5 Accruals and prepayments

this chapter covers...

In the last chapter we have looked at the preparation of financial statements – or final accounts – using the extended trial balance, or spreadsheet, approach.

There are a number of adjustments which are made to the financial statements at the year end in order to show a more realistic view of the state of the business. This chapter is concerned with the adjustments to be made for accruals and prepayments of expenses and income.

To illustrate the effect of adjustments for accruals and prepayments on financial statements we shall be referring to the extended trial balance of Tara Smith seen in the previous chapter.

ACCRUAL OF EXPENSES

An accrual is an amount due, or the calculation of an amount due, in an accounting period which is unpaid at the end of that period, eg an insurance premium or an electricity bill not yet paid.

In the financial statements, accrued expenses are:

- added to the expense account (eg insurance account, electricity account) shown in the trial balance, before it is listed in the statement of profit or loss
- shown as a liability in the year end statement of financial position

The reason for dealing with accruals in this way is to ensure that the statement of profit or loss records the expense that has been incurred for the year, instead of simply the amount that has been paid. In other words, the expense is adjusted to relate to the time period covered by the statement of profit or loss. The year end statement of financial position shows a liability for the amount that is due, but unpaid.

journal entry

A journal entry – see Chapter 11 – is made at the end of the financial year for accruals of expenses. The journal entry records the amounts of accruals in a book of prime entry and gives the bookkeeper the authority to record the transactions in the double-entry accounts.

Case Study

TARA SMITH: ACCRUAL OF AN EXPENSE

The trial balance of Tara Smith at 31 December 20-4 (see page 55) shows a debit balance for telephone expenses of £500. Before preparing the financial statements, a telephone bill for £100 is received on 4 January 20-5, ie early in the new financial year. An examination of the bill shows that it is for costs incurred in 20-4, therefore an adjustment needs to be made to the financial statements for 20-4 to record this accrued expense.

accruals – the extended trial balance

The accrual is shown in the extended trial balance as follows:

- in the adjustments columns
  - record £100 on the debit side of the telephone row
  - record £100 on the credit side of the accruals row
- on the debit side of the statement of profit or loss column the total cost of the telephone row is now £600 (ie £500 from the trial balance, plus £100 accrual)
- on the credit side of the statement of financial position column £100 from the accruals row is shown as a liability of the business

This adjustment is shown on Tara Smith's extended trial balance (page 72): the figures affected by the accrual (and also the prepayment – see below) are shaded for ease of reference.

accruals – the double-entry bookkeeping

In the double-entry accounts, the amount of the accrual and the transfer of the year's expense to the statement of profit or loss are shown. The telephone account in the records of Tara Smith will appear as follows:

Telephone account

Dr					Cr
20-4		£	20-4		£
31 Dec	Balance b/d	500	31 Dec	Statement of profit or loss	600
31 Dec	Balance c/d	100			
		600			600
20-5		£	20-5		£
			1 Jan	Balance b/d	100

Notes:

- The bookkeeper's trial balance showed the debit side balance brought down of £500 on the telephone account
- As £100 is owing for telephone expenses at the end of the year, the transfer to the statement of profit or loss is the expense that has been incurred for the year of £600
- The amount of the accrual is carried down to the credit side of the telephone account; it is listed on the statement of financial position at 31 December 20-4 as a liability

Later on, for example on 15 January 20-5, the telephone bill is paid from the bank and the telephone account now appears as:

Telephone account

Dr					Cr
20-5		£	20-5		£
15 Jan	Bank	100	1 Jan	Balance b/d	100

The effect of the payment on 15 January is that telephone account now has a 'nil' balance and the bill received on 4 January will not be recorded as an expense in the statement of profit or loss drawn up at the end of 20-5.

the effect of an accrual on profit

Taking note of the accrual of an expense has the effect of reducing profit for the year. As the expenses have been increased, profit is reduced. In this case the telephone bill due for the period reduces the profit of Tara Smith by £100 from £12,000 to £11,900.

PREPAYMENT OF EXPENSES

A prepayment is a payment made in advance, or the calculation of an amount paid in advance, of the accounting period to which it relates.

