Association of Taxation Technicians

Examination

May 2006

PRINCIPLES OF ACCOUNTING

SUGGESTED SOLUTIONS

Answer 1

Debtors Account

		Bank: Specific doubtful debts recovered:	
		EFG Ltd	18,000
		MNO Ltd	56,000
		Bad debt expense account:	
		RST Ltd	15,000

General Provision for Bad Debts Account

Balance c/d (working)	62,000	Balance b/d	54,000
		Bad debt expense account	8,000
	62,000		62,000
		Balance b/d	62,000

Specific Provision for Bad Debts

		Balance b/d	164,000
Balance c/d	200,000	Bad debt expense account	36,000
	200,000		200,000
		Balance b/d	200,000

Bank Account

Bad debt expense account:			
XYZ Ltd	3,000		
Debtors account:			
EFG Ltd	18,000		
MNO Ltd	56,000		

Bad Debt Expense Account

General provision for bad debts	8,000	Bank: XYZ Ltd	3,000
Specific provision for bad debts	36,000		
Debtors account: RST Ltd	15,000	Profit & loss account	56,000
	59,000		59,000

b) A bad debt is when a debtor becomes unable to pay the amount he owes. The amount is therefore written out of the business's accounting records because it is no longer an asset. The loss of the debtor is an expense of the business and the expense must be charged to the profit and loss account. Sales, in the trading account, are not reduced as the sale itself was good. It is the collection of the debt which is the problem.

A doubtful debt is when there is uncertainty as to whether a debt will be recoverable. An example of
this is when a debt has remained unpaid for a period of time exceeding the normal settlement time.
A provision is set up against doubtful debts but the debts still remain in the business's records as
assets.

c) A specific provision is a provision against specifically identified debtors.

A general provision is against debtors as a whole excluding those which have been specifically provided for. A general provision will be based on a percentage of remaining debtors taking into consideration the following factors:

i) the nature and type of business; and
ii) the previous experience of the business.

A specific provision is allowed to reduce profits in the tax computation since it relates to a specific debt which can be identified and evaluated whereas a general provision is not allowable because it is subjective.

<u>Workings</u>

General doubtful debt provision at 30 November 2005 is:-

Trade debtors	1,750,000
Less: specific provision	(200,000)
	1,550,000

4% of £1,550,000 = <u>£62,000</u>

Answer 2

a) 1. The grant received is in respect of the purchase of machinery which is capital expenditure. The grant should not, therefore, be recognised in the profit and loss account for the year to 31 December 2005 since the related expense, the depreciation charge, will be spread over 10 years under the terms of the company's depreciation policy. The grant should, therefore, be amortised over 10 years at the rate of £3,000 p.a. commencing in the year to 31 December 2005.

2. The grant receive for taking on an unemployed person is a revenue grant because it relates to employment costs which are revenue costs as opposed to capital costs. Consequently, the grant should be recognised in the profit and loss account in the year to 31 December 2005, the year in which it was received.

3. Research expenditure is required by SSAP 13 to be written off as incurred unless the expenditure is on fixed assets acquired to provide research facilities, in which case they can be capitalised. The expense of Bloggs Limited is in respect of employment costs and should therefore be written off as incurred.

4. My preferred accounting treatment would be to write off the whole of the development expenditure in the year to 31 December 2005 on the grounds that this is the most prudent way of accounting for this expenditure. SSAP 13 would, however, permit Bloggs Limited to amortise the cost over the expected useful life of the product (5 years) provided that there was evidence available regarding the technical and commercial viability of the product.

5. The goodwill is purchased goodwill and guidance on how to account for purchased goodwill is given in FRS 10. FRS 10 suggests that goodwill should be capitalised as an asset in the balance sheet of the acquiring business. However, FRS 10 does require goodwill to be amortised if it has a limited useful economic life. The goodwill should, therefore, be written off to the profit and loss account on a straight line basis over 10 years starting in the year to 31 December 2005.

