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Business tax interactive worksheet

Adjustment of trading profits for the self-employed

In this module we will look at the key topics, work through a detailed example and give you the opportunity to attempt a practice question.

Key points

Make sure that you are familiar with the pro-forma adjustment of profits.

| | | |
|--|---|-----|
| | £ | £ |
| Net profit as per accounts | | X |
| Add expenses charged in the accounts that are not allowable as trading expenses | X | |
| | — | X |
| | | — |
| Less income included in the accounts which is not assessable as trading income | X | |
| | — | (X) |
| Adjusted profit/(loss) | | X |
| | | === |

Question practice will help you to learn how to identify disallowable expenditure and non-assessable income included in trading accounts. A summary of the important items is listed below:

Disallowed expenses

- Expenses that fail the remoteness test and so are not 'wholly and exclusively' for trading purposes.
- Fines on the business.
- Donations to national charities – might be allowed as a charge on income if Gift Aid donations. Political donations are never allowable.
- Capital expenditure (for example, purchase of equipment included in the Income Statement).
- Depreciation – capital allowances granted instead.
- Costs of bringing newly acquired second-hand assets to useable condition.
- Legal and professional expenses relating to capital items or breaking the law.
- Specific allowances for debtors (for example, bad debts) are allowable for tax purposes.
- Customer entertaining (staff entertaining can be allowable if less than £150 per head in a tax year).
- Customer gifts unless the gift incorporates business advertising, the cost is less than £50 per annum per customer and the gift is not food, drink, tobacco or cash vouchers.

Non-assessable income

- Income taxed in any other way (for example, interest or property income).
- Profits on sale of fixed assets.

Worked example

Harry is a self-employed plumber and prepares accounts annually to 30 April.
For the year ended 30 April 2014, his profit and loss account was as follows.

| | £ | £ |
|--|--------|----------------|
| Gross profit | | 256,000 |
| Bank Interest received | | 460 |
| Expenses: | | |
| Wages and salaries | 48,020 | |
| Advertising, promotions and entertaining | 2,896 | |
| Accountancy and legal costs | 2,250 | |
| Motor expenses | 33,300 | |
| Telephone, rent and office costs | 6,895 | |
| Depreciation | 12,750 | |
| Loss on sale of fixed assets | 896 | |
| | | <u>107,007</u> |
| Profit | | 149,453 |

The expenses include the following items:

| | | |
|----|---|---------|
| 1. | Wages and salaries | |
| | Harry's drawings | £20,000 |
| | Harry's wife's wages as receptionist | £8,750 |
| 2. | Advertising, promotion and entertaining | |
| | Christmas party for customers | £1,280 |
| 3. | Motor expenses | |
| | (of which 25% private) | |
| | Harry's motor expenses | £5,800 |
| 4. | Accountancy and legal costs | |
| | Trade debt collection fees | £225 |
| | Solicitor fees on purchase of premises | £550 |

Calculate Harry's adjusted trading profit for the year ended 30 April 2014.

The adjustment of profit pro-forma

| | £ | £ |
|---|--------|---------|
| Net profit as per accounts | | 149,453 |
| Add: | | |
| Drawings | 20,000 | |
| Customer entertaining – Christmas party | 1,280 | |
| Private motoring = £5,800 x 25% | 1,450 | |
| Legal fee – purchase of premises | 550 | |
| Depreciation | 12,750 | |
| Loss on sale of fixed asset | 896 | 36,926 |
| | | <hr/> |
| Less Bank interest received | | (460) |
| | | <hr/> |
| Adjusted profit/(loss) | | 185,919 |
| | | ===== |

Your pro-forma should start with the net profit, never the gross profit figure.

Run through the expenses and notes to pick up on items that need consideration as disallowable or non-assessable as trading income (see below).

Hint: It's easy to concentrate on the notes only and ignore the information provided in the profit and loss account. Easy marks are lost by failing to include items not in the notes but still disallowable, such as depreciation.

- Wages and salaries

| | | |
|--------------------------------------|---------|---|
| Harry's drawings | £20,000 | Disallow as not a business expense |
| Harry's wife's wages as receptionist | £8,750 | This wage is incurred wholly and exclusively for the business as a genuine business expense and so is allowable |
- Advertising, promotion and entertaining

| | | |
|-------------------------------|--------|---|
| Christmas party for customers | £1,280 | Customer entertaining is always disallowable, not to be confused with staff Christmas entertaining which can be allowable |
|-------------------------------|--------|---|
- Motor expenses (of which 25% private)

| | | |
|------------------------|--------|------------------------------------|
| Harry's motor expenses | £5,800 | 25% disallowable for private usage |
|------------------------|--------|------------------------------------|
- Accountancy and legal costs

| | | |
|--|------|-----------------------------------|
| Trade debt collection fees | £225 | Allowable as a business expense |
| Solicitor fees on purchase of premises | £550 | Disallowable as capital in nature |
- From the profit and loss account

| | | |
|------------------------|---------|----------------------------------|
| Depreciation | £12,750 | Disallowable |
| Loss on sale | £896 | Disallowable |
| Bank interest received | £460 | Non-assessable as trading income |

Practice question

Janet is self-employed and runs a bookstore. She prepares accounts annually to 31 March. For the year ended 31 March 2015, her profit and loss account was as follows.

| | £ | £ |
|--|------------|---------------|
| Gross profit | | 65,896 |
| Expenses: | | |
| Rent and rates | 21,856 | |
| Wages and salaries | 33,859 | |
| Advertising, promotions and entertaining | 1,852 | |
| Accountancy and legal costs | 857 | |
| Motor expenses | 5,658 | |
| Telephone, rent and office costs | 3,589 | |
| Depreciation | 8,750 | |
| Sundry | <u>250</u> | <u>76,671</u> |
| Loss | | (10,775) |

The expenses include the following items:

- Wages and salaries
Janet's drawings £15,000
- Advertising, promotion and entertaining
Staff Christmas party (for 5 staff) £650
- Motor expenses
Janet's motor expenses £3,200 (of which 80% private)
- Sundry
Gift-aid donation £150

Calculate Janet's adjusted trading profit/(loss) for the year ended 31 March 2015.

Hint: Put together the adjustment of profits pro-forma and then run through the profit and loss account and notes to identify disallowable expenses.



When you've attempted this question, you can check your answer by displaying the numerical solution and the key steps.

Click to display/hide the solution.

Adjustment of profit/(loss) for the year ended 31 March 2015

| | £ | £ |
|--|--------------|---------------|
| Net loss as per accounts | | (10,775) |
| Add: | | |
| Drawings | 15,000 | |
| Entertaining – staff Christmas party allowable as cost less than £150 per person | 0 | |
| Private motoring = £3,200 x 80% | 2,560 | |
| Donation – gift aid payment is a charge so is disallowed in the trading profit adjustment | 150 | |
| Depreciation | <u>8,750</u> | 26,460 |
| Less Non-assessable income (none) | | <u>0</u> |
| Adjusted profit | | <u>15,685</u> |

Note: It's important to be familiar with the pro-forma adjustment so you can deal with both adjustment of profits and adjustment of losses.