BUS7C2 Finance and Accounting for Business

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Lecture 4: Adjustments for Financial Statement

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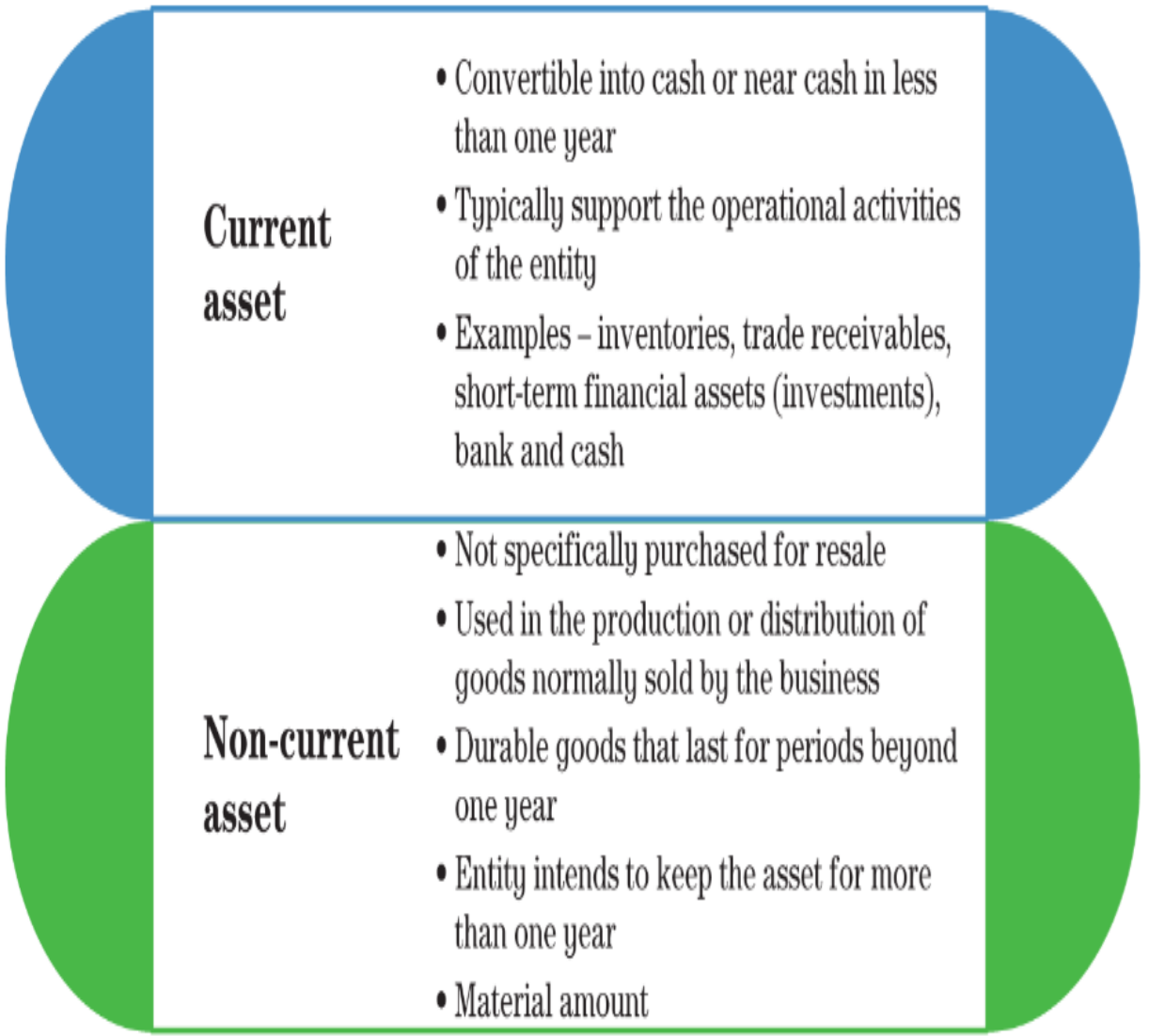
Learning Objective

