



Osborne Books Tutor Zone

Credit Management

Answers to practice assessment 1

Task 1

- (a) (b) The seller promising the goods in return for payment by the buyer
- (b) (c) Oral or in writing
- (c) (c) Held either on a paper-based system or a computer system
- (d) (b) The supermarket is not bound by the price because the special deal was only an invitation to treat
- (e) (a) There is no valid contract because the consideration (the work done) came before the promise to pay
- (f) (c) Quantum Meruit
- (g) 9.75%
- (h) £133.15 *Workings:* $(£9,000 \times 1.2) \times (8\% + 1\%) \times 50/365$
- (i) The Trade Descriptions Act makes it a **criminal offence** to make false statements about **goods offered for sale** and to make **misleading statements** about **services** offered.

Task 2

(a)

Ice Breakers Limited	20-3 Indicator	20-3 Rating	20-2 Indicator	20-2 Rating
Operating profit margin %	9.09	5	-29.11	-5
Interest cover	5	10	None	-30
Liquidity ratio	2.2	10	0.96	-20
Gearing %	42.94	10	39.46	10
Total credit rating		35		-45

Workings:

	Formula	20-3	20-2
Operating profit margin %	$\frac{\text{Profit from operations} \times 100}{\text{Sales revenue}}$	$\frac{45 \times 100}{495} = 9.09\%$	$\frac{(115) \times 100}{395} = -29.11\%$
Interest cover	$\frac{\text{Profit from operations}}{\text{Interest payable}}$	$\frac{45}{9} = 5$	None
Liquidity ratio	$\frac{\text{Current assets less inventories}}{\text{Current liabilities}}$	$\frac{177 - 87}{41} = 2.2$	$\frac{163 - 72}{56 + 39} = 0.96$
Gearing %	$\frac{\text{Total debt} \times 100}{\text{Total debt plus equity}}$	$\frac{450 \times 100}{450 + 598} = 42.94\%$	$\frac{406 \times 100}{406 + 623} = 39.46\%$

(b) (c) Request latest management accounts and defer decision

Task 3

(a) Other signs that a company is overtrading:

- An increase in the amount of trade receivables.
- An increase in the level of inventories.
- Credit control procedures appearing to struggle.
- Increase in irrecoverable debts.
- Reduction in the monies held in the bank.
- Failure to pay suppliers on time, or an increase in the accounts payable payment period.

(b) **Trevor Ltd has a higher increase in turnover**

- The turnover for Trevor Ltd has increased by 32% and the turnover for Petal Ltd has increased by 25%, however, we are not making a comparison between the two companies, we are assessing if each one should have an increase in their credit limits.
- Increases in turnover may be a good sign or they may indicate overtrading, other factors must be taken into consideration.

The gross profit of Trevor Ltd has increased by £81,000, whereas for Petal Ltd the figure is £50,000

- Trevor Ltd has an increase in gross profit, but the gross profit margin has declined slightly, the decrease does not appear to be a major concern.
- Petal Ltd has a smaller increase in gross profit due to a smaller increase in turnover; the gross profit margin has improved slightly which is a good sign.

Trevor Ltd has a much higher profit from operations

- The profit from operations for Trevor Ltd has remained almost constant; however, there has been a fall in the profit from operations margin from 25% to 19%. This would appear to be due to an increase in the administrative expenses.
- The profit from operations for Petal Ltd has increased and there has been a minor improvement in the profit from operations margin, which is a good sign.

The interest cover for Trevor Ltd is much higher

- The interest cover for Trevor Ltd has fallen, but the company is still able to meet its interest commitments by over 4.5 times. There has been an increase in long term borrowing of £200,000 and in the short term the cash balance has fallen by £226,000 into a bank overdraft, which is a worrying sign.
- Petal Ltd has a slight improvement in the interest cover; it has increased long term borrowing by £100,000 and has retained a positive cash balance.

Trevor Ltd has lower trade receivables and the collection period is also lower than Petal Ltd

- The trade receivables for Trevor Ltd have increased, which is to be expected with an increase in turnover. There has however been an increase in the collection period which may mean the company is struggling to keep up-to-date with credit control following the increase in turnover.
- Petal Ltd has seen an increase in trade receivables, but the collection period has remained roughly the same, suggesting that the increased turnover has not had a detrimental effect on credit control.

