PREPARING FINAL ACCOUNTS: ADJUSTMENTS

1. Bad Debts and Allowance for Doubtful Debts – Receivables (Debtors)
2. Depreciation – Non-current Assets
3. Prepayments and Accruals – Revenues and Expenses

Bad debts, allowances for doubtful debts, and provisions for discounts on accounts receivable

Bad debts

- Many businesses sell on credit and there is therefore a risk that some customers will not pay for their goods and become a bad debt.

- When a debt is considered bad, the asset shown in the debtor's account is worthless and so eliminated.

- Bad debts are considered a business expense and are charged to the income statement as an expense.

Recording a bad debt

- Credit the debtor's account to remove the debt.

- Debit the bad debt account to increase the expense.

Recording a bad debt (Continued)

Exhibit 25.1

C. Bloom

2011			£	2011			£
Jan	8	Sales	520	Dec	31	Bad debts	520

R. Shaw

2011			£	2011			£
Feb	16	Sales	375	Aug	17	Cash	125
				Dec	31	Bad debts	250
			375				375

Bad Debts

2011			£	2011			£
Dec	31	C Bloom	520	Dec	31	Profit and loss	770
		R Shaw	250				
			770				770

Income Statement (extract) for the year ending 31 December 2011

	£
Gross profit	xxx
Less Expenses:	
Bad debts	(770)

Allowance for doubtful debts

- It is likely that some debts held by the business will prove to be bad debts.
- The prudence concept says that this possibility needs to be provided for in the current period.
- Therefore an allowance needs to be made in the current period for debts that might be bad by:
- **Debiting** the Profit and Loss account with the allowance

  Crediting the allowance for doubtful debts account

Creating an allowance for doubtful debts

Exhibit 25.3

At 31 December 2011, the accounts receivable figure after deducting bad debts was £10,000. It is estimated that 2 per cent of debts (i.e. £200) will eventually prove to be bad debts, and it is decided to make a provision for these. The accounts will appear as follows:

Profit and Loss

2011	£		
Dec 31 Allowance for doubtful debts	200		

Allowance for Doubtful Debts

		2011	£
		Dec 31 Profit and loss	200

In the financial statements, the allowance is shown as follows:

Income Statement (extract) for the year ending 31 December 2011

	£
Gross profit	xxx
Less Expenses:	
Allowance for doubtful debts	(200)

Statement of Financial Position (extract) as at 31 December 2011

Current assets	£	£
Accounts receivable	10,000	
Less Allowance for doubtful debts	(200)	
		9,800

As shown, in the statement of financial position, the balance on the allowance for doubtful debts is deducted from the accounts receivable total.

Increasing the allowance

To increase the allowance:

- Debit the profit and loss account with the increase in the allowance.
- Credit the allowance for doubtful debts account.

Increasing the allowance (Continued)

Exhibit 25.4

Profit and Loss

			£					
2012			£					
Dec	31	Allowance for doubtful debts	40					

Allowance for Doubtful Debts

2012			£	2012			£
Dec	31	Balance c/d	240	Jan	1	Balance b/d	200
				Dec	31	Profit and loss	40
			240				240
				2013			
				Jan	1	Balance b/d	240

Income Statement (extract) for the year ending 31 December 2012

	£
Gross profit	xxx
Less Expenses	
Allowance for doubtful debts (increase)	(40)

Statement of Financial Position (extract) as at 31 December 2012

Current assets	£	£
Accounts receivable	12,000	
Less Allowance for doubtful debts	(240)	
		11,760

Reducing the allowance

To reduce the allowance:

- **Debit** the allowance for doubtful debts account.
- **Credit** the profit and loss account.

Reducing the allowance (Continued)

Exhibit 25.5

Allowance for Doubtful Debts

2013			£	2013			£
Dec	31	Profit and loss	30	Jan	1	Balance b/d	240
	31	Balance c/d	210				
			240				240
				2014			
				Jan	1	Balance b/d	210

Profit and Loss

2013			£
Dec	31	Allowance for doubtful debts	30

Income Statement (extract) for the year ending 31 December 2013

	£
Gross profit	xxx
Add Reduction in allowance for doubtful debts	30

Statement of Financial Position (extract) as at 31 December 2013

Current assets	£	£
Accounts receivable	10,500	
Less Allowance for doubtful debts	(210)	
		10,290

Provisions for cash discounts on accounts receivable

- Some businesses create provisions for cash discounts to be allowed on the accounts receivable outstanding at year end.
- It is argued that the cost of discounts should be charged in the period when the sales were made.
- The procedure used is similar to that used for the allowance for doubtful debts.