At the end of this lecture; students will:

1. **Critically evaluate** the impact of different depreciation methods on an entity's reported profit and asset values.
2. **Justify** the accounting treatments for irrecoverable and doubtful debts by applying the concept of prudence.
3. **Appraise** the application of the accruals concept in the treatment of prepayments, accruals, and deferred income.
4. **Formulate** the journal entries required for year-end adjustments for depreciation, irrecoverable and doubtful debts, prepayments and accruals

The nature of non-current assets



Non-current assets:

assets that are purchased with the intention of long term use within the business -property, plant and equipment.

Classification of Non-Current Assets

~ Tangible Assets

- assets which have a tangible, physical form
- e.g., land, buildings, machinery, cars, computers, etc.
- Governed by **IAS 16 - Property, Plant and Equipment (PPE)**

~ Intangible Assets

- assets for long-term use in the business that have no physical form,
- e.g., patents, licenses and goodwill.
- Governed by **IAS 38 - Intangible Assets**

~ Financial Assets

- assets that derive value from a potential claim (i.e. for more than one year)
- e.g. subsidiaries, joint ventures, shares, debentures held, long-term loan
- Governed by **IFRS 9 - Financial Instruments**

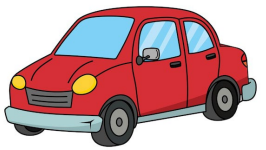
- Non-current assets can be acquired via cash, credit, loans, or leases; leased assets are **right-of-use assets**.
- PPE cost includes purchase price, delivery, taxes, irrecoverable VAT, installation, professional fees, and testing.
- Additional capital expenditure may be added if it enhances or restores consumed benefits.

- Purchase price of PPE may be partly settled through **part exchange** of an old asset.
- All tangible non-current assets, **except freehold land**, have a finite useful life.
- Many PPE items have a **residual value** at the end of their useful lives.
- **Depreciation** spreads the cost of PPE, less residual value, over its useful life.

Depreciation

Depreciation: The systematic allocation of the cost of an asset, less its residual value, over its **useful life**.

- **Expenses** for a period should reflect the **depreciation cost** of consumed non-current assets.
- To **calculate the depreciation charge** for a reporting period, the following factors are relevant:
  - asset cost
  - useful life
  - residual value



Economic life: The total period over which an asset is expected to be economically usable by one or more users.

Useful life: The estimated period for which an item of PPE is expected to be available for use to a business.

The economic life of an asset may be longer than its useful life

Residual value is the expected disposal proceeds.

Depreciation represents the **economic benefits consumed** from a tangible non-current asset during the period.

Consumption includes **wearing out, using up, or reduction** in useful life.

Causes of consumption:

- **Usage** over time.
- **Effluxion of time** (natural aging or deterioration).
- **Obsolescence** due to:
  - Technological advancements
  - Price fluctuations.
  - Changes in demand for goods/services produced by the asset.

A well-maintained car may have an **economic life** of ten years or more, but if an entity has a policy of replacing its cars every four years, the **useful life** of the car to the entity will be four years.

Methods of Calculating Depreciation; Misconceptions

Straight Line vs Declining Balance (DDB)