6. Although the legal form of the transaction is that Bloggs Limited is simply renting the van, the effect of the transaction is that it is borrowing money and 'purchasing' the asset. Bloggs Limited should, therefore, bring the price of the van into fixed assets and depreciate in the normal way. It should also recognise the liability for the future payments.

   The interest/finance charge incurred under the agreement should be charged to the profit and loss account over the period of the agreement. There are several methods of allocating the interest to the profit and loss account.

7. The company is simply renting the use of the vehicle and these payments should be shown in the P&L as they are incurred.

b) Research expenditure is expenditure incurred on an original investigation undertaken to gain new scientific or technical knowledge. Development expenditure, on the other hand, is the use of scientific or technical knowledge to produce new or substantially improved materials, devices, products etc, prior to the commencement of commercial production.

c) Capital expenditure is incurred in:

i) the acquisition of assets for use in the business as opposed to being acquired for resale eg cars, buildings, machinery etc

ii) the alteration or improvement of assets for the purpose of increasing their revenue earning capacity.

Revenue expenditure is expenditure which is expensed or charged to the profit and loss account when such expenditure is incurred eg repairs, wages etc

A finance lease is a long-term lease where the term of the lease is likely to cover all or most of the asset's life.

An operating lease is short-term leasing. The lease involves the hirer paying rental on an asset for a period which is normally substantially less than its useful life.

The main distinguishing feature of a finance lease as compared to an operating lease is that substantially all the risks and rewards of the asset belong to the hirer.

Answer 3

1. Cashflow statement

Alpha Limited

Cashflow Statement for the year ended 31 December 2005

		£
Profit for year before taxation and interest	W1	71,000
Adjustments for items not involving movement of funds:		
Depreciation	W2	31,000
Loss on sale of fixed assets		6,000
		108,000
Increase in stock	W3	(8,000)
Decrease in trade debtors	W3	5,000
Decrease in trade creditors	W3	(23,000)
Net cash inflow from operating activities		82,000
Interest paid		(17,000)
Proceeds from issue of shares	W4	10,000
Redemption of debentures		(80,000)
Proceeds from sale of fixed assets	W5	30,000
Payments made to purchase fixed assets		(45,000)
Dividends paid	W6	(30,000)
Corporation Tax paid	W7	(8,000)
Increase in cash		(58,000)
Represented by:		
Decrease in bank balance	W8	(58,000)

2.Important of cashflows

Cash is of great importance to the survival of businesses.

The profit and loss account due to accruals, depreciation etc does not provide information regarding the cash movements of a business so on its own could be misleading.

Due to depreciation, stock valuation policies etc it is possible to manipulate the results in the P&L account. A cashflow statement is not as easily manipulated.

Many users of accounts find a cashflow statement easier to understand.

FRS 1 was introduced as it was felt an additional statement detailing the difference between cash and profit provided added value to the users of accounts.

Workings

				£
W1	Increase in retained earnings from balance sheet (44,000 - 20,000)			24,000
	Add Corporation Tax charge			14,000
	Add dividends for year			16,000
	Add interest charge			17,000
	Profit for year before taxation and interest			71,000
W2	Opening NBV of fixed assets			192,000
	Additions			45,000
	Disposals at NBV			(36,000)
				201,000
	Closing NBV of fixed assets			(170,000)
	Depreciation charge for year			31,000
		31/12/05	31/12/04	
W3	Increase in stock	22,000	14,000	8,000
	Decrease in trade debtors	47,000	52,000	(5,000)
	Decrease in trade creditors	11,000	34,000	(23,000)
W4	Increase in share capital	45,000	38,000	7,000
	Increase in share premium	26,000	23,000	3,000
	Proceeds from issue of shares			10,000

W5	NBV of assets disposed of	36,000
	Loss on disposal	(6,000)
	Proceeds from sale	30,000
W6	Proposed dividend brought forward	14,000
	Interim dividend paid in the year	16,000
	Total dividends paid in the year	30,000
W7	Corporation tax creditor at 31/12/04	6,000
	Tax charge for the year	14,000
	Corporation tax creditor at 31/12/05	(12,000)
	Corporation tax paid in year	8,000
W8	Bank overdraft at 31/12/05	(31,000)
	Cash at bank at 31/12/04	27,000
	Cash increase/(decrease)	(58,000)

Answer 4

1.

