Association of Taxation Technicians

# Examination

May 2005

## PRINCIPLES OF ACCOUNTING

### Suggested Solutions

Norfolk Limited - Answers

**Balance sheet at 30 April 2005**

| | | | |
|---|---|---|---|
| Fixed assets | | £ | £ |
| Premises | W2 | | 616,000 |
| Machinery | W1 | | 168,000 |
| | | | 784,000 |
| Current assets | | | |
| Stock | W6 | 38,000 | |
| Trade debtors | W5 | 133,000 | |
| Cash | | 67,000 | |
| | | 238,000 | |
| Current liabilities | | | |
| Trade creditors | W7 | 78,000 | |
| Corporation tax creditor | W8 | 52,000 | |
| | | 130,000 | |
| | | | 108,000 |
| Net assets | | | 892,000 |
| Ordinary share capital | W3 | | 30,000 |
| Share premium | W4 | | 240,000 |
| Profit and loss account | W9 | | 622,000 |
| | | | 892,000 |

W1 - machinery

| | |
|---|---|
| | £ |
| Addition - year ended 30/4/03 | 250,000 |
| Depn - year ended 30/4/03 | (50,000) |
| | 200,000 |
| Depn - year ended 30/4/04 | (40,000) |
| | 160,000 |
| Addition - year ended 30/4/05 | 50,000 |
| | 210,000 |
| Depn - year ended 30/4/05 | (42,000) |
| Net book value at 30/4/05 | 168,000 |

W2 - premises

| | |
|---|---|
| Cost | 700,000 |
| 6 years depreciation at 2% p.a | (84,000) |
| Net book value at 30/4/05 | 616,000 |

Norfolk Limited - Answers

W3 - share capital

| | £ |
|---|---|
| 300,000 x 10p | 30,000 |

W4 - share premium

| | |
|---|---|
| 300,000 x 80p | 240,000 |

W5 - debtors

| | |
|---|---|
| Opening debtors - 76,000 x 100/95 | 80,000 |
| Sales in year | 2,400,000 |
| Receipts | (2,340,000) |
| | 140,000 |
| General provision - 5% | (7,000) |
| Trade debtors at 30/4/05 | 133,000 |

W6 - stock

| | |
|---|---|
| Opening stock | 68,000 |
| Purchases | 1,890,000 |
| | 1,958,000 |
| Stock sold - 2,400,000 x 100/125 | (1,920,000) |
| Stock at 30/4/05 | 38,000 |

W7 - trade creditors

| | |
|---|---|
| Opening creditors | 44,000 |
| Increase | 34,000 |
| Trade creditors at 30/4/05 | 78,000 |

W8 - corporation tax creditor

| | |
|---|---|
| Tax charge for the year | 49,000 |
| Over provision re prior year | 3,000 |
| Corporation Tax creditor at 30/4/05 | 52,000 |

W9 - profit and loss account

| | |
|---|---|
| Net profit for the year | 162,000 |
| Balance brought forward | 460,000 |
| Balance at 30/4/05 | 622,000 |

Whitehead Limited - Answers

1 SSAP 5 offers guidancew on how to account for VAT in company accounts. However the principles apply equally to other business entities.

A person who is registered for VAT must charge VAT on supplies to customers. This is done by adding the rate of VAT applicable to the supply to the selling price. The VAT so charged is known as output VAT.

The output VAT must then be paid over to H M Customs & Excise. The registered person is acting as a collector of VAT on behalf of H M Customs & Excise.

Since the VAT charged does not belong to the registered person it is excluded from the value of turnover in the accounts.

Businesses incur VAT on the purchases and expenses. This is known as input VAT and can be reclaimed from H M Customs & Excise. As such it is excluded from the value of purchases of expenses in the accounts.

Not all input VAT is recoverable. eg VAT on customer entertaining is nor recoverable

Examples of journal entries are:

| | | £ | £ |
|---|---|---|---|
| Dr | Cash/debtor (VAT inclusive amount) | X | |
| Cr | Sales (VAT exclusive amount) | | X |
| Cr | VAT creditor (VAT amount) | | X |
| | Being journals to record a sale | | |

| | | £ | £ |
|---|---|---|---|
| Cr | Cash/creditor (VAT inclusive amount) | | X |
| Dr | Expense (VAT exclusive amount) | X | |
| Dr | VAT creditor (VAT amount) | X | |
| | Being journals to record a purchase | | |