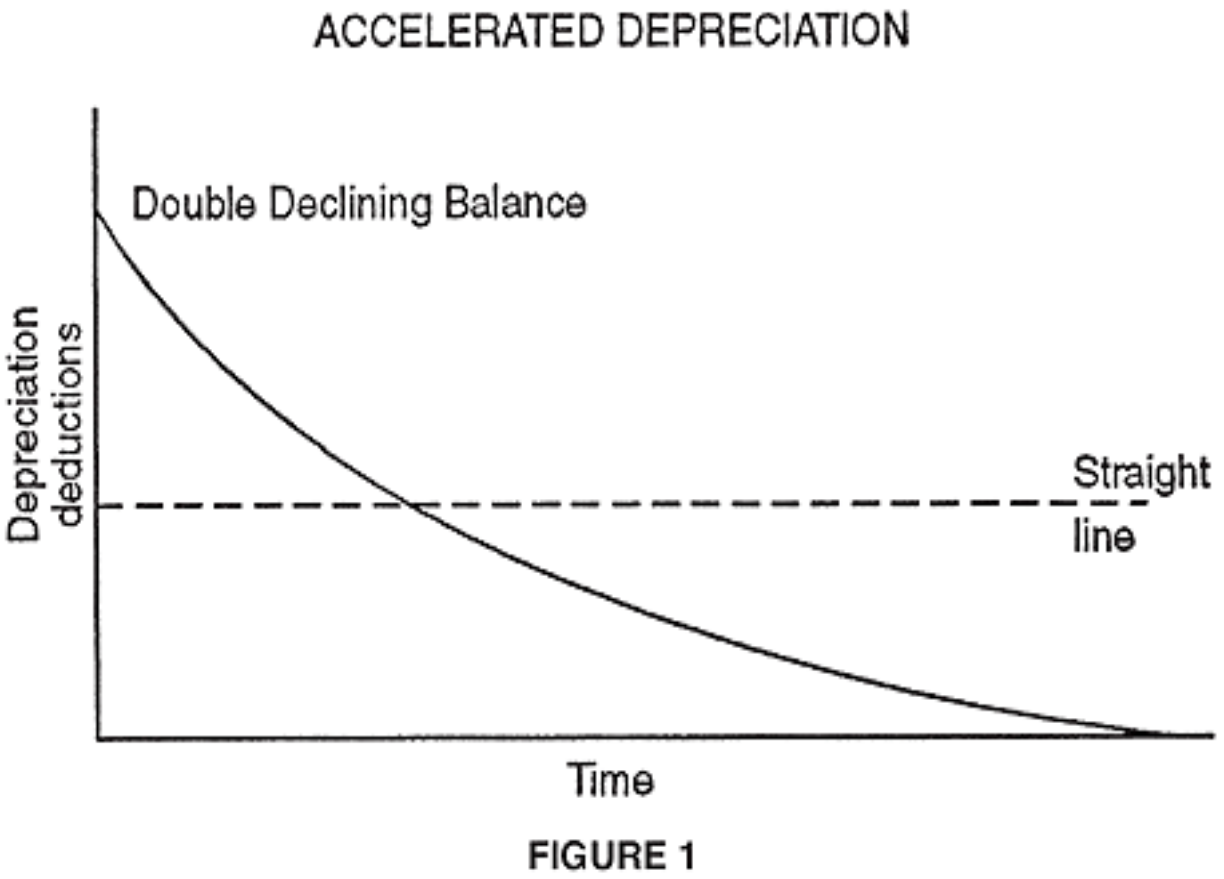


FIGURE 1

Common Depreciation Misconceptions

1. It does **not reflect the fall in value** of an asset over its life.
2. It is not ***'setting aside money'*** to replace the asset at the end of its useful life.

3. Even if the asset was not going to be replaced, its **cost should still be allocated** over its useful life.

Calculating Depreciation

Straight Line (SL) Depreciation

$$\text{Depreciation Per Year Formula} = \frac{(\text{Cost of Asset} - \text{Salvage Value})}{\text{Useful Life of Asset}}$$

Declining Balance (DB) Depreciation

Declining Balance Depreciation Rate

$$\text{DB Rate} = 1 - \sqrt[\text{Years}]{\frac{\text{Salvage value}}{\text{Cost}}}$$

Calculating Depreciation : Example

Rhys purchased equipment with a value of £10,000 and expects it to have a useful life of 4 years and an estimated salvage value of £1,296.

