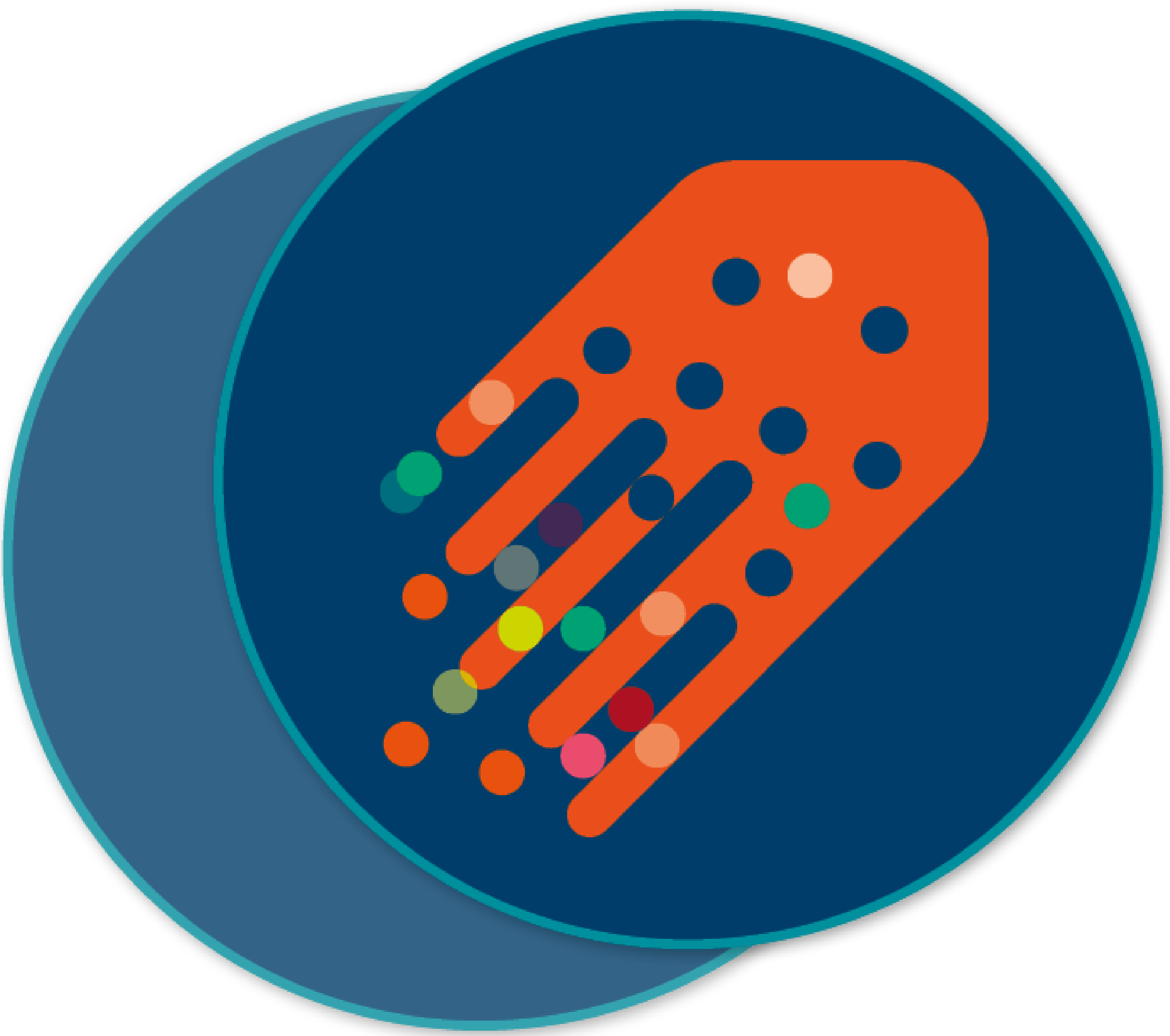
ACT Practice Paper

Diploma in Treasury Management (AMCT)

Unit 4b: Working Capital and Trade Finance



This is a practice paper for Unit 4b of the Diploma in Treasury Management (AMCT), based on the syllabus assessed from 1 August 2022.