2

VAT creditor account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 4/30/2004 | Bank account | 9,500 | 4/1/2004 | Balance b/f | 9,500 |
| 6/30/2004 | VAT inputs | 83,500 | 6/30/2004 | VAT outputs | 62,000 |
| 9/30/2004 | VAT inputs | 61,500 | 7/31/2004 | Bank account | 21,500 |
| 10/31/2004 | Bank account | 4,500 | 9/30/2004 | VAT outputs | 66,000 |
| 12/31/2004 | VAT inputs | 99,000 | 12/31/2004 | VAT outputs | 93,000 |
| 3/31/2005 | VAT inputs | 63,500 | 1/31/2005 | Bank account | 6,000 |
| | | | 3/31/2005 | VAT outputs | 81,000 |
| 3/31/2005 | Balance c/f | 17,500 | | | |
| | | 339,000 | | | 339,000 |
| | | | 4/1/2005 | Balance b/f | 17,500 |

Whitehead Limited - Answers

Bank account (extract)

| | | £ | | | £ |
|---|---|---|---|---|---|
| 7/31/2004 | VAT creditor | 21,500 | 4/30/2004 | VAT creditor | 9,500 |
| 1/31/2005 | VAT creditor | 6,000 | 10/31/2004 | VAT creditor | 4,500 |
| | | | 1/1/2005 | Corporation Tax | 95,500 |
| | | | 10/1/2004 | Interest account | 7,200 |
| | | | 1/1/2005 | Interest account | 7,840 |
| | | | 1/14/2005 | Income Tax account | 1,800 |

Corporation Tax account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 1/1/2005 | Bank account | 95,500 | 4/1/2004 | Balance b/f | 100,000 |
| 3/31/2005 | P&L account | | 3/31/2005 | P&L account | |
| | Overprovision 31/03/04 | 4,500 | | Provision for 31/03/05 | 122,500 |
| 3/31/2005 | Balance c/f | 122,500 | | | |
| | | 222,500 | | | 222,500 |
| | | | 4/1/2005 | Balance b/f | 122,500 |

Deferred Tax account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 3/31/2005 | Balance c/f | 54,500 | 4/1/2004 | Balance b/f | 61,500 |
| | P&L account | 7,000 | | | |
| | | 61,500 | | | 61,500 |
| | | | 4/1/2005 | Balance b/f | 54,500 |

Interest account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 10/1/2004 | Bank account | 7,200 | | | |
| 10/1/2004 | Income Tax account | 1,800 | | | |
| 1/1/2005 | Bank account | 7,840 | | | |
| 1/1/2005 | Income Tax account | 1,960 | | | |
| 3/31/2005 | Balance c/f | 8,400 | | | |
| | | | 3/31/2005 | P&L account | 27,200 |
| | | 27,200 | | | 27,200 |
| 4/1/2005 | Bank account | 6,720 | 4/1/2005 | Balance b/f | 8,400 |
| 4/1/2005 | Income Tax account | 1,680 | | | |

Income Tax account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 1/14/2005 | Bank account | 1,800 | 10/1/2004 | Interest account | 1,800 |
| 3/31/2005 | Balance c/f | 1,960 | 1/1/2005 | Interest account | 1,960 |
| | | 3,760 | | | 3,760 |
| 4/14/2005 | Bank account | 1,960 | 4/1/2005 | Balance b/f | 1,960 |
| 7/14/2005 | Bank account | 1,680 | 4/1/2005 | Interest account | 1,680 |

Whitehead Limited - Answers

3

Profit and loss account

| | | |
|---|---|---|
| | | £ |
| Corporation Tax: | | |
| | Charge for the year | 122,500 |
| | Over provision in respect of prior years | (4,500) |
| | | 118,000 |
| Deferred tax: | | |
| | Movement in year | (7,000) |
| | | 111,000 |

Balance sheet

| | | |
|---|---|---|
| | | £ |
| Creditors: amounts due within one year; | | |
| | Corporation tax | 122,500 |
| Provisions for liabilities and charges: | | |
| | Deferred tax | 54,500 |

4 Deferred tax is an accounting adjustment. It is not a type of tax itself.

There are differences between the tax rules and accounting rules in recognising income and expenses and so distortions can arise between the tax charge under the tax rules and the tax due on the profits according to the accounts. An example of the differences are timing differences which arise between capital allowances and depreciation.

Deferred tax is a system of dealing with such distortions. Deferred tax ensures that the tax charge shown in the accounts is in line with the profits shown as earned in the accounts.