1. Calculate the DB rate using the previous formula.
2. What are the DB depreciation for the 4 years?

$$\text{Rate} = 1 - \sqrt[\text{Years}]{(\text{Salvage value} / \text{Cost})}$$

$$\text{Rate} = 1 - \sqrt[4]{(1{,}296 / 10{,}000)} = 40\%$$

Calculating Depreciation : Example

Declining Balance Depreciation

Year	Opening	Depreciation	Closing	Calculation
1	10,000	4,000	6,000	40% of 10,000
2	6,000	2,400	3,600	40% of 6,000
3	3,600	1,440	2,160	40% of 3,600
4	2,160	864	1,296	40% of 2,160

PROS

1. Suitable for assets that deteriorate more in early years (e.g. **plant & machinery, motor vehicles, office equipment**).
2. Also, applicable when **utilisation remains consistent** each year.
3. **Declining depreciation** and **rising repair costs** create a stable annual expense.
4. Provides a **realistic reflection** of resale value reduction.

CONS

1. It contains an **arbitrary** assumption about the rate of decline.
2. It is relatively **complex.**

Calculating Depreciation : Example

Rhys purchased equipment with a value of £10,000 and expects it to have a useful life of 4 years and an estimated salvage value of £1,296.

1. Calculate the SL depreciation per year.
2. What are the SL depreciation for the 4 years?

$$\frac{£10{,}000 - £1{,}296}{4} = \$2{,}176 \text{ per year}$$

Calculating Depreciation : Example

Year	Opening	Depreciation	Closing
1	10,000	2,176	7,824
2	7,824	2,176	5,648
3	5,648	2,176	3,472
4	3,472	2,176	1,296

PROS

1. It is most appropriate for **assets that are depleted** as a result of the passage of time (e.g. buildings, leases, patents).
2. It may be suitable where an asset's utilisation is the same in each year (e.g. plant & machinery, vehicles).
3. **It is easy to understand** and simple to calculate.

CONS

1. It may not give an **accurate measure of the loss in value or reduction in useful life** (e.g. the large decrease in resale value of vehicles in the first year of their life).

Accounting For Depreciation (Financial Statement Extract)

Depreciation Expense Account (SPL)					
Date	**Details**	**Amount £**	**Date**	**Details**	**Amount £**
Yr 1	Acc. Depr.	4,000	Yr 1	SPL	4,000
Yr 2	Acc. Depr.	2,400	Yr 2	SPL	2,400
Yr 3	Acc. Depr.	1,440	Yr 3	SPL	1,440
Yr 4	Acc. Depr.	864	Yr 4	SPL	864

Accumulated Depreciation Account (SFP)					
Date	**Details**	**Amount £**	**Date**	**Details**	**Amount £**
Yr 1	Bal c/d	4,000	Yr 1	Depr. Exp.	4,000
			Yr 2	**Bal b/d**	**4,000**
Yr 2	**Bal c/d**	**6,400**	Yr 2	Depr. Exp.	2,400
			Yr 3	**Bal b/d**	**6,400**
Yr 3	**Bal c/d**	**7,840**	Yr 3	Depr. Exp.	1,440
			Yr 4	**Bal b/d**	**7,840**
Yr 4	**Bal c/d**	**8,704**	Yr 4	Depr. Exp.	864
			Yr 5	**Bal b/d**	**8,704**

DEBIT - Depreciation Expense (statement of profit or loss) £XXX

CREDIT - Accumulated Depreciation (statement of financial position) £XXX

Statement of Financial Position (Extract)

	Yr 1	Yr 2	Yr 3	Yr 4
Equipment (cost)	10,000	10,000	10,000	10,000
Accumulated Depreciation	4,000	6,400	7,840	8,704
Equipment (carrying amount)	6,000	3,600	2,160	1,296

Asset Register

1. **A Comprehensive listing** of all non-current assets.
2. **Categorized by** department, location, or asset type.
3. **Includes non-financial data** (e.g., chassis numbers, model number, batch number).
4. **Contains financial details** for tracking asset values.