Proprietors capital account

		£			£
Balance c/f		30,000	Bank		30,000
			Balance b/f		30,000

Bank

		£			£
Proprietors capital account		30,000	Van		18,000
Debtors		69,900	Creditors		60,000
			Rent		3,600
			Rates		1,400
			Telephone		850
			Motor expenses		2,250
			Wages		4,800
			Drawings		4,500
			Balance c/f		4,500
		99,900			99,900
Balance b/f		4,500			

Van

		£			£
Bank		18,000	Balance c/f		18,000
Balance b/f		18,000			

Depreciation expense

		£			£
Provision for depreciation	W1	3,375	P&L account		3,375

Provision for depreciation

		£			£
Balance c/f		3,375	Depreciation expense	W1	3,375
			Balance b/f		3,375

Purchases

		£			£
Creditors		84,000	P&L account		84,000

Creditors

		£			£
Bank		60,000	Purchases		84,000
Balance c/f		24,000			
		84,000			84,000
			Balance b/f		24,000

Stock

		£			£
P&L account		21,000	Balance c/f	W2	21,000
Balance b/f		21,000			

Sales

		£			£
P&L account		81,900	Debtors	W2	81,900

Debtors

		£			£
Sales	W2	81,900	Bank		69,900
			Balance c/f		12,000
		81,900			81,900
Balance b/f		12,000			

Provision for doubtful debts

		£			£
Balance c/f		1,710	Bad debt expense	W3	1,710
			Balance b/f		1,710

Bad debt expense

		£			£
Provision for doubtful debts	W3	1,710	P&L account		1,710

Rent

		£			£
Bank		3,600	P&L account		5,400
Balance c/f		1,800			
		5,400			5,400
			Balance b/f		1,800

Rates

	£		£
Bank	1,400	P&L account	1,400

Telephone

	£		£
Bank	850	P&L account	850

Motor expenses

	£		£
Bank	2,250	Balance c/f	200
		P&L account	2,050
	2,250		2,250
Balance b/f	200		

Wages

	£		£
Bank	4,800	P&L account	5,150
Balance c/f	350		
	5,150		5,150
		Balance b/f	350

Drawings

	£		£
Bank £500 x 9	4,500	Balance c/f	4,500
Balance b/f	4,500		

W1	Depreciation	£
	£18,000 x 25% x 9/12	3,375
W2	Sales	
	Purchases	84,000
	Closing stock - £84,000 X 1/4	(21,000)
		63,000
	Mark up - £63,000 x 30%	18,900
	Sales	81,900
W3	Bad debts	
	Debtors	12,000
	Specific provision	(1,500)
		10,500
	General provision - £10,500 x 2%	210
	Total bad debt provision	1,710
W4	Prepaid motor expenses	
	£800 x 3/12	200
W5	Rent accrual	
	£600 x 3	1,800

2.

Mrs Warner
Profit and Loss account for 9 months ending 31 March 2006

		£	£
Sales			81,900
Less cost of sales:			
	Purchases	84,000	
	Less closing stock	(21,000)	
			(63,000)
Gross profit			18,900
Less expenses:			
	Rent	5,400	
	Rates	1,400	
	Telephone	850	
	Motor expenses	2,050	
	Wages	5,150	
	Depreciation	3,375	
	Bad debts	1,710	
			(19,935)
Net loss for the period			(1,035)

3.

Mrs Warner
Balance Sheet as at 31 March 2006

		Cost £	Depn £	£	£	£
Fixed Assets						
	Van	18,000	3,375			14,625
Current Assets						
	Stock				21,000	
	Debtors			12,000		
	Less provision for bad debts			(1,710)		
					10,290	
	Prepayments				200	
	Bank account				4,500	
					35,990	
Current Liabilities						
	Trade creditors				24,000	
	Accruals				2,150	
						9,840
						24,465
Financed by:						
	Capital introduced					30,000
	Loss for the period					(1,035)

Drawings	(4,500)
	24,465