INTRODUCTION

This practice paper has been produced by the Awarding Body at the Association of Corporate Treasurers (ACT) to assist students in their preparation for the Diploma in Treasury Management assessments. It contains a practice exam for the specified unit as well as the answers. Ideally, students should have completed the majority of their Diploma in Treasury Management studies for Unit 4b before attempting this practice paper.

Students should allow themselves 180 minutes to complete the exam plus an additional 15 minutes reading time. They should then review their performance to identify areas of weakness on which to concentrate the remainder of their study time. Although the practice paper in this guide is typical of a Diploma in Treasury Management assessment, it should be noted that it is not possible to test every single aspect of the syllabus in any one exam.

To prepare properly for the examination, candidates should make full use of the tuition options where available and read as widely as possible to ensure that the whole syllabus has been covered.

ASSESSMENT TECHNIQUE

This is a professional paper that as well as testing theory expects application to practice at a managerial level.

The best way to approach written assessments is to work methodically through the questions. Candidates should not spend too much time on any one question if you are struggling to think of an adequate answer. Remember you can flag any question to come back to later should you want to continue your way through the exam.

When all the questions have been answered, it is prudent to use any remaining time to go through each question again, carefully, to double-check that nothing has been missed. Altering just one response could make the difference between passing and failing.

Please ensure you show your workings within your answer when prompted as this means there are marks available for the workings out. You will be able to make rough workings on a piece of paper during the exam and on screen should you wish to, however these will not count towards your final mark.

ASSESSMENT INFORMATION AND TEST SPECIFICATION

The Diploma in Treasury Management assessments for Units 4a and 4b each have three written questions, all of which are mandatory. They will also involve a pre-seen case study workbook for Section A that is released no later than two weeks prior to the assessment date. The papers will be split into Sections A and B and each unit exam is worth a total of 100 marks. For the purpose of this practice paper the questions follow each case study.

Diploma in Treasury Management assessment test specification:

Section	Number of questions	Marks available
Section A	1 case study-based question	50
Section B	2 shorter case study-based questions, of which both are mandatory	50
Total	3	100

Under exam conditions, 3 hours (180 minutes) is allowed for each of the Diploma in Treasury Management assessments plus an additional 15 minutes reading time.

When you take your actual exam, you will be sitting online using your own PC/Laptop. You have access to an online scientific calculator, but for the purpose of this practice paper, you may use a non-programmable scientific calculator.

In order for you to determine how well you have performed, exemplar answers are listed at the end of this paper. There are also references to the relevant Learning Outcomes if you need to revisit the associated material.

SECTION A – 50 marks

Answer ALL questions in Section A. This questions tests knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level. You are required to present your answers in a report format.

Total available for Section A: 50 marks

Company history and growth

Riviera Holidays (RH), located in France, was founded in 2019 by a retired French teacher to provide stress-free holidays to people over the age 50 on the French Riviera, especially if they came from abroad and spoke little or no French.

The teacher asked a relative to design a suitable website and enlisted several villas and boutique hotels to be part the RH offering. The idea was for prospective holiday makers being able to design and book their holiday to France using their own language and then having own language support available throughout their holiday. The main differentiating point from a traditional package holiday companies was the access to such venues and experiences normally only the locals were able to find.

The founder covers bookings in several languages but in 2021 employed two part-time representatives able to offer four additional languages. This meant that sales doubled in only a year. A few months ago, the founder also employed a part-time accountant and full time Treasury Manager. Out of the employees, all except one are based in France. That employee is based in India and paid in INR. You are the newly appointed Treasury Manager.

Industry, customers and suppliers

Traditional package holiday companies have existed for decades as well as bespoke travel firms aiming to serve a very specific niche of the market. The 'mature' or over-50 market is well served and often overcrowded with choice. This means that although there is enough demand to satisfy most companies, the margins remain low.