provisions for cash discounts

Exhibit 25.7

Year ended 31 December	*Accounts receivable*	*Allowance for doubtful debts*	*Provision for cash discounts allowed*
	£	£	%
2010	4,000	200	2
2011	5,000	350	2
2012	4,750	250	2

Provision for Cash Discounts on Accounts Receivable

			£				£
2010				2010			
Dec	31	Balance c/d	76	Dec	31	Profit and loss	76
2011				2011			
Dec	31	Balance c/d	93	Jan	1	Balance b/d	76
				Dec	31	Profit and loss	17
			93				93
2012				2012			
Dec	31	Profit and loss	3	Jan	1	Balance b/d	93
		Balance c/d	90				
			93				93
				2013			
				Jan	1	Balance b/d	90

Income Statements (extracts) for the years ending 31 December

	£
Gross profits (2010, 2011 and 2012)	xxx
Less Expenses:	
(2010) Provision for cash discounts on accounts receivable	(76)
(2011) Increase in provision for cash discounts on accounts receivable	(17)
Add (2012) Reduction in provision for cash discounts on accounts receivable	3

Statements of Financial Position (extracts) as at 31 December

		£	£	£
2010	Accounts receivable		4,000	
	Less Allowance for doubtful debts	200		
	Provision for cash discounts on accounts receivable	76		
			(276)	
				3,724
2011	Accounts receivable		5,000	
	Less Allowance for doubtful debts	350		
	Provision for cash discounts on accounts receivable	93		
			(443)	
				4,557
2012	Accounts receivable		4,750	
	Less Allowance for doubtful debts	250		
	Provision for cash discounts on accounts receivable	90		
			(340)	
				4,410

Depreciation of non-current assets: nature and calculations

Depreciation of non-current assets

- Depreciation is the part of the original cost of a non-current asset that is consumed during its period of use by the business.
- Depreciation is charged to the profit and loss account each year.
- The amount charged is based on an estimate of how much economic usefulness has been used up in the accounting period.

Causes of depreciation

- Physical deterioration such as wear and tear through use or erosion and decay.
- Economic factors such as obsolescence or inadequacy.
- Time, where assets have a legal life fixed under a contract.
- Depletion, where the assets are of a wasting character.

Land and buildings

- Land is not depreciated because it has an unlimited useful life.

- Buildings are depreciated over their useful life because they can fall into disrepair or become obsolete.

Depreciation methods – straight line

Straight line depreciation is calculated as the cost of the asset, minus the estimated disposal value, divided by the number of expected years of use.

$$\frac{\text{Cost (£22,000)} - \text{Estimated disposal value (£2,000)}}{\text{Number of expected years of use (4)}} = \frac{\text{£20,000}}{4}$$

$= £5,000$ depreciation each year for four years.

Depreciation methods – reducing balance

Reducing balance depreciation is calculated using a fixed percentage, on the net value of the asset.

	£
Cost	10,000
First year: depreciation (20%)	(2,000)
	8,000
Second year: depreciation (20% of £8,000)	(1,600)
	6,400
Third year: depreciation (20% of £6,400)	(1,280)
Cost not yet apportioned, end of Year 3	5,120

Choice of method

- The method chosen should be the one that allocates the cost to each period in accordance with the overall economic benefit from the use of the asset.
- Therefore, if more benefit is derived from the asset in early years, then the reducing balance method is more appropriate.
- However, if benefits are spread equally over the years, the straight line method is suitable.

Other methods of depreciation

- The **revaluation method**, where items are valued each year and the difference charged as depreciation.
- The **depletion** unit method, where a charge is made dependent upon how much of the asset has been used up.
- The **machine hour method**, where a charge is made dependent on how many hours the machine has worked for.

Other methods of depreciation (Continued)

- The **sum of the years' digits** method, where a proportion is charged on the basis of the life of the asset.

- The **units of output** method which charges according to the proportion of units produced, compared to the total units expected to be achieved.

Recording depreciation

To record depreciation:

- The asset is maintained at its cost in the ledger account.
- Another ledger account is opened, to record the depreciation to date – the accumulated provision for depreciation account.
- The depreciation charge for the year is debited to the profit and loss account.

Recording depreciation (Continued)

A business has a financial year end of 31 December. A computer is bought for £2,000 on 1 January 2008. It is to be depreciated at the rate of 20% using the reducing balance method.