Answer: Leah-Clare

Bank Account

| | | | |
|---|---|---|---|
| Debtors | 220,000 | Creditors | 120,000 |
| Capital | 25,000 | Salaries | 15,000 |
| | | Rent | 2,000 |
| Government grant | 1,000 | Insurance | 750 |
| | | Heat & light | 900 |
| | | Finance loan creditor | 600 |
| | | Finance loan creditor | 1,300 |
| | | Computer | 1,200 |
| | | Drawings | 12,000 |
| | | Balance c/d | 92,250 |
| | 246,000 | | 246,000 |

Purchases Account

| | | | |
|---|---|---|---|
| Creditors | 200,000 | Profit & loss account | 200,000 |

Creditors Account

| | | | |
|---|---|---|---|
| Bank | 120,000 | Purchases | 200,000 |
| Balance c/d | 80,000 | | |
| | 200,000 | | 200,000 |

Sales Account

| | | | |
|---|---|---|---|
| Profit & loss account | 280,000 | Debtors | 280,000 |

Debtors Account

| | | | |
|---|---|---|---|
| Sales | 280,000 | Bank | 220,000 |
| | | Balance c/d | 60,000 |
| | 280,000 | | 280,000 |

Answer

Sundry income account: Grant

| | | | |
|---|---|---|---|
| Profit & loss account | 1,000 | Bank | 1,000 |

Stock Account

| | | | |
|---|---|---|---|
| Profit & loss account | 40,000 | Balance c/d | 40,000 |

Salaries Account

| | | | |
|---|---|---|---|
| Bank | 15,000 | Profit & loss account | 15,000 |

Rent Account

| | | | |
|---|---|---|---|
| Bank | 2,000 | Prepaid c/d | 200 |
| | | Profit & loss account | 1,800 |
| | 2,000 | | 2,000 |
| Prepayment b/d | 200 | | |

Insurance Account

| | | | |
|---|---|---|---|
| Bank | 750 | Prepaid c/d | 250 |
| | | Profit & loss account | 500 |
| | 750 | | 750 |
| Prepayment b/d | 250 | | |

Heat and Light Account

| | | | |
|---|---|---|---|
| Bank | 900 | Profit & loss account | 1,050 |
| Accrued c/d | 150 | | |
| | 1,050 | | 1,050 |
| | | Accrual b/d | 150 |

Telephone Account

| | | | |
|---|---|---|---|
| Accrued c/d | 275 | Profit & loss account | 275 |
| | 275 | | 275 |
| | | Accrual b/d | 275 |

Answer 1 (3)

Van Account

| | | | |
|---|---|---|---|
| Loan creditor | 13,000 | Balance c/d | 13,000 |

Computer Account

| | | | |
|---|---|---|---|
| Bank | 1,200 | Balance c/d | 1,200 |

Capital Account

| | | | |
|---|---|---|---|
| Balance c/d | 25,000 | Bank | 25,000 |

Drawings Account

| | | | |
|---|---|---|---|
| Bank | 12,000 | Balance c/d | 12,000 |

Bad Debts Expense Account

| | | | |
|---|---|---|---|
| Provision for bad debts | 4,500 | Profit & loss account | 4,500 |

Provision for Doubtful Debts Account

| | | | |
|---|---|---|---|
| Balance c/d | 4,500 | Bad debts expense account | 4,500 |

Depreciation Expense Account

| | | | |
|---|---|---|---|
| Provision for depreciation - van | 3,250 | Profit & loss account | 3,650 |
| Provision for depreciation - computer | 400 | | |
| | 3,650 | | 3,650 |
| | ------ | | ------- |

Provision for Depreciation Account - Van

| | | | |
|---|---|---|---|
| Balance c/d | 3,250 | Depreciation expense account | 3,250 |

-

Provision for Depreciation - Computer

| | | | |
|---|---|---|---|
| Balance c/d | 400 | Depreciation expense account | 400 |

Loan creditor account – Van

| | | | |
|---|---|---|---|
| Bank: initial deposit | 1,300 | Van account | 13,000 |
| Bank: first instalment | 600 | Interest ( 1st instalment) | 112 |
| Balance c/d | 11,212 | | |
| | 13,112 | | 13,112 |

Finance Charge Account

| | | | |
|---|---|---|---|
| Loan creditor account | 112 | Profit & loss account | 112 |

Answer 1 (4)

Leah-Clare - Profit and loss account
for the year ended 31 December 2004

| | £ | £ |
|---|---|---|
| Sales | | 280,000 |
| Less Cost of Sales: | | |
| Purchases | 200,000 | |
| Less: closing stock | (40,000) | 160,000 |
| Gross profit | | 120,000 |
| Sundry income | | 1,000 |
| | | 121,000 |
| Less Expenses: | | |
| Salaries | 15,000 | |
| Rent | 1,800 | |
| Insurance | 500 | |
| Heat and light | 1,050 | |
| Telephone | 275 | |
| Finance interest | 112 | |
| Bad debts expense | 4,500 | |
| Depreciation | 3,650 | ( 26,887) |
| Net profit | | 94,113 |
| | | -------- |