Most RH customers are wealthy and come from a diverse range of European countries as well as United States and speak no French. They often expect much more from RH staff than is in their job description and one of the new sales representatives has expressed an intention to leave if the situation does not improve.

RH customers pay a 10% deposit at time of booking and the rest 10 days before their holiday. Only a small fraction goes through the point-of-sale system. Instead, customers often choose to pay direct to RH bank account in the currency of their home country. They may pay the correct amount but RH's bank often charges a large fee for non-EUR receipts which means that RH receives less than the original booking amount.

If the customer cancels their booking 10 days before the holiday, RH will refund the deposit in full. RH didn't have any cancellations during the first year of operating and naturally all holidays were cancelled in 2020 due to the Covid pandemic. Since 2020, approximately 40% of the original bookings get cancelled 10-20 days before the start but then 20% of these are replaced by last minute new bookings.

Offering a full refund is typical in this industry for the larger providers. Smaller businesses have had varied policies historically but since the pandemic, most now offer full refunds too up to 48 hours before the booking start date.

RH pays the villas and hotels 20 days before the booking is due to start via a bank account transfer. This is highly unusual as the industry norm is to only pay the hotels within seven days of the booking start date.

Strategy and outlook

The RH founder has enjoyed running and building the company for the past few years but has recently experienced poor health and is looking for ways to exit the business. The founder also realises that in order to grow, the business needs a different skillset, one including strategy, risk and finance.

The founder has narrowed the future options to three possibilities which they are keen to explore in more detail:

- continue as-is but employ a dedicated manager to take over the operations
- merge with another travel company. RH has been on friendly terms with an Italian company who own a number of villas on the Italian riviera. RH knows that the company is experiencing cashflow problems but also has recently employed an experienced and keen general manager
    - the Italian company is valued at EUR20m, has a loyal customer base and has a very steady cashflow normally. The recent difficulties have been due to poor trade finance management for their holiday brochure printing in China
    - both companies understand that they are discussing things from a merger point of view but in reality, it will be RH acquiring the Italian company. However, due to the brand, size of operations and customer bases, it would be RH which would be ultimately absorbed into the target. RH founder could stay on in a non-executive capacity for as long as they wished. If this option is selected, it is likely to go ahead in 12 months' time
- divest by selling RH to a local travel company. The buyer is very large, internationally known and keen to gain access to RH customers. RH founder would be able to retire comfortably.

RH has had preliminary discussions with its bank regarding the options. The bank has indicated that it might be willing to provide a EUR20m loan facility for the acquisition of the Italian target if RH and the planned new combined entity is able to present them with a robust business plan.

Should the founder sell RH, the existing revolving credit facility (RCF) of EUR1m would become immediately repayable. The RCF is currently fully drawn.

Financial management

The founder has looked after all financial aspects of the company since the business was formed until the TM and accountant started. No written policies or procedures have ever existed. Most matters have been dealt with as they have arisen.

The TM's new remit will involve:

- all cash management
- all working capital arrangements, including management of the company merchant card services. The current service is provided by RH's main bank
- all debt management
- all FX management, including any hedging although none exist at present
- all trade finance arrangements although none exist at present.

RH does not have an agreed overdraft facility but regularly leave their bank account overdrawn for a day or two at a time. The existing RCF matures in June 2023.

Summarised financial information

	FY22 to date	FY21	FY20	FY19
Days payable outstanding	5	5	4	5
Days receivable outstanding	20	18	1	12
Working capital percentage of sales	70%	71%	98%	80%
Cash balance as at year end	EUR200	EUR6200	(EUR2000)	(EUR30)

RH's financial year end is 31 December. No statement of comprehensive income or financial position has been produced in the past as RH accounted for transactions on a cash basis. The new accountant is looking to change this and has already started to calculate days payable and receivable for instance.