A prepayment is, therefore, the opposite of an accrual: with a prepayment of expenses, some part of the expense has been paid in advance.

In the financial statements, prepaid expenses are:

- deducted from the expense account shown in the trial balance before it is listed in the statement of profit or loss
- shown as an asset in the year end statement of financial position

As with accruals, the reason for dealing with prepaid expenses in this way is to ensure that the statement of profit or loss records the cost incurred for the year, and not the amount that has been paid – the expense relates to the time period covered by the statement of profit or loss. The year end statement of financial position shows an asset for the amount that has been prepaid.

journal entry

A journal entry – see Chapter 11 – is made at the end of the financial year for prepayments of expenses. The journal entry records the amounts of prepayments in a book of prime entry and gives the bookkeeper the authority to record the transactions in the double-entry accounts.

Case Study

TARA SMITH: PREPAID EXPENSES

Tara Smith tells you that the trial balance figure for rent paid – for a storage unit – of £750 includes £75 of rent for January 20-5 paid in advance. An adjustment needs to be made to the financial statements for 20-4 to record this prepaid expense.

prepayments – the extended trial balance

The prepayment is shown in the extended trial balance as follows:

- in the adjustments columns
  - record £75 on the credit side of the rent paid row
  - record £75 on the debit side of the prepayments row
- on the debit side of the statement of profit or loss column the total cost of rent paid is now £675 (ie £750 from the trial balance, less £75 prepaid)
- on the debit side of the statement of financial position column £75 from the prepayments row is shown as an asset of the business

The prepayment adjustment is shown on Tara Smith's extended trial balance (page 72), together with the accrual we have just dealt with – both are shaded for ease of reference.

prepayments – the double-entry bookkeeping

In the double-entry accounts, the amount of the prepayment and the transfer of the year's expense to the statement of profit or loss are shown.

The rent paid account in the records of Tara Smith will appear as follows:

Dr		Rent paid account			Cr
20-4		£	20-4		£
31 Dec	Balance b/d	750	31 Dec	Statement of profit or loss	675
			31 Dec	Balance c/d	75
		750			750
20-5		£	20-5		£
1 Jan	Balance b/d	75			

Notes:

- The trial balance total for rent paid is £750
- As £75 is prepaid at the end of the year, the transfer to the statement of profit or loss is the expense that has been incurred for the year of £675
- The amount of the prepayment is carried down to the debit side of rent paid account; it is listed on the statement of financial position at 31 December 20-4 as an asset
- This now gives the rent paid account a debit balance of £75 which will be included in the expense for rent paid for the year and will be transferred to the statement of profit or loss on 31 December 20-5.

the effect of a prepayment on profit

Taking note of the prepayment of an expense has the effect of increasing a previously reported profit for the year – expenses have been reduced, so profit is greater.

Case Study

TARA SMITH: ACCRUALS AND PREPAYMENTS IN THE FINANCIAL STATEMENTS

We will now focus on how the adjustments for accruals and prepayments are shown in the statement of profit or loss and statement of financial position of Tara Smith. Remember that we are taking note of the following items at 31 December 20-4:

- telephone accrued £100
- rent prepaid £75

extended trial balance

The layout for the extended trial balance – see next page – includes rows for accruals and prepayments. The columns which are affected are adjustments, statement of profit or loss and statement of financial position – the altered figures are shaded for illustrative purposes. Note that:

- the statement of profit or loss columns show the net figure for each expense after allowing for the accrual or prepayment
- the statement of financial position columns show the accrual as a liability and the prepayment as an asset

The effect of taking note of accruals and prepayments is to alter profit for the year from that shown by the extended trial balance for Tara Smith, seen earlier (page 57):

	£
Profit for the year before adjustments	12,000
Less telephone accrued	100
	11,900
Add rent prepaid	75
Profit for the year after adjustments	11,975

EXTENDED TRIAL BALANCE **TARA SMITH TRADING AS "THE FASHION SHOP"** **31 DECEMBER 20-4**