Case study – A problem debtor

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

- Chapter 8 *Adjustments to the Profit and Loss Account and Balance Sheet: 1*

(a) Profit and loss account for Richard's business for the nine months ended 30 September 20X4, and a balance sheet at that date (without making any adjustment in respect of the amounts owed by Charlie).

<u>Richard: Profit and loss account for the 9 months ending 30 September 20X4</u>

	£	£	£
Sales			250 836
Cost of sales			
Opening stock		17 881	
Add: purchases	140 255		
import duties related to purchases	1 536		
		141 791	
		159 672	
Less: closing stock		(19 870)	
			(139 802)
Gross profit			111 034
Discounts received			183
			111 217
Expenses			

Staff wages		23 391	
Premises rental and other charges		31 580	
Administration charges	7 726		
Add: accrued telephone expense	422		
		8 148	
Accrued accountancy charges		1 300	
Discounts allowed		870	
Interest paid and bank charges		1 560	
Delivery expenses		2 612	
			(69 461)
Net profit			41 756

Richard: Balance sheet at 30 September 20X4

	£	£
Fixed assets		8 311
Current assets		
Stock	19 870	
Debtors	93 242	
	113 112	
Current liabilities		
Creditors	51 760	
Accruals	1 722	
Bank overdraft	23 861	
	77 343	

Net current assets (£113 112 – 77 343)		35 769
Net assets		44 080
Capital		
Opening capital balance 1 January 20X4	64 084	
Add: net profit for the year	41 756	
	105 840	
Less: drawings	(61 760)	
Closing capital balance 30 September 20X4		44 080

(b) Profit and loss account and balance sheet treating the amounts owed by Charlie as a bad debt.

If the debt from Charlie cannot be recovered, it will be treated as a bad debt in Richard's accounts. The appropriate accounting treatment is to deduct the debt from the debtors balance, thus reducing assets, and from profit for the period. The latter adjustment directly affects the capital account.

The effect, in summary, will be as follows:

Profit for the 9 months to 30 September 20X4 currently stands at £41 756. If Charlie's debt of £50 600 is deducted a loss arises:

£41 756 – 50 600 = £8 844 Loss

In the balance sheet the debt of £50 600 is deducted from the total debtors of £93 242, leaving a revised debtors balance of £42 642. The revised balance sheet is as follows:

Richard: Revised balance sheet at 30 September 20X4

	£	£
Fixed assets		8 311
Current assets		
Stock	19 870	
Debtors	42 642	
	62 512	
Current liabilities		
Creditors	51 760	
Accruals	1 722	
Bank overdraft	23 861	
	77 343	
Net current liabilities (£62 512 – 77 343)		(14 831)
Net liabilities		(6 520)
Capital		
Opening capital balance 1 January 20X4	64 084	
Less: loss for the year	(8 844)	
	55 240	
Less: drawings	(61 760)	
Closing capital balance 30 September 20X4		(6 520)

(c) Discussion of the prospects for the business

Note that the balance sheet now shows net liabilities and that the capital account is negative. The business is insolvent and Richard is in very deep trouble. There is no money available to pay the creditors, and the overdraft limit is virtually reached. The future looks bleak for the business, and for Richard.

Can the business survive this disaster? Looking at the original set of accounting statements before the adjustment is made for the bad debt, we can see that the business is basically profitable. If it could be refinanced there is no reason for it not to continue to be a viable concern. The original balance sheet before adjustment suggests that Richard's spending has got out of hand: the high level of drawings of £61 760 is not sustainable. Even if new sources of finance were to be found, Richard would need to curtail his spending by a significant amount.

(d) Suggest possible ways in which Richard could obtain further finance to support his business.

If Richard had any personal assets these could be sold to raise much-needed cash for the business. What we know of Richard's personal life suggests that he is short of assets; he cannot borrow on the security of a house because the family home is now owned by Hermione. If the business is to survive, Richard urgently needs to explore other options. Some possibilities might be:

- A personal loan. It is possible that the bank may be prepared to lend Richard some money. However, even if this is the case, there are likely to be stringent conditions attached to any loan.

- A personal loan from a private source. Richard's mother originally lent him the money to start the business. It is possible that she may be willing to make further loans. There may be other relatives or friends who will stand by Richard in his difficulties.
- Financial assistance from Richard's supplier in Italy. For many years Giovanni has been supplying goods to Richard for distribution in the UK. If Richard goes out of business, Giovanni loses his UK outlet and it may be difficult and expensive to establish another. Giovanni may be prepared to, say, go into partnership with Richard in order to keep the distribution outlet open. As the business is basically profitable, it could be to Giovanni's personal benefit to put money into the venture to keep it afloat.
- Legal action against Charlie for recovery of the debt. This should probably be attempted in any case, but the reports of Charlie's former business activities and the fact that he cannot currently be found indicate that it will probably be very difficult to recover any cash.

If Richard cannot obtain fresh finance for the business, it will not be able to meet its liabilities. Because he is a sole trader he is personally liable for the debts incurred by the business, and it is quite likely that he will become personally bankrupt. In the circumstances, his panic seems completely justified.