Q1	(a) Analyse RH's current working capital, liquidity management and trade finance problems, issues and risks. (b) Based on your response to question A, recommend and justify appropriate working capital, liquidity management and trade finance solutions to RH assuming the acquisition plans are taken forward. **Syllabus refs: U4b.1.1.LO21, U4b.2.1.LO22, U4b.2.2.LO22, U4b.2.3.LO22, U4b.2.4.LO22, U4b.4.1.LO24**	30 marks 20 marks
		Total: 50 marks

Q1 answer	Mark scheme. Each point should be fully developed and applied to RH. a) Working capital **Calculations based on 2022:** **CCC: 0+20-5=15** Both payable and receivable appear very poorly managed. Indicates too much buyer and supplier power and/or lack of understanding of metrics when contracts were agreed. However, looking at the numbers alone does not tell the whole picture given the pandemic. Instead, is a better indication that the industry norm is to pay seven days after booking, not 20 days in advance. CCC is long given the type of business and lack of management is evident. Excluding 2020, this has remained stable so indicates the business has steady flows. Extremely high working capital need throughout history, partially due to pandemic and perhaps also due to being a new company. Other issues are: • merchant cards – reliance on one provider creates concentration risk and only using them for overheads is missing a working capital opportunity • risk of going concern due to cash balance, RCF headroom and expiry date and liquidity requirement	30 marks

- no working capital solutions used.

Liquidity management

Issues are:

- lack of FX management and policy – especially in relation to foreign employee
- dipping into overdraft
- extremely low cash balance
- RFC being fully utilised
- counterparty risk – both debtors and treasury banking counterparties
- non-payment could have big impact on liquidity
- refinance risk given the maturity of the RCF
- paying for hotels before receiving funds from customers
- receiving less than expected from customers due to bank charges
- high booking cancellations increasing outflow.

Trade finance instruments

Issues are:

- lack of use and understanding in treasury and wider company
- non-existent historical use
- role of treasury non-existent
- poor risk management overall given how these could mitigate them.

20 marks

b) RH will still have all existing business area as well as new ones from the Italian company. Complementary, just of different scale and in a different country. Additionally, the target owns its own villas so this introduces new risks. So here we need to consider solutions which not only address current issues but also minimise future problems.

Additional items for an acquisition are coordinating and forecasting cashflows within the integrated group, integration of the two companies, especially the treasury functions, bank account configuration, existing covenants and banking relationships. Also, any FX policy should consider pre-transaction risk and currency of payment by customers.

Working capital solutions

These will mainly apply to the Italian target who will have more suppliers due to the villas:

- setup a supply chain finance programme
- merchant cards – start using for payment for invoices
- negotiate extended payment terms to align with industry – seven days after
- recruit dedicated credit control person and/or try to increase automation in account receivable process.

Liquidity management solutions

- Develop a FX management policy, including any hedging programme for INR.
- RCF is likely to be cheaper than the unauthorised overdraft so negotiate an increase to the current RCF or at least agree an overdraft facility.
- Establish processes to monitor counterparty risk - both customers and treasury banking counterparties.
- Negotiate with bank to extend current RCF until acquisition goes through.
- Treasury should take more of a leading role in all of the above, increasing controls and efficiency.

Additionally, if the target is valued at EUR20m and the loan from the bank is to this value, is RH able to produce the required business plans. If yes, need to ensure enough funds are allocated on any re-branding of RH, potential redundancies and other operational alignment activities

Trade finance solutions

- None currently used and of limited use given RH is in the service industry.
- For any new customers, try to introduce cash in advance.
- Educate treasury and wider company on options and how/when to use them.
- Create a strategy and a policy on the use of trade finance instruments. Link it to wider risk management framework.

This mark scheme is not exhaustive – all valid points within answers will be awarded marks.

Total: 50 marks

SECTION B – 50 marks

TWO mandatory questions. Questions test knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at ‘management’ level. Candidates are expected to be able to synthesise knowledge from different elements of the syllabus rather than be tested on discrete areas.

Total available for Section B: 50 marks

Section B, Question 1 Case Study

Background

Dream Choc (DC), is a long-established manufacturer of chocolate, supplying local and national markets.

DC has always produced three brands of chocolate which are generally marketed as follows:

- value brand – for the budget conscious
- regular brand – for everyday enjoyment
- superior brand – for premium quality.