Workings

The finance charge is the difference between the total paid by way of instalments and deposit compared to the cash price if purchased outright.

| | £ |
|---|---|
| Total instalments – | |
| Deposit (10%) | 1,300 |
| 24 monthly instalments of £600 | 14,400 |
| | 15,700 |
| Cash price | (13,000) |
| Finance charge is | 2,700 |

Finance charge per instalment = $\frac{2,700}{24}$ = £112.50

Leah-Clare – Balance Sheet at 31 December 2004

| | £ | £ |
|---|---|---|
| Fixed Assets | | |
| Car | 13,000 | |
| Less: depreciation | 3,250 | 9,750 |
| Computer | 1,200 | |
| Less: depreciation | 400 | 800 |
| | | 10,550 |
| Current Assets | | |
| Stock | 40,000 | |
| Debtors (60,000 – 4,500) | 55,500 | |
| Prepayments (200 + 250) | 450 | |
| Bank | 92,250 | |
| | 188,200 | |
| Creditors | | |
| Trade creditors | 80,000 | |
| Accruals (150 + 275) | 425 | |
| Loan creditor | 11,212 | |
| | 91,637 | 96,563 |
| | | 107,113 |
| Financed by | | |
| Capital introduced | | 25,000 |
| Add: Profit | | 94,113 |
| | | 119,113 |
| Less: Drawings | | ( 12,000) |
| | | 107,113 |

Answer: Denver Ltd

Ordinary share capital account

| | | £ |
|---|---|---|
| 01.04.04 | Balance b/f | 1,000,000 |
| 30.06.04 | Share issue (500 000 at £1) | 500,000 |
| 31.12.04 | Bonus issue (500 000 at £1) | 500,000 |
| 28.02.05 | Rights issue (200 000 at £1) | 200,000 |

Preference share capital account

| | | £ |
|---|---|---|
| 01.04.04 | Balance b/f | 200,000 |

Share premium account

| | | £ |
|---|---|---|
| 01.04.04 | Balance b/f | 300,000 |
| 30.06.04 | Share issue (500 000 at £1.50) | 750,000 |
| 28.02.05 | Rights issue (200 000 at £2) | 400,000 |

Bank account

| | £ | | £ |
|---|---|---|---|
| 30.06.04 Share issue (500 000 at 2.50) | 1 250 000 | 01.10.04 Preference dividend | 10 000 |
| 28.02.05 Rights issue (200 000 at £3) | 600 000 | | |

Profit and loss account

| | £ |
|---|---|
| 31.12.04 Bonus issue | 500 000 |

Dividends paid account

| | £ |
|---|---|
| 01.10.04 Preference dividend | 10 000 |

Dividends payable account

| | £ |
|---|---|
| 31.03.05 Preference dividend due | 10,000 |

Creditor: Dividends payable

| | | | |
|---|---|---|---|
| | | | £ |
| | 31.03.05 | Dividends payable | 10,000 |

2) The effect of a bonus issue is to reduce the market value of each share. A company may therefore have a bonus issue with a view to making its shares more marketable. Unlike a rights issue a bonus issue does not raise any additional finance for the company. A bonus issue simply capitalises part of the company's reserves. A rights issue is a way of raising additional finance by offering new shares to existing share holders in proportion to their existing holdings.

3). A shareholder who receives a rights offer has three options available to him:
a.  he can take up the rights by paying the amount required to the company and thereby increasing his shareholding;
b.  he can sell his rights to a third party who may then buy the shares from the company at the offer price; or
c.  he can decide to do nothing and as a consequence his rights will lapse.

Normally a shareholder will take up his rights but if he is not in a position to do so he would normally try to sell his rights to a third party. If this is not possible and the offer is allowed to lapse then the company will sell the rights for him and send him the proceeds.

4) The cash flow statement would show the cash generated by the issue of the new shares and the rights issue. As the bonus issue does not generate any cash this would not affect the cash flow.

The payment of the preference dividend would be an outflow of funds. The dividend payable on 1 April 2005 would not feature in the cash flow statement.

Financing

| | |
|---|---|
| | £ |
| Issue of ordinary share capital | 1 850 000 |
| Dividend paid | (10 000) |

5)  The difference between these two classes of shares is in essence the difference between the ordinary share holders whose reward will be geared to how well the company performs and the preference shareholders whose entitlement is fixed.

6) As a limited company Denver Ltd could issue a capital instrument in order to raise finance. Usually capital instruments are issued in respect of debentures, loans and debt instruments.