Recording depreciation (Continued)

Computer

			£				£
2008			£				
Jan	1	Cash	2,000				

Accumulated Provision for Depreciation: Computer

			£				£
2008			£	2008			£
Dec	31	Balance c/d	400	Dec	31	Profit and loss	400
2009				2009			
Dec	31	Balance c/d	720	Jan	1	Balance b/d	400
				Dec	31	Profit and loss	320
			720				720
2010				2010			
Dec	31	Balance c/d	976	Jan	1	Balance b/d	720
				Dec	31	Profit and loss	256
			976				976
				2011			
				Jan	1	Balance b/d	976

Profit and Loss

			£		
2008			£		
Dec	31	Acc Provn for Depn: Computer	400		
2009					
Dec	31	Acc Provn for Depn: Computer	320		
2010					
Dec	31	Acc Provn for Depn: Computer	256		

Income Statement (extracts) for the years ending 31 December

		£
2008	Depreciation	400
2009	Depreciation	320
2010	Depreciation	256

Note: In this case, the depreciation for the period being entered in the income statement is being described as 'depreciation' and *not* by the name of the account it originated from (the accumulated provision for depreciation account).

Statements of Financial Position (extracts)

	£	£
As at 31 December 2008		
Computer at cost	2,000	
Less Accumulated depreciation	(400)	
		1,600
As at 31 December 2009		
Computer at cost	2,000	
Less Accumulated depreciation	(720)	
		1,280
As at 31 December 2010		
Computer at cost	2,000	
Less Accumulated depreciation	(976)	
		1,024

Accruals and prepayments and other adjustments for financial statements

The financial statements

- The financial statements need to contain the expenditure relating to the period.
- Therefore, if expenditure is owing or has been overpaid, an adjustment is needed.

The financial statements (Continued)

Example – Two businesses are renting buildings and are charged £6,000 per year.

Business A pays £5,000 in the year. It therefore owes £1,000, but the rent expense in the income statement must be shown as £6,000.

Business B pays £6,500 in the year. It has therefore overpaid £500, but the rent expense in the income statement must be shown as £6,000.

Accrued expenses

Rent of £4,000 per year as payable at the end of every three months. The rent was paid on time in March, but this is not always the case.

Amount	Rent due	Rent paid
£1,000	31 March 2011	31 March 2011
£1,000	30 June 2011	2 July 2011
£1,000	30 September 2011	4 October 2011
£1,000	31 December 2011	5 January 2012

Accrued expenses (Continued)

The rent for the last quarter was paid on 5 January, which is after year end, so the books will appear as:

Rent

2011			£	
Mar	31	Cash	1,000	
Jul	2	Cash	1,000	
Oct	4	Cash	1,000	

Accrued expenses (Continued)

The true rent figure for the year must be shown in the profit and loss account

Rent

2011			£	2011			£
Mar	31	Cash	1,000	Dec	31	Profit and loss	4,000
Jul	2	Cash	1,000				
Oct	4	Cash	1,000				

Accrued expenses (Continued)

The accrued rent expense must be shown on the rent account

Rent

2011			£	2011			£
Mar	31	Cash	1,000	Dec	31	Profit and loss	4,000
Jul	2	Cash	1,000				
Oct	4	Cash	1,000				
Dec	**31**	**Accrued c/d**	**1,000**				
			4,000				4,000
				2012			
				Jan	1	Accrued b/d	1,000

Prepaid expenses

Insurance for a business is at the rate of £840 a year, starting from 1 January 2011. The business has agreed to pay this at the rate of £210 every three months. However, payments were not at the correct times.

Amount	Insurance due	Insurance paid
£210	31 March 2011	£210 28 February 2011
£210 £210	30 June 2011 30 September 2011	£420 31 August 2011
£210	31 December 2011	£420 18 November 2011

Prepaid expenses (Continued)

The insurance has been paid at odd times, and so when the correct figure is taken to the profit and loss account, the books will appear as:

Insurance

2011			£	2011			£
Feb	28	Bank	210	Dec	31	Profit and loss	840
Aug	31	Bank	420				
Nov	18	Bank	420				

Prepaid expenses (Continued)

The prepaid insurance expense must be shown on the insurance account:

Insurance

2011			£	2011			£
Feb	28	Bank	210	Dec	31	Profit and loss	840
Aug	31	Bank	420		**31**	**Prepaid c/d**	**210**
Nov	18	Bank	420				
			1,050				1,050
2012							
Jan	1	Prepaid b/d	210				

Revenue owing at the end of period

Revenue owing for sales is already shown in the books as the debit balances on customers' accounts but there may be other kinds of revenue which may not have been received at the end of the period.

Revenue owing at the end of period (Continued)

Our warehouse is larger than we need and so we rent part of it to another business for £1,800 per annum.