The value brand sells in the largest quantities, but the superior brand generates the largest profit due to the price point of the product. There are also large differences in country demand – for instance Belgium prefers the top end but UK, the lower end.

DC sells to 43 different countries directly as well as many others indirectly through wholesalers. It holds 872 bank accounts in various currencies. Most are located in its home country Belgium with two main cash management banks, but it also has a large number of accounts in the UK, UAE, Norway and Australia. Each of DC's subsidiaries has its own bank account and foreign exchange (FX) is netted off at country level as far as possible.

DC's treasury has been run by the same group treasurer for over 40 years and they have lacked effective solutions to manage cash effectively. In fact, they have only had one cash pool in use and it is only for their Belgian EUR bank accounts. This is because Belgium has a dedicated country treasurer instead of being managed by the group treasurer. DC has other treasurers for US, Nordics, North Africa and Asia. They all liaise and report to the group treasurer but do have a high degree of autonomy. The purpose of the group treasury is to operate as an in-house bank, although often this is not the case.

Each of the DC entities has invoices to and from the parent as well as from other group entities. At the moment, each entity pays their invoices on a weekly cycle to each other and every currency they are invoiced in. This of course results in several transactions to and from the same entities on the same day. More than one of the treasurers has raised this as inefficient. However, to date, nothing has been implemented.

Each DC subsidiary manages its own invoicing and collections and has its own finance department. A project team which includes the group treasurer has been formed, to look at either automating many processes or making finance more centralised.

Q1	(a) Evaluate the factors influencing the demand for each of DC's three brands included in the case study. (b) ASSESS the suitability of **THREE** different cash management structures to DC. **Syllabus refs: U4b.1.3.LO21, U4b.3.1.LO23, U4b.3.2.LO23, U4b.5.1.LO25, U4b.5.3.LO25**	10 marks 15 marks
		Total: 25 marks
Q1 answer	a) Demand is the quantity of a good that is purchased at any given price and the law of demand suggests that as the price of a normal good increases the quantity demanded decreases. If the price of the good changes then there will simply be movement along the demand curve. The demand curve may also move to the right or the left depending on other factors. In other words, the quantity demanded may increase (or fall) even though there has been no change in the price of the good. These factors include: • the price of other goods • if the price of a substitute good falls then the demand for our chocolate will probably fall and the demand curve will move to the left. This applies to all price points • if the price of a complementary good falls then the demand for our chocolate should increase and the demand curve will move to the right • consumer incomes. In the case of normal and luxury goods, for example, our regular or superior brands, as consumer incomes increase the quantity demanded will increase and the demand curve will shift to the right • if the good is considered inferior, for example, our value brand, the quantity demanded may fall as incomes increase. This is because consumers are now able to afford the regular brand. The demand curve would shift to the left	10 marks

- tastes and fashion
- if that type of chocolate is in fashion then demand may increase regardless of the price. If the organisation has recently advertised the brands then demand should increase and the demand curve will move to the right
- market demand
- demand for chocolate may also depend on the age and size of the population
- the distribution of income between necessities and luxuries will also be a factor in determining the overall demand for chocolate. Given the current economic climate, less income is allocated to the luxury goods by many.

Given that DC manufactures chocolate at each price point, it may be that total sales remain relative steady even if demand for any one product varies.

b) DC choices between local and global cash management structures are driven by: 15 marks

- the size and complexity of the organisation. DC is large, operates in a number of countries and has various currencies so is clearly complex
- the degree of centralisation. DC does have a group treasury but also independent area treasurers
- potential savings from more centralised structures. Given the number of accounts, savings are likely to be substantial
- local regulations which may disallow certain cross-border structures, for example in relation to pooling.

Candidates are free to discuss any three structures, but likely pooling, netting and cash concentration are the ones most selected.

Pooling

The primary purpose of a notional pool is to reduce bank interest to be paid or increase interest to be received, with a side benefit being that bank balances are aggregated into a single pool, improving access for treasury to the overall pool balance.

It is the fact that funds do not physically move in a notional pool that is its defining characteristic. This type of structure is frequently seen in corporate groups with some form of centralised treasury and interest is charged or credited by the bank on the net position only, rather than on the gross balance in the separate amounts.

