

UNIT SIX

THEORY

ACCOUNTING
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Unit 6 | Sole Proprietorship Accounts

- Importance of financial statements of a sole proprietorship business
- Income Statement and Statement of Financial Position

6.2 | Adjustments when preparing the financial statements

- Accrued expenses and Prepaid expenses
- Income receivable and Income received in advance
- Bad and Doubtful debts
- Depreciation (straight line and reducing balance)
- Stocks (stock damages, stock donations, stock on sale or return basis)
- Value Added Tax (VAT)
- EPF (Employee Provident Fund) and ETF (Employee Trust Fund)

Double entries for the adjustments

	Adjustment	Double entry		
1	Closing stock	Closing stock a/c Trading a/c / Income Statement	Debit	Credit
2	Drawings of goods	Drawings a/c Purchases a/c	Debit	Credit
3	Donations of goods	Donations of goods a/c Purchases a/c	Debit	Credit
4	Accrued expenses	Relevant expense a/c Accrued expenses a/c	Debit	Credit
5	Accrued income	Accrued Income a/c Relevant income a/c	Debit	Credit
6	Prepaid expenses	Prepaid expenses a/c Relevant expense a/c	Debit	Credit
7	Income received in advance	Relevant income a/c Income received in advance a/c	Debit	Credit
8	Bad debts	Bad debts a/c Debtors Control a/c	Debit	Credit
9	Provision for doubtful debts	Doubtful debts a/c Provision for doubtful debts a/c	Debit	Credit
10	Depreciation of property & plant	Depreciation a/c Accumulated depreciation a/c	Debit	Credit

Accrued expenses

Any expense that is relevant to the current accounting period but which has not yet been paid is known as accrued expense (it is treated as a current liability).

Expense paid in cash + Accrued expense
= Annual expense

DR Relevant expense account
CR Accrued expense account

Prepaid expenses

Payments made in excess over the expense that is relevant to the current accounting period is known as prepaid expense (it is treated as a current asset).

Expense paid in cash - Prepaid expense
= Annual expense

DR Prepaid expense account
CR Relevant expense account

Income receivable (accrued income)

Any income that is relevant to the current accounting period but which has not yet been received is known as income receivable (it is treated as a current asset).

Income received in cash + Income receivable
= Annual income

DR Income receivable account
CR Relevant income account

Income received in advance (pre-received income)

Income received which is relevant to the next accounting period is known as income received in advance (it is treated as a current liability).

Income received in cash – Income received in advance = Annual income

*DR Relevant income account
CR Income received in advance account*

Bad debts

- A bad debt is an expense that a business incurs when it cannot recover the money from trade debtors.
- It is a contingency that must be accounted for by all businesses who extend credit to customers, as there is always a risk that payment will not be received.
- To comply with the matching principle, bad debt expense must be estimated using the allowance method in the same period in which the sale occurs.

Reasons for bad debts:

- Death of the debtor
- Insolvency/bankruptcy of debtor
- Negligence of debtor

Journal entry:

*DR Bad debts account
CR Debtors control account*

Presentation in the financial statements**Income statement:**

- Record bad debts expense under Distribution expenses

Statement of Financial Position:

- Reduce the Debtors account under Current assets

Recovery of bad debts

- Bad debt recovery is a payment received for a debt that was written off and considered uncollectible. Since bad debts incur an expense when written off, bad debt recovery is considered an income.
- The accounting for bad debt recovery is a 2-step process:
 1. Reverse the original recording of the bad debt
*DR Debtors control account
CR Bad debts account*
 2. Record the cash receipt from the bad debt recovery
*DR Cash control account
CR Debtors control account*
- The accounting for bad debt recovery if it was written off in the previous year:
*DR Cash control account
CR Bad debts recovered account*

Doubtful debts

- Doubtful debts are those debts which a business or individual is unlikely to be able to collect. Reasons for potential non-payment can include disputes over supply, condition of the item, or financial stress in the customer's operations.
- Under the prudence concept, a provision is made for the losses that could arise from current debtors in future, known as the provision for doubtful debts.

Difference between bad debts and doubtful debts

- A bad debt is an account receivable that has been clearly identified as not being collectible and so should be written off at once.
- A doubtful debt is an account receivable that might become a bad debt at some point in the future, for which it may be necessary to create an allowance for doubtful debts.
- When accounting for bad and doubtful debts, two methods are generally used:
 1. Direct write off method
 2. Allowance method

Direct write off method

- **Direct write off method:** Charging bad debts to expense when individual invoices have been identified as uncollectible.
 - *DR Bad debts account*
CR Debtors control account
- The direct write off method violates the matching concept since it delays the recognition of expenses. For example, a company records Rs. 1 million in credit sales for one period, and then waits 3-4 months to collect all of the accounts receivables, before finally recording bad debts off to expense. This causes a lengthy delay between revenue recognition and the recording of expenses directly related to that revenue.

Allowance method

- **Allowance method:** Involves setting aside a reserve for bad debts that are expected in the future (provision for doubtful debts account).
- Provisions can be estimated in two ways:
 1. General provision: Calculated as a percentage of all debtors (or total sales)
 2. Specific provision: Calculated by analyzing each debtor

Journal entries at initial recognition:

DR Doubtful debts account
CR Provision for doubtful debts account

Journal entries once confirmed:

DR Provision for doubtful debts account
CR Debtors control account