Data Kept in an Asset Register

- Internal reference number (for physical identification purposes)
- Manufacturer's serial number (for maintenance purposes)
- Description of asset
- Location of asset
- Department which uses the asset
- Purchase / lease commencement date (for calculation of depreciation)
- Cost, and any enhancement expenditure
- Depreciation method and estimated useful life (for calculation of depreciation)
- Carrying amount

Irrecoverable and Doubtful Debts

Prudence

degree of caution in the adoption of accounting policies and estimates. Ensures that profits and assets are not overstated, while losses and liabilities are recognized as soon as they are likely

- The **prudence concept** requires recognising expected losses as soon as they are identified.
- If a **debt is doubtful**, the asset's value must be **adjusted down** in the accounts.
- Ensures assets and income are **not overstated**, and liabilities are **not understated**.

- **Irrecoverable debt (Bad Debt)**:
  - Believed to be **unrecoverable**.
  - Fully **removed from the ledger** and the financial statements (SFP).
- **Doubtful debt**:
  - Settlement is **uncertain** but possible.
  - Recognised with an **allowance**, not written off.
  - Remains **outstanding** while efforts continue for collection.

There are two main types of allowances for doubtful debts

- **Specific allowance** – calculated by reference to a particular invoice or trade receivables' balance.
- **General allowance** – this is an allowance against trade receivables as a whole normally expressed as a percentage of the trade receivables balance.

Accounting for Doubtful Debts - Example

Accounting for Doubtful Debts

Debit : Allowance for Doubtful Debts Adjustment a/c (SPL)

Credit : Allowance for Doubtful Debts a/c (SFP)

- Items in the **statement of financial position** are carried forward to the next period.
- The **allowance for doubtful debts (SFP)** may have a **brought-forward balance**.
- Adjustments may be needed, as the allowance typically **changes each year**.

Shauna has trade receivables at her year-end of £25,000. There is concern about whether £5,000 of this will be settled.

Required:

Prepare the journal entries to account for this doubtful debt

Dr Allowance for doubtful debts adjustment (SPL)

£5,000

Cr Allowance for doubtful debts (SFP) **£5,000**

Mina has trade receivables at the year-end of £50,000. There is an allowance for doubtful debts brought forward of £8,000. She feels that in this accounting period the allowance should be increased to £10,000.

Required:

Prepare the journal entries to account for the increase in the allowance.

Dr Allowance for doubtful debt adjustment (SPL) **£2,000** (£10,000 – £8,000)

Cr Allowance for doubtful debt (SFP) **£2,000**

Accounting for Irrecoverable Debts - Example

Accounting for Irrecoverable Debts

Debit : Irrecoverable Debt Expense a/c (SPL)

Credit : Trade Receivable a/c (SFP)

Sherry has trade receivables at her year-end of £20,000.

Adam, a customer owing £3,500 has been declared bankrupt. She received a letter from the administrator that Adam's debt will not be paid.

Required:

Prepare the journal entries to account for this debt

Dr Irrecoverable Debt Expense a/c (SPL) **£3,500**

Cr Trade Receivable a/c (SFP) **£3,500**

A business has trade receivables of £712,000 of which £32,000 are to be written off as irrecoverable debts.

Of the remainder, a specific allowance is to be made against a debt of £4,000 and a general allowance of 4% is required against the remaining trade receivables.

The opening balance on the allowance for doubtful debts account is £24,000.

Required:

Prepare the journal entries for the irrecoverable and doubtful debts.