The trade payables are almost identical for both companies

- The trade payables for Trevor Ltd have more than doubled in both the amount and in the payment period, this is not a good sign and would suggest that the company is struggling to pay its suppliers on time.
- There has been a slight increase in the trade payables for Petal Ltd, the trade payables payment period has improved slightly, which is a good sign.

Trevor Ltd has had a decrease in the level of inventories which is a good sign, whereas Petal Ltd has had an increase

- The level of inventories for Trevor Ltd has decreased slightly, but the inventory holding period has decreased by almost two weeks. This would indicate (along with the increase in the trade payables collection period) that the company is unable to receive and pay for supplies on credit, and is at risk of running out of inventories.
- Petal Ltd has an increase in the level of inventories, but the inventory holding period has remained constant, which is positive.

Trevor Ltd is less of a financial risk as the net assets are much higher than Petal Ltd's

- Trevor Ltd has invested in non-current assets of just over £100,000; this appears to have been funded by an increase in both the long and short term borrowing totalling £269,000. Gearing has increased, as well as the increase in borrowing there has been a reduction in the share capital of £300,000, the reason for this would need to be investigated, but it may suggest that the shareholders are not happy with the business. There has been a huge decrease in the current ratio, which is a worrying sign.
- Petal Ltd has more or less maintained its current ratio and the level of gearing has decreased. There has been an increase of £379,000 in the level of non-current assets which has been financed by a £300,000 increase in share capital and £100,000 in long term loans.

My conclusion is that the increased credit limit requested for Petal Ltd is declined and the one for Trevor Ltd is accepted

- The increased credit limit for Petal Ltd should be accepted.
- The increased credit limit for Trevor Ltd should be rejected as it is showing strong signs of overtrading.

Task 4

Sales revenue has decreased by **9.43%**, this means the company may have **sold fewer units**.

The gross profit margin has **increased**, which means **the cost of purchases may have decreased**.

Profit from operations has increased by **£140,000** which is due to **the change in the gross profit margin**.

The return on capital employed has **increased**, which is an indication that **the profitability for investors is improving**.

There has been an **improvement** in the interest cover which means that the company is still **able** to meet its interest commitments.

There has been a reduction in trade receivables. **This may be due to the reduction in sales** and a **decrease** in the trade receivables collection period which would indicate that **credit control procedures have improved**.

The trade payables payment period has fallen by **34.12** days, it is still **high**.

The quick ratio has improved which is **a good sign in terms of liquidity**.

I recommend that credit be given on strict 30 day terms.

Workings:

	Formula	20-2	20-1
Gross profit margin %	$\frac{\text{Gross profit} \times 100}{\text{Sales revenue}}$	$\frac{1,163 \times 100}{2,584} = 45.01\%$	$\frac{1,027 \times 100}{2,853} = 36\%$
Return on capital employed %	$\frac{\text{Profit from operations} \times 100}{\text{Net assets}}$	$\frac{739 \times 100}{8,080 - 415} = 9.64\%$	$\frac{599 \times 100}{7,275 - 738} = 9.16\%$
Interest cover	$\frac{\text{Profit from operations}}{\text{Interest payable}}$	$\frac{739}{101} = 7.32$	$\frac{599}{102} = 5.87$
Trade payables pmt period in days	$\frac{\text{Trade payables} \times 365}{\text{Cost of sales}}$	$\frac{408 \times 365}{1,421} = 104.8$	$\frac{695 \times 365}{1,826} = 138.92$
Trade receivables coll'n period in days	$\frac{\text{Trade receivables} \times 365}{\text{Sales revenue}}$	$\frac{555 \times 365}{2,584} = 78.4$	$\frac{752 \times 365}{2,853} = 96.21$
Quick ratio	$\frac{\text{Current assets less inventories}}{\text{Current liabilities}}$	$\frac{793 - 238}{415} = 1.34$	$\frac{1,092 - 340}{738} = 1.02$

Task 5

(a) (a) and (d) are False; (b) and (c) are True

(b) For a retention of **title** claim to be successfully enforced the goods subject to the clause must be **clearly identifiable**.

There must be retention of **title** clause shown on **sales documentation**, which does not just include **sales invoices**.