Amount	Rent due	Rent received
£450	31 March 2011	4 April 2011
£450	30 June 2011	6 July 2011
£450	30 September 2011	9 October 2011
£450	31 December 2011	7 January 2012

Revenue owing at the end of period (Continued)

The rent receivable account will appear as:

Rent Receivable

	2011			£
	Apr	4	Bank	450
	Jul	6	Bank	450
	Oct	9	Bank	450

Revenue owing at the end of period (Continued)

Once the correct figure has been transferred to the profit and loss account, the accrued revenue must be shown in the rent receivable account:

Rent Receivable

2011			£	2011			£
Dec	31	Profit and loss	1,800	Apr	4	Bank	450
				Jul	6	Bank	450
				Oct	9	Bank	450
				Dec	**31**	**Accrued c/d**	**450**
			1,800				1,800
2012							
Jan	1	Accrued b/d	450				

The statement of financial position

The part of the statement of financial position in respect of the accounts so far seen is therefore:

Statement of Financial Position as at 31 December 2011 (extract)

	£	£
Current assets		
Inventory	xxx	
Accounts receivable	450	
Prepayments (400 + 210)	610	
Bank	xxx	
Cash	xxx	
⋮		x,xxx
Current liabilities		
Trade accounts payable	xxx	
Accrued expenses	1,000	
		(x,xxx)

Expense accounts covering more than one period

- It is more likely that there will be opening accruals and prepayments on an account.

- This really tests your knowledge of double entry bookkeeping and you will have to distinguish between accruals and prepayments and the beginning and the end of the year.

Activity

(A) On 31 December 2010, three months' rent amounting to a total of £3,000 was owing.

(B) The rent chargeable per year was £12,000.

(C) The following rent payments were made in the year 2011: 6 January, £3,000; 4 April, £3,000; 7 July, £3,000; 18 October, £3,000.

(D) The final 3 months' rent for 2011 is still owing.

Activity (Continued)

Rent

2011				£	2011				£
Jan	6	Bank	(C)	3,000	Jan	1	Accrued b/d	(A)	3,000
Apr	4	Bank	(C)	3,000	Dec	31	Profit and loss	(B)	12,000
Jul	7	Bank	(C)	3,000					
Oct	18	Bank	(C)	3,000					
Dec	**31**	**Accrued c/d**	**(D)**	**3,000**					
				15,000					15,000
					2012				
					Jan	1	Accrued b/d		3,000

Extended trial balances

- An extended trial balance is a worksheet for drafting a set of financial statements.
- It is very useful when there are a lot of adjustments to be made.
- The trial balance is extracted from the ledgers and the adjustments are made against this.
- The financial statements are then worked out across the page.

An extended trial balance

Exhibit 28.2

JOHN BROWN WORKSHEET See Review Question 28.11	Trial Balance 1 Dr	 2 Cr	Adjustments 3 Dr	 4 Cr	Trading Account 5 Dr	 6 Cr	Profit and Loss Account 7 Dr	 8 Cr	Balance Sheet 9 Dr	 10 Cr
Sales		400,000				400,000				
Purchases	350,000				350,000					
Sales returns	5,000				5,000					
Purchases returns		6,200				6,200				
Inventory 1.1.2013	100,000				100,000					
Allowance for doubtful debts		800		180 (*iv*)						980
Wages and salaries	30,000		5,000 (*ii*)				35,000			
Rates	6,000			500 (*iii*)			5,500			
Telephone	1,000		220 (*v*)				1,220			
Shop fittings	40,000			4,000 (*vi*)					36,000	
Van	30,000			6,000 (*vi*)					24,000	
Accounts receivable	9,800								9,800	
Accounts payable		7,000								7,000
Bad debts	200						200			
Capital		179,000								179,000
Bank	3,000								3,000	
Drawings	18,000								18,000	
	593,000	593,000								
Inventory 31.12.2013 – Asset			120,000 (*i*)						120,000	
Inventory 31.12.2013 – Cost of goods sold				120,000 (*i*)		120,000				
Accrued expenses				5,000 (*ii*)						5,000
				220 (*v*)						220
Allowance for doubtful debts			180 (*iv*)				180			
Prepaid expenses			500 (*iii*)						500	
Depreciation shop fittings			4,000 (*vi*)				4,000			
Depreciation van			6,000 (*vi*)				6,000			
			135,900	135,900						
Gross profit (balancing figure)					71,200			71,200		
					526,200	526,200				
Net profit (balancing figure)							19,100			19,100
							71,200	71,200	211,300	211,300