Accounting for Irrecoverable and Doubtful Debts : *Example*

	£
Trade receivables	**712,000**
Irrecoverable debts	(32,000)
Specific allowance	(4,000)
Net Receivables to Calculate General Allowance	**676,000**
General allowance (£676,000 × 4%)	27,040
Specific allowance	4,000
Total Allowance (Doubtful Debt) required for the period	**31,040**
Opening Balance : Allowance for Doubtful Debt	(24,000)
Allowance for Doubtful Debt Adjustment (Increase) for the Period (A)	**7,040**
Irrecoverable Debt for the Period (B)	**32,000**

Accounting for Doubtful Debts (A)

Debit : Allowance for Doubtful Debts Adjustment a/c (SPL) **£7,040**

Credit : Allowance for Doubtful Debts a/c (SFP) **£7,040**

*This increases the balance on the "Allowance for Doubtful Debts a/c" from **£24,000** to **£31,040***

Accounting for Irrecoverable Debt (B)

Debit : Irrecoverable Debt Expense a/c (SPL) **£32,000**

Credit : Trade Receivable a/c (SFP) **£32,000**

Accruals and Prepayments

- **Accruals concept** governs profit or loss and financial position statements.
- **Income** recorded when **earned**, regardless of cash receipt.
- **Expenditure** recorded when **incurred**, regardless of payment status.
- Applies to **sales, purchases, and other income/expenses**.

Accrual Basis

Transactions should be recorded in the financial statements for the period they occur, with income recognized when earned and expenses when incurred, regardless of cash flow timing.

Accrued expense
an expense that has been incurred in the current accounting period, which has not yet been paid for.

Prepaid expense
a payment made in advance for an expense that relates to a period following the current accounting period.

Accounting for an Accrued Expense

Debit : Expense* a/c (SPL)

Credit : Accrued Expenses a/c (Current Liability in SFP)

**Will depend on the expense that the accrual relates to e.g. rent, electricity or gas.*

Accounting for a Prepared Expense

Debit : Prepaid Expense a/c (Current Asset in SFP)

Credit : Expenses* a/c (SPL)

**Will depend on the expense that the accrual relates to e.g. rent, electricity or gas.*

Accruals and Prepayments : Examples

A business has a year-end of 31 December 2008. The last phone bill received and paid during the year covered the period to 31 October 2008.

Post year-end an invoice that covered November, December 2008 and January 2009 was received. The phone charge for that period was £600.

Required:

Calculate the year-end accrual for the phone expense

Solution

If £600 is equal to 3 months of telephone expense, we can estimate that 2 months is £400.

(£600/3 months = £200 per month, £200 will then be multiplied by 2 to represent 2 months, equalling £400).

The year year-end accrual for November and December 2008 = £400

Andrews's year-end is 31 December 2008.

The bank summary for premises insurance shows that Andrew paid £1,500.

This was to cover the period 1 January 2008 to 31 March 2009.

Required:

Calculate the prepayment as at 31 December 2008.

Solution

The full payment amount is £1,500 which relates to 15 months, 3 months' worth can be calculated at £300.

(£1,500/15 months = £100 per month, £100 will then be multiplied by 3 to represent 3 months, equalling £300).