It should be noted, however, that although the interest cost at group level may be zero, if the accounts are owned by different legal entities, the lenders will still have to be compensated and the borrowers will have to pay interest on an arm's-length basis in order to comply with tax rules. Many banks will offer corporates the functionality to calculate these recharges as part of the pooling solution. A master account solution is used to bring the pool balance to zero (or target) while leaving the subsidiaries' operating accounts untouched.

In some regulatory jurisdictions, like UAE for DC, banks are prohibited from paying credit interest on current account balances, so pooling for the purposes of minimising group debt is the major objective.
Even in groups where there is little opportunity to offset debit balances, the group can still benefit from the centralisation afforded by a pooling arrangement by consolidating the deficits and funding the net deficit from a cheaper source of borrowing, such as commercial paper.

In some countries surplus balances do not earn any interest at all for DC. The surplus cash in the pool can be physically extracted and invested in an instrument that has a higher interest yield such as short-term money market instruments, short-dated certificates of deposit or money market funds.

Pooling will work extremely well in many jurisdictions for DC, but especially Europe.

Cash concentration
The second major technique for managing group funds is cash concentration, where balances - both debit and credit - in participating accounts are physically transferred into a centralised concentration account for management by group treasury.
The major difference between concentration and notional pooling is that the balances in the accounts are physically moved into the concentration account.

In some countries DC operates in like US, notional pooling is restricted or prohibited so cash concentrations provides an alternative. Also, in a cross-border situation, cash concentration is more easily accomplished than notional pooling. Given the range of countries DC operates in, this provides a solution to many.

These could be done as zero or target balance or a mixture, depending on what DC thinks might be most effective or cheapest for them.

Netting
Netting is a means of reducing the volume of payments by off-setting payables and receivables arising from two or more parties trading with each other. Netting is particularly useful in reducing the all-in cost of cross-border cash management and especially for entities in the same group.
DC area treasurers have been wanting to improve the interco invoice process and netting is perfect as it can not only work for the same currency, it can even work for multi-currency. 10 individual flows can easily be reduced to one.

Other options

Open Banking has been available to individuals for a long while but it’s only now becoming widely available to companies. DC could utilise these in specific countries instead of payment for structures like the above. It would not result in full automation but would make processes more efficient.

Payment and collection factories can also make a difference to reducing intercompany traffic, although these best work in reducing external traffic. So these might be best for the project team to look at who want to make this process better.

Setting up a shared service centre is another option which would help this problem with DC as it would centralise both AP and AR.

DC already operates an in-house bank of sorts. However, they could use it better so it produces the wanted savings.

	Finally, regardless of the option DC decides to go for, IT systems will be of high importance in manging them. DC might go for a treasury management system, ERP, or perhaps something more specific like eBAM. All will aid the automation and efficiencies. This mark scheme is not exhaustive – all valid points within answers will be awarded marks.	
		Total: 25 marks

Section B, Question 2 Case Study

Background

Company LH, a specialist infrastructure construction company, has specialised in the construction of bridges, roads and electrical grids. LH has been operating in its current form for over 30 years and is well-respected in its industry. It is the largest electrical grid construction company in Africa and second largest in China. LH is incorporated in the UK, headquartered in Hong Kong, and its largest projects in recent years have been in Africa.

The government of Malawi has been considering tendering out the reconstruction of large parts of its rail network, provision of all equipment and subsequent operation for the first 10 years. They are open to any one company tendering for all three but have indicated that they would prefer two or three separate companies to minimise risks. LH is currently interested in tendering for all three parts, despite not having any experience in operating a rail network.

The tender has not yet been issued and it is still in the development stage. At the moment, Malawi is considering adding various bond requirements to all parts of the tender and contracts. In recent years, they have been let down at various stages of the tender process for other infrastructure projects. For instance, the winner of one such project decided not to take up the contract, projects have been delayed or not been completed at all and cost overruns had to be addressed. Malawi is also keen on exploring how export credit agencies could be used.

