Case study – Preparing and Using Accounts

This is the solution to the case study found at the end of:

- Chapter 7 *The Profit and Loss Account*

The first requirement is to prepare a profit and loss account for Jimmy Bowden's business at 28 February 20X5 and a balance sheet at that date.

The list of balances can be reorganised as follows:

	£	Category
Sales	143 520	Trading account
Opening stock	9 274	Trading account
Fixed assets	3 823	Balance sheet: fixed assets
Opening capital balance 1 March 20X4	19 776	Balance sheet: capital
Cash in the bank account	1 685	Balance sheet: current assets
Rental expense	16 500	Profit and loss account
Insurance	2 023	Profit and loss account
Electricity	2 056	Profit and loss account
Trade creditors	8 229	Balance sheet: current liabilities
Debtors	1 800	Balance sheet: current assets
Drawings	23 153	Balance sheet: capital
Bank interest received	118	Profit and loss account
Purchases	103 221	Trading account
Income from repairs services	4 389	Profit and loss account
Repairs service expenses – bicycle parts	1 317	Profit and loss account
Administration, finance and sundry	2 278	Profit and loss account

expenses		
Assistant's wages	8 902	Profit and loss account
Closing stock	16 337	Trading account AND balance sheet: current assets

Then the profit and loss account and balance sheet can be prepared as follows:

<u>Jimmy Bowden: Profit and loss account for the year ending 28 February 20X5</u>

	£	£
Sales		143 520
Less: cost of sales		
Opening stock	9 274	
Add: purchases	103 221	
	112 495	
Less: closing stock	(16 337)	
		(96 158)
Gross profit		47 362
Repairs service: income	4 389	
Repairs service: expenses – bicycle parts	(1 317)	
		3 072
Other income – bank interest received		118
		50 552
Expenses		
Rental expense	16 500	
Insurance	2 023	

Electricity	2 056	
Administration, finance and sundry expenses	2 278	
Assistant's wages	8 902	
		(31 759)
Net profit		18 793

Jimmy Bowden: Balance sheet at 28 February 20X5

	£	£
Fixed assets		3 823
Current assets		
Stock	16 337	
Debtors	1 800	
Cash	1 685	
	19 822	
Current liabilities		
Creditors	(8 229)	
Net current assets (£19 822 – £8 229)		11 593
Net assets		15 416
Capital		
Opening capital balance 1 March 20X4	19 776	
Add: net profit for the year	18 793	
	38 569	

Less: drawings	(23 153)	
Closing capital balance 28 February 20X5		15 416

Having prepared the profit and loss account and balance sheet for Jimmy's business, it is now possible to address his questions about the profitability of the business.

A logical first step is to take the table of figures he provided for 20X4 and slot in the equivalent figures for 20X5:

	20X5	20X4
Bicycle sales for the year	143 520	164 728
Gross profit on bicycle sales	47 362	49 418
Gross profit margin	33%*	30%
Profit on repairs service	3 072	3 422
Total expenses	31 759	27 263
Interest received	118	260
Net profit	18 793	25 837
Net profit margin	13.1%**	15.7%

Notes: calculations are as follows:

* Gross profit margin

$$\frac{£47362}{143520} \times 100 = 33\%$$

** Net profit margin

$$\frac{£18793}{143\,520} \times 100 = 13.1\%$$

From this information, a report with recommendations can be constructed as follows:

18th March 20X5

Report to Jimmy Bowden on business profitability based on the financial statements at 28 February 20X5

There has been a substantial decline in sales, gross and net profits and net profit margin between 20X4 and 20X5. The fall in sales is over £20 000, which represents a decline of almost 13%. The effect on gross profit is not quite so significant because the gross profit margin percentage has actually improved. This is presumably because the sales of higher value bicycles to enthusiasts produce better profit margins.

There has been a small drop in profitability in the repairs service but this is a fairly insignificant part of the business.

Total expenses have increased from £27 263 to £31 759, an increase of 16.5% which seems high in the context of a low general inflation rate in the economy. A more detailed comparison of expenses would be useful in order to pinpoint the specific expenses which have risen. There may be a need for better control of business expenses.

Net profits have fallen from £25 837 to £18 793, and the net profit margin has fallen from 15.7% to 13.1%. The decline is significant and an action plan should be drawn up to address the problems the business faces.

The business is not under immediate threat. The bank balance at 28 February 20X5 is £1685 and there are no long-term borrowings. But, creditors total £8229, and there could be problems if they start to press for immediate payment. However, because of the good record of profitability in the past, the bank is likely to grant overdraft facilities if they are required. The level of drawings from the business of a little over £23 000 is not justified by the present level of profitability. Closing stock is much higher than opening stock, because of the shortfall in Christmas sales.

Recommendations

1. Mr Bowden should consider a campaign of local advertising. This could be allied to a stock clearance sale at discounted prices.
2. The current level of business profitability does not support drawings at the level of £23 000 per year. Mr Bowden should plan for a lower level of personal expenditure until business profitability improves.
3. Business expenses should be considered item by item to identify areas where savings might be possible.
4. If other measures fail, the possibility of moving to new shop premises nearer the centre of town could be considered. Suitable premises should be identified and a business plan and budget drawn up on the basis of the likely increase in sales and expenses if the move were to be made.

Signed: Business adviser