(c) (b) Invoice discounting

The amount Family Ties Ltd can borrow is £1,562,400

Workings: $(£1,780,000 - £44,000) \times 90\%$

(d) (a) It forms part of the formal offer in the contract of sale

(e) (c) A court order which will give the seller a right to the sale proceeds of property owned by the customer

(f) (a) An action for the price

(g) (a) Bankruptcy

Task 6

- (a) In order to claim VAT bad debt relief, the debt must have been **written off** in the accounts.
The debt must have remained unpaid for **six months** after the **due date for payment**.
The debt must be less than **four and a half** years old.

- (b) The simple annual interest rate of the discount is **25.09%**.

Workings:

$$\left(\frac{3}{97} \right) \times \left(\frac{365}{60 - 15} \right) \times 100 = 25.09\%$$

The compound annual rate of discount is **28.03%**.

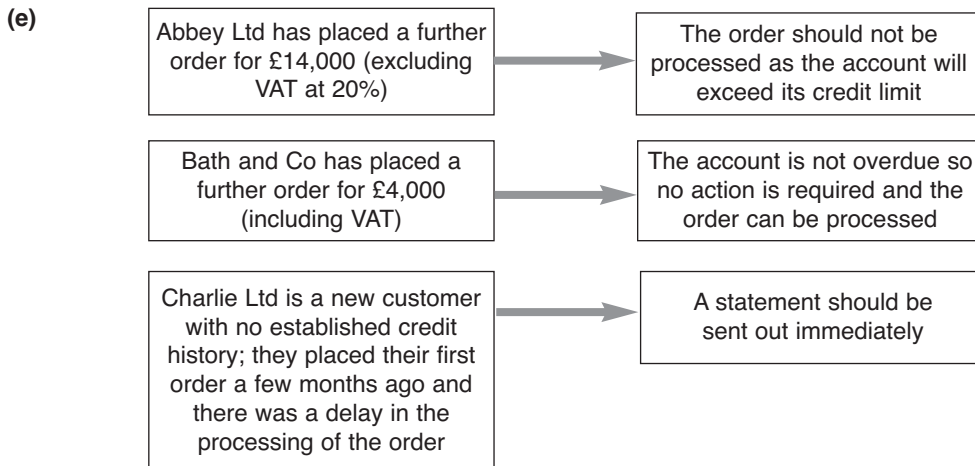
Workings:

$$\left\{ \left(1 + \frac{3}{97} \right)^{\left(\frac{365}{60 - 30} \right) - 1} \right\} \times 100 = 28.03\%$$

- (c) (a) A credit agency report

- (d) £60,592

Workings: (£63,000 × 80% × 98%) + (£56,000 × 20%)



- (f) 52 days. Workings: (£48,405 / [6,9015 × £49]) × 365 = 52

Task 7

(a) Donlan Ltd

- The invoice is overdue, the account should have been put on stop on 28 August 20-3
- Contact the administrator of Donlan Ltd and establish the likelihood of the account being paid
- It will not be possible to instigate legal proceedings whilst the company is in administration
- A provision should be made in the accounts and a claim should be made from the credit insurer

Salter Ltd

- The products which have been manufactured by Faith Ltd may be separately identifiable from other products
- A member of staff should visit the premises of Salter Ltd to identify the products supplied in the presence of the receiver
- A claim should be made from the insurer for £4,340
- The VAT of £1,240 is reclaimable from HMRC
- A provision of £1,860 should be made in the accounts

Bleaney Ltd

- For the invoice dated 31 August 20-3 use the normal credit control process which will be a telephone call on 6 October 20-3 followed by a letter on 13 October 20-3
- For the invoice dated 31 May 20-3 contact Bleaney Ltd and ask why the payment has not been made yet
- As Bleaney Ltd usually pays on time it is likely that the older invoice is in dispute
- It is not necessary at this stage to make any provision in the accounts

(b)

Dr		Jello Ltd		Cr	
		£			£
1 Aug	B/fwd	37,500			
2 Aug	Invoice	6,720	6 Aug	Credit Note	648
			16 Aug	Bank	37,500
			31 Aug	C/fwd	6,072
		<u>44,220</u>			<u>44,220</u>

Dr		Jello Ltd		Cr	
		£			£
1 Sept	B/fwd	6,072	16 Sept	Bank	2,500
24 Sept	Invoice	3,600			
			30 Sept	C/fwd	7,172
		<u>9,672</u>			<u>9,672</u>