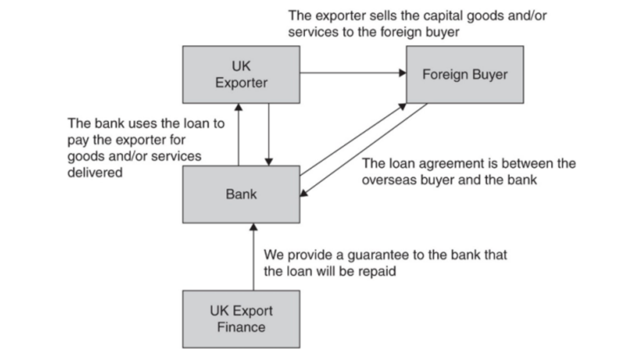
LH treasury team has been tasked with various projects to ensure LH is in the best possible place to respond to the Malawi tender once it is issued. LH is familiar with various bonds used in large infrastructure projects but the finance director wants to further educate the LH board about the risks involved.

The tender values LH is expecting are USD8bn for the construction, USD2.2bn for the provision of equipment and USD100m for the operation for full 10 years. Payment is usually received in stages and from research, LH assumes it will require USD500m of working capital for this project until it has been completed. The project is very valuable but has risks to LH as the working capital requirement is 20% of total operations and will require LH to fully utilise its loan facilities.

Q2	(a) Discuss the role of export credit agencies in the case.	10 marks
	(b) Assess the types of bonds which might be required from LH and the risks to LH which might arise from issuing these bonds.	15 marks
	Syllabus refs: U4b.4.4.LO24, U4b.4.5.LO24	
		Total: 25 marks

Q2 answer		15 marks
	a) An export credit agency (ECA) is a government, or government backed, agency which exists to support the country's exports by providing facilities such as guarantees and advice. Many countries have such agencies and in the UK the ECA is UK Export Finance (UKEF). The UKEF works closely with exporters, banks, buyers and project sponsors and has 90 years' experience of supporting exports to, and investments in, markets across the world. The UKEF principally provides loans to buyers of UK goods and services and guarantees, insurance and reinsurance against loss, taking into account the government's international policies. The role of the UKEF includes: • insuring UK exporters against non-payment by their overseas buyers • helping overseas buyers to purchase goods and services from UK exporters by guaranteeing or funding bank loans to finance the purchases • sharing credit risks with banks to help exporters raise tender and contract bonds, in accessing pre-shipment and post-shipment working capital finance, and in securing confirmations of letters of credit • insuring UK investors in overseas markets against political risks. Many ECAs, including UKEF, provide longer term finance for exports sold on credit terms of more than two years. **Drawbacks** • There is usually a minimum contract value. • The documentation is complex and takes a long time to finalise. • In the case of UK, the buyer may object to having a loan from a UK bank and to paying interest and charges to a UK bank. This is usually for political reasons. Exporters who think they may be eligible for either buyer or supplier credit facilities from their ECA should make contact at an appropriately early stage.	

Figure 1: buyer credit loan facility provided by UKEF



Gov.uk (2020)

ECAs for bonds
In many countries there are quasi-government bodies that offer insurance to both bond issuers and applicants against unfair calling of bonds.
UKEF offers a Bond Insurance Policy (BIP) which can be made available on a case-by-case basis. The main types of bond covered are advance payment bonds and performance bonds.
The benefits of the UK Export Finance cover are that the applicant is:

- given 100% cover
- protected against loss suffered because of unfair calls by the beneficiary on the bond, or by the local bank on the counter-guarantee
- protected against the risks of unfair calls under the bond, or any related counter-indemnity caused by political events, war, hostilities, civil disturbances or similar events outside the UK.

Any BIP cover must remain confidential between UK Export Finance and the exporter.

b) A bond is issued by a bank or an insurance company and is a guarantee to the beneficiary, Malawi, that the applicant, XX, will fulfil its contractual obligations. 15 marks

Many countries, most international aid agencies, such as the World Bank, and most government purchasing organisations in the developing world, now require bonds as a condition of granting a commercial contract. So it is expected that Malawi would demand one.