The prepayment as at 31 December 2008 (Jan – Mar 2009) = £300

Accruals and Prepayments : Examples

Accounting for an Accrued Expense

Debit : Expense (Telephone) a/c (SPL) : £400

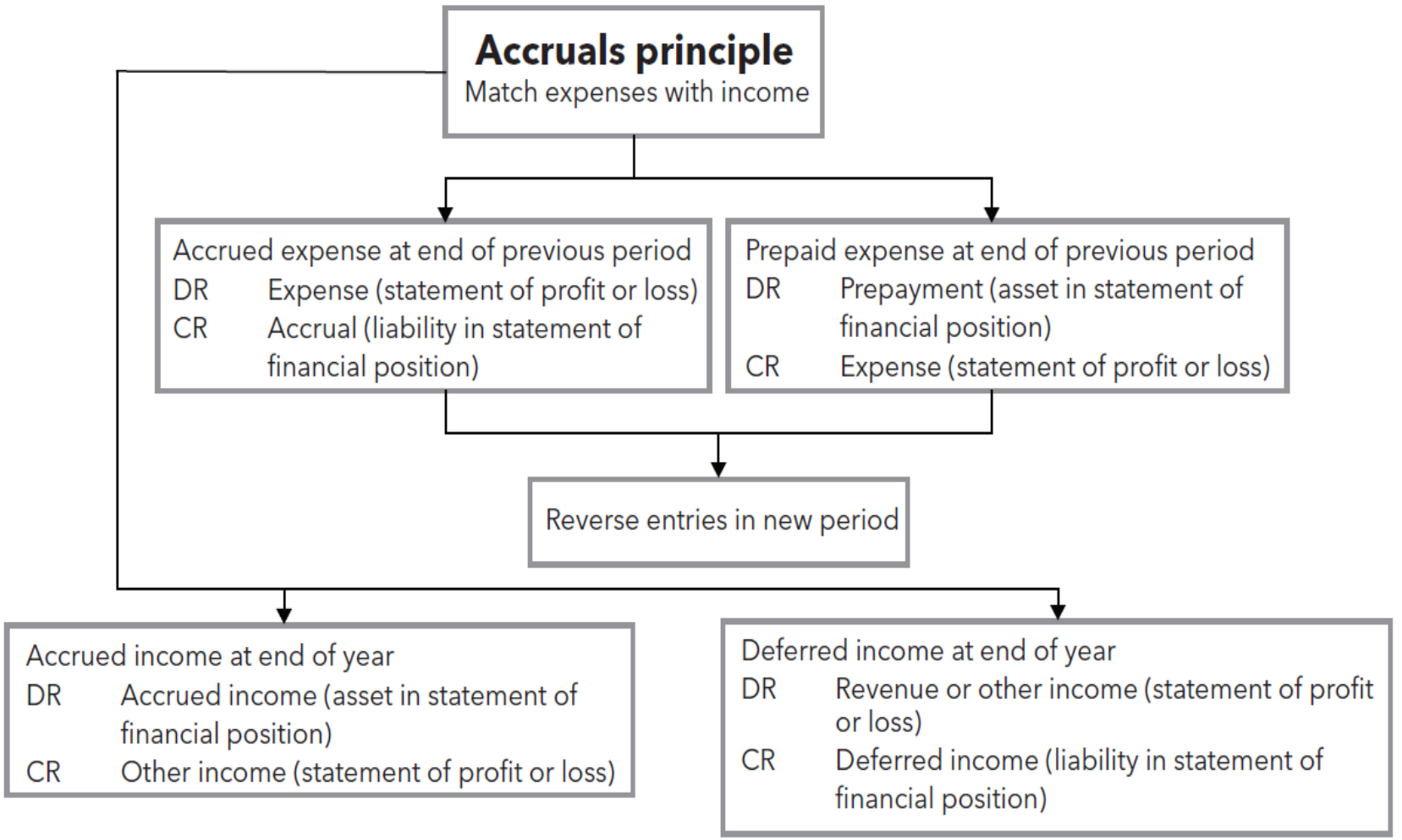
Credit : Accrued Expenses a/c (Current Liability in SFP) : £400

