including the loan and interest.

2

Operating lease

$\$150,000 \times 5 \text{ years} = \$750,000$

1

(3 marks)

(ii) The option that company B should take is for the 5 year loan.

1

The loan is the cheaper option available to them

1

With the loan option the company will own the asset at the end of the load

1

Operating lease will cost more and the asset would return to the leasing company at the end of the agreement.

1

(4 marks)

(c)

An example of a central bank is the Bank of England in the UK.

1 mark for giving an example of a central bank

(1) A central bank is a public institution that usually issues currency and regulates the money supply

(2) A central bank can control interest rates in their country (i.e. price fixing)

(3) Central banks can oversee the commercial banking system within their respective countries

(4) A central bank possesses a monopoly on printing the national currency, which usually serves as the nation's legal tender

(5) A central bank acts as a lender of last resort to the banking sector during times of financial crisis (e.g. bailouts)

(6) A central bank may have supervisory powers to prevent banks and other financial institutions from reckless or fraudulent behaviour

(7) Central banks in most developed nations are independent in that they operate under rules designed to render them free from political interference.

1 mark for each explanation, to a maximum of 4

(5 marks)

(Total 20 marks)

Answer to question 3

(a)

- Online banking – companies can track international receipts from goods exported and also manage international payments made to suppliers outside the home country.
- Foreign exchange services – banks will offer their commercial companies the ability to buy any currency they need to pay suppliers from a different country or trading currency.
- Export invoice finance – many international banks offer their commercial customers the ability to factor the sales invoices of goods and service that have been exported abroad. The bank will advance up to 85% of the sales invoice value. The company also has the facility to decide which currency they would like the bank to operate the factoring service.
- Export documentary credit - A Documentary Credit is a commitment given by the buyer's bank to you, as the exporter, that they will make payment to you on presentation of a pre-agreed, specified set of documents to a nominated bank in the UK
- Other reasonable answers will be accepted

1 mark for each correct service identified to a maximum of 3

(3 marks)

- (b) Bill of exchange - A Bill of Exchange is a negotiable instrument governed by detailed legislation in most countries and used for extending credit to a buyer which also gives the seller security. This document usually is accepted by the buyer, "the drawee" who thereupon is called the "acceptor". The acceptance is written on the Bill of Exchange by stating "accepted". By accepting the draft, the acceptor has undertaken to pay the Bill of Exchange amount at its maturity. The legal structure of a Bill of Exchange is similar to that of a cheque, but a cheque must be drawn on a bank and is payable upon presentation to that bank

(2 marks)

- (c) A foreign exchange market is a market in which one currency is converted into another. This market is operated by commercial banks, national central banks, brokers and others.

1 mark for definition

The foreign exchange market does not have a particular location; part of it exists anywhere when one currency is exchanged for another.

1 mark for where foreign exchange market exists

An example of a foreign exchange market is where one company who trades in Euro currency purchases dollars from a bank to pay a supplier.

1 mark for example

(3 marks)

- (d) (i) A spot rate is the currency rate that can be exchanged immediately. It is the day's exchange rate.
- (ii) A forward rate is a contract where currency is exchanged in the future on a specific date and at a specific rate.

(2 marks)

- (e) Calculations of option 1

The first rate stated in the questions is today's rate which is known as the spot rate. Using the spot rate of \$1.44 to €1 the calculation for numbers of euro's required to be exchanged is:

$$\frac{\$2,500,000}{\$1.44} = €1,736,111 \quad \mathbf{1}$$

Calculation of option 2

Using the forward rate of \$1.47 and a fee of €10,000 the costs for Monks Ltd will be:

$$\frac{\$2,500,000}{\$1.47} = €1,700,680 + €10,000 = €1,710,680 \quad \mathbf{1}$$

- (i) Option 2 is recommended as using the forward rate of \$1.47 and paying the bank fee of €10,000 will cost Monks Ltd €25,431 less than using the spot rate of \$1.44.

1 mark recommendation and 1 mark for reason

(4 marks)

- (ii) Option 1 is a spot rate, Option 2 is the forward rate

(2 marks)

(f)

- (1) A bank will be able to offer an individual a bureau de change service. This is where an individual can change their home currency into a currency of their choice. For example if an individual was going on holiday to Singapore and was based in the UK. The individual would be able to go to the bank and change the sterling they were wishing to take with them to Singapore into Singapore dollars.
- (2) Bank is also able to offer an individual the opportunity to transfer money to an individual or company outside their home country. There are a number of ways the transfers can be made. The individual is able to transfer the money through online bank accounts, phoning the branch and arranging the transfer over the phone and also by attending a branch whereby they can arrange the transfer.

Accept other reasonable services and examples

1 mark for stating the service, 1 mark for explanation of the service

(2 marks)

(Total 20 marks)

QUESTION 4

(a) Cash budget for Camp components for 1st January 2011 – 30th June 2011.

| | Jan | Feb | March | April | May | June |
|-----------------------|--------|--------|--------|--------|---------|--------|
| Cash inflow | | | | | | |
| Cash sales | 17500 | 20000 | 25000 | 13500 | 16000 | 16000 |
| Cash from receivables | 15000 | 17500 | 20000 | 25000 | 13500 | 16000 |
| Total receipts | 32500 | 37500 | 45000 | 38500 | 29500 | 32000 |
| Cash outflow | | | | | | |
| Direct costs | -21000 | -24000 | -30000 | -16200 | -19200 | -19200 |
| Electricity | | -2000 | | | -2000 | |
| Telephone | -1250 | | | -1250 | | |
| admin salaries | -4500 | -4500 | -4500 | -4500 | -4500 | -4500 |
| New machine | | | | | -75000 | |
| Total Payments | -26750 | -30500 | -34500 | -21950 | -100700 | -23700 |
| Net cash flow | 5750 | 7000 | 10500 | 16550 | -71200 | 8300 |
| Cash b/fwd | -4800 | 950 | 7950 | 18450 | 35000 | -36200 |
| Cash c/fwd | 950 | 7950 | 18450 | 35000 | -36200 | -27900 |

(14 marks)

(b) Actions that could be taken to raise funds to purchase the new machine as budgeted, include raising new cash or re-examining the forecast and implementing actions to improve the current forecast. It must also be borne in mind that sufficient working capital needs to be available to run BB after the new machine has been purchased.

Actions could include:

- (1) Arranging a long-term loan with a bank, or other financial institution, for \$37,000, to provide additional working capital.
- (2) Issuing new equity to cover the non-current asset purchase and provide additional working capital, a minimum of \$37,000.
- (3) Negotiating an increase in the overdraft facility from \$5,000 to \$37,000.
- (4) Considering increasing selling price of components to generate more income.
- (5) Investigating the possibility of acquiring the machine by hire purchase or lease.
- (6) Checking the accuracy of the forecast opening bank balance and the likelihood of it being significantly different to forecast

(6 marks)

1 mark for stating the action and 1 mark for providing an explanation (maximum of 3 actions)

(Total 20 marks)