In practice, the words 'bond' and 'guarantee' are used interchangeably, with some countries tending to use one of these words and some the other. However, strictly speaking, the word 'bond' relates to an indemnity which makes the bond issuer primarily liable. The word 'guarantee' makes the guarantor secondarily liable. With primary liability, the beneficiary can claim directly from the bond issuer, usually without the need to prove default of the applicant.

Bonds are critical to the infrastructure business like LH's. They offer longer-term guarantees which reflect the nature of the risks. Bonds are critical to successful bidding for longer-term commercial contracts.

Types of bonds which might be requested by Malawi are detailed below.

Tender bonds (bid bonds)
The purpose of a tender or bid bond is to prevent the submission of frivolous tenders for commercial contracts. This bond is a bank guarantee to the buyer that the seller will take up the commercial contract if it is awarded. In the 'small print' of the tender bond there will usually be a commitment that the seller and its bank will join in a performance bond if the commercial contract is awarded. Given the issues Malawi has experienced, it is likely they will request this.

Performance bonds
Performance bonds guarantee that the goods or services will be of the required standard, or that a construction project will be finished on time and to specification. As with all bonds a stated penalty is payable if the specification is not met. The amount payable will be a stated percentage of the full contract price: often, it is 10%, but it can be anything up to 100%. A contractor may have to arrange a series of performance bonds to cover each stage of a particular construction contract.

Warranty bonds (maintenance bonds)
Warranty bonds or maintenance bonds undertake that the seller will maintain the equipment for a period of time. The amount payable if there is any breach of this condition will be specified in the bond.

Retention bonds
In commercial contracts relating to infrastructure projects, there is often a clause whereby the buyer is

allowed to retain a percentage of the full contract value beyond the date of completion of the project by the seller. This retention money is held for a stated period beyond completion to cover any costs incurred in correcting any defects subsequently discovered, or costs of other work that may be required. The retention bond allows the buyer to release the retention money before the end of the retention period. The retention bond guarantees the return to the buyer of such retention money in the event of non-performance of post-completion obligations by the seller.

Advance payment bonds
Some commercial contracts stipulate payment in advance (which could be for the whole contract value or more usually just for a percentage). An advance payment bond undertakes to refund to the buyer any advance payments if the goods or services are unsatisfactory, or if the goods or services are not provided.

Risks:

- financial penalties for non-compliance or non-performance. For instance, failure to take up the commercial contract results in a penalty for the amount of the bond, typically 2-3% of the full contract value
- the beneficiary may call for payment, even when such a call is unjustified. Political events in the overseas country might lead to the unfair calling of a bond
- advance payment or retention bonds could be called even though the beneficiary has not paid over the agreed advanced payment or retention money in the first place
- some countries, especially in the Middle East, have laws that prevent the local bank from cancelling the bond without the beneficiary's specific authority. This prohibition applies even if the bond contains an expiry date. There have been instances when the local bank has threatened to call for payment unless the bond is formally extended. Given the position on the calling of on demand bonds, the applicant's bank has little choice other than to extend the bond. This means, of course, the annual bank charges continue to be levied by both banks. There have been instances when tender bonds have not been cancelled, even when the commercial contract has

	been awarded and a performance bond has been issued • banks may require collateral from the applicants. Alternatively, the applicant may be asked to lodge cash in a 'hypothecated' account. The credit balance in a hypothecated account cannot be withdrawn without the bank's consent and it is held specifically to reduce the bank's liability if the bond is called • the reduction in other borrowing facilities due to the contingent liability from the bond. This problem is particularly acute in the case of tender bonds. Established international contractors regularly submit tenders for major projects, with a tender bond being required for each tender. The average success rate is often said to be one in eight for tenders. Hence, if a contractor has eight tenders outstanding at any one time each for 2% of the contract value, the total potential borrowing facilities will be reduced by 16% of the average value of a single contract. This mark scheme is not exhaustive – all valid points within answers will be awarded marks.	
		Total: 25 marks

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