Accounting for a Prepared Expense

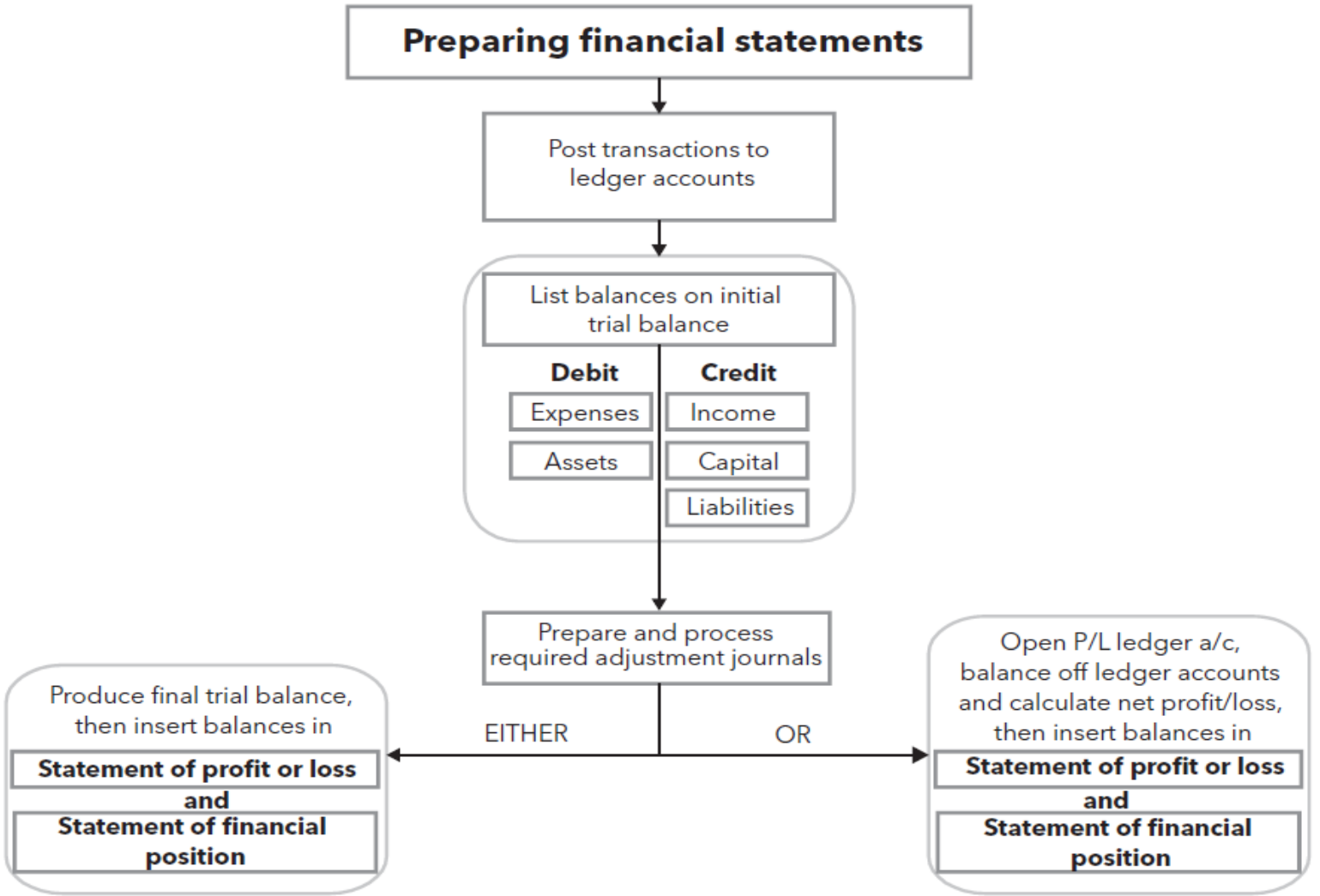
Debit : Prepaid Expense a/c (Current Asset in SFP) : £300

Credit : Expenses (Insurance) a/c (SPL) : £300

- ❑ The accrual principle also applies to income.
- ❑ Accrued income arises when receipt of income (such as rent or subscription) is in arrears at the
- ❑ end of the reporting period.
- ❑ Deferred income arises when income has been received in advance at the end of the reporting
- ❑ period, so it needs to be carried forward and treated as income of the following reporting period.


Accruals principle
Match expenses with income
Accrued expense at end of previous period
DR Expense (statement of profit or loss)
CR Accrual (liability in statement of financial position)
Prepaid expense at end of previous period
DR Prepayment (asset in statement of financial position)
CR Expense (statement of profit or loss)
Reverse entries in new period
Accrued income at end of year
DR Accrued income (asset in statement of financial position)
CR Other income (statement of profit or loss)
Deferred income at end of year
DR Revenue or other income (statement of profit or loss)
CR Deferred income (liability in statement of financial position)

Preparing Financial Statements : Summary



Thank you, very much!

Any questions?

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