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MUF0022 FINANCIAL ACCOUNTING

Adjustments for Prepayments

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2.1 Learning Outcomes

Explain why adjustments are needed for prepayments (expenses/ revenues)

Explain why the Asset approach is applied

Explain why the Liability approach is applied

Apply relevant Accounting Principles and Qualitative Characteristics

2.2 Key Terms & Concepts

- links between reporting periods, nature of transactions, and need to adjust for timing- prepaid/ accrued
- identify balance day and balance day adjustments
- Record the following adjustments in the general journal, general ledger and subsidiary records:
- Prepaid Expense (Asset approach)
- Prepaid Revenue (Liability approach)
- Impact of adjustments on Financial Statements
- Relevant application of APs & QCs

Prepayments for Expenses

In our studies of the ***recording process*** so far we have considered the five accounting elements- ***A, L, OE, R , E***– and we have prepared Financial Statements on the basis that Revenue has been earned and Expenses have been incurred.

However, what would happen if a business pays it rent six months in advance on the 1 January 2018 for $4 500 and we prepare Financial Statements on 31 January 2018?

Think about the following questions:

- Has the business incurred or used up all the $4 500 when the expense is paid on 1 January 2018?
- Has the business used up all the $4 500 by 31 January when the Financial Statements are prepares?
- What is the significance of 31 January 2018?

The business pays the rent in advance. This is known as a ***prepayment***. Specifically this is an example of a ***Prepaid Expense***– an amount has been paid before it has been incurred or used.

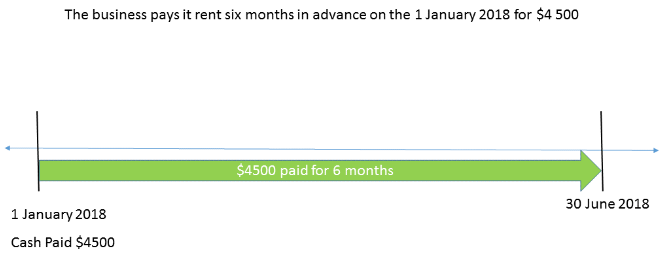
On the 1 January 2018 the cash has left the bank account and the amount of $4 500 has been paid but not used. It might be recorded like this in the General Ledger:

- DR: Prepaid Rent (Asset)
- CR: Bank (Asset)

Why would we record the transaction in the Prepaid Rent account instead of the Rent Expense account?

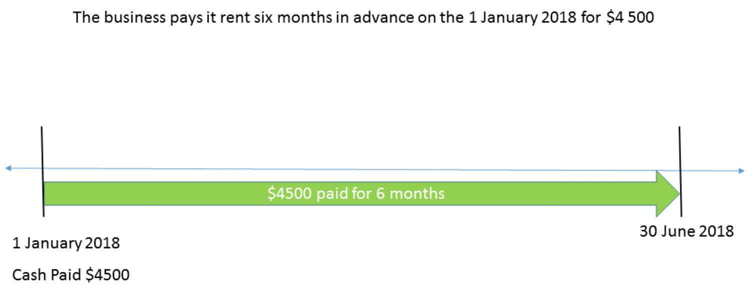
Recording the initial payment of the Rent in the Prepaid Rent ledger account recognises that this is an Asset to the business. This is known as the ***Asset Approach*** to recording Prepaid Expenses.

Prepaid expenses will be recorded as assets at the time of the initial payment because none of the amount has been used at this point. The amount paid represents a future economic benefit that is likely to be used up in the coming twelve months. This makes the prepaid expense accounts a current asset to the business:



At the end of the month of January, the business is ready to prepare its Financial Statements. This means that 31 January is the end of this Reporting Period, also known as the ***Balance Day***.

On Balance Day the business must measure and record the amount of Rent that has now been used up or incurred, and make an adjustment to the Prepaid Rent account to recognise that the entire $4500 is no longer the current asset remaining:



Prepayments for expenses means that a cash payment has been made but the expense is yet to be incurred in the current reporting period. Prepaid Expenses are recorded as assets when first paid for. It is a current asset because it is a resources controlled by the entity as a result of past events, and from which future economic benefits are expected to flow to the entity within the next twelve months.

Steps in ***recording prepayments for expenses***:

Event	Journal	General Ledger
1. Cash paid	Cash payments journal	DR Prepaid Expense CR Bank
2. Balance day	General Journal	DR Expense CR Prepaid Expense

The recording of this ***adjusting entry*** on Balance Day will also have an impact on the Financial Statements that are then prepared.

How will prepaid expenses be reported in the:

1. Income Statement?
2. Cash Flow Statement?
3. Balance Sheet?

In the ***Income Statement*** only the portion of the prepaid expense that has been incurred/consumed will be included under the heading of 'Other Expenses'.

The ***Cash Flow Statement*** will report the initial payment for the prepaid expense will be included under the heading of 'Cash Flows from Operating Activities'.

The ***Balance Sheet*** will show the portion of the prepaid expense that has not yet been consumed, and that remains in the prepaid account as a Current Asset.

We prepare Financial Statements to show the ***adjustments*** for Prepaid Expenses because it is useful for decision makers if we only include the transactions that are related to the current reporting period so that an accurate assessment of performance can be made. This is a reflection of the ***Reporting Period*** principle, and an application of the Qualitative Characteristic of ***Relevance.*** We also adjust the amount of the Prepaid Expense to ensure that we are recording losses when likely and gains only when probable, so as to ensure that our assets are not overstated, and that our Liabilities and expenses are not understated. This is the application of ***Conservatism*** from our conceptual understanding of the accounting framework.

Prepayments of Revenue

If prepaid expenses are a record of when a business pays for an expense before it has been used, how might you define a prepaid revenue?

What would happen if a business receives a cash deposit in advance on the 1 January 2018 of $1000 for a product it will not deliver until 24 March 2018? The product costs $2500 and the total sale price is $5000.

Think about the following questions:

- Has the business earned the $1000 when the customer pays the deposit on 1 January 2018?
- If Balance Day is on 31 January, how should it report the $1000 deposit?
- What is the significance of 24 March 2018?

The customer pays the business in advance. This is known as a ***prepayment***. Specifically this is an example of a ***Prepaid Revenue***– an amount has been paid to the business before it has been earned.

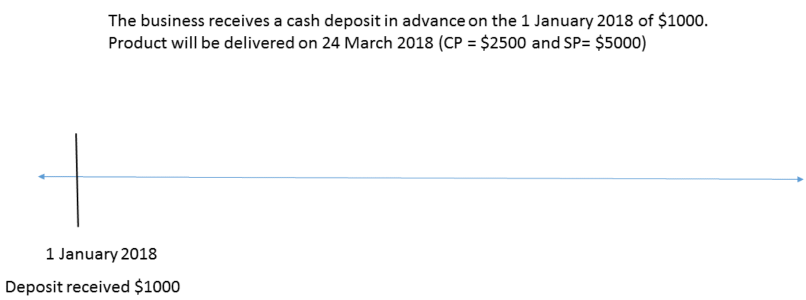
On the 1 January 2018 the cash has been deposited in the bank account and the amount of $1000 has been paid but not earned. It might be recorded like this in the General Ledger:

- DR: Bank (Asset)
- CR: Prepaid Sales (Liability)

Why would we record the transaction in the Prepaid Sales account instead of the Sales Revenue account?

Recording the initial payment of the deposit in the Prepaid Sales ledger account recognises that this is a Liability to the business. This is known as the ***Liability Approach*** to recording Prepaid Revenue.

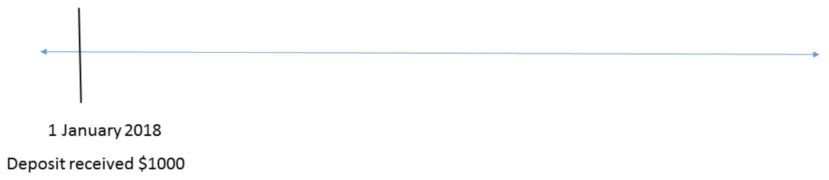
Prepaid revenue will be recorded as a liability at the time is received by the business because none of the amount has been earned at this point. The amount paid represents a present obligation of the entity arising from the past events, where the settlement of which will result in the outflow of resources in the upcoming twelve months. This makes the prepaid revenue account a current liability to the business:



At the end of the month of January, the business is ready to prepare its Financial Statements. Once again, this means that 31 January is the end of this Reporting Period, also known as the ***Balance Day***.

On Balance Day the business must measure and record the amount of revenue that has now been earned, and make an adjustment to the Prepaid Sales account to recognise what has been earned and what still remains as a current liability:

The business receives a cash deposit in advance on the 1 January 2018 of $1000.
Product will be delivered on 24 March 2018 (CP = $2500 and SP= $5000)



Prepayments of revenue means that a cash receipt has been received but the revenue is yet to be earned in the current reporting period. Prepaid Revenue amounts are recorded as liabilities when first received by the business. It is a current liability because it is represents an obligation for the entity as a result of past events, and from which future outflows of resources within the next twelve months.

Steps in recording prepayments for expenses:

Event	Journal	General Ledger	
1. Cash received	Cash receipts journal	DR Bank CR Prepaid Sales	
2. Goods are provided by the trading business to the customer	General Journal (for the amount received in advance)	DR Prepaid Sales CR Sales Revenue	+
	Other entries for the amount remaining depending on Cash or Credit Terms	Cash Terms DR: Bank CR: Sales & DR: Cost of Sales CR: Stock Control	Credit Terms DR: Debtors Control CR: Sales & DR: Cost of Sales CR: Stock Control

The recording of this ***adjusting entry*** may not be on Balance Day. The adjusting entry will be on the date that the revenue has been earned by the provision of the goods to the customer.

At balance day, what will be the impact on the Financial Statements that are then prepared.

How will prepaid revenue be reported in the:

1. Income Statement?
2. Cash Flow Statement?
3. Balance Sheet?

The ***Income Statement*** matches revenue earned with expenses incurred for a given period of time. Therefore, if the amount of the prepaid revenue has not been earned by the balance day, it will not be reported in the Income Statement at all.

The ***Cash Flow Statement*** will report the initial cash received from the customer as the deposit.

The ***Balance Sheet*** will show the prepaid revenue that has not yet been earned, and that remains in the prepaid account as a Current Liability.

We prepare Financial Statements to summarise and classify financial information so that it is useful for decision makers. How do the Accounting Principles of Reporting Period and Conservatism apply to the recording and reporting of Prepaid Revenue? What is your understanding of the Qualitative Characteristic of Relevance in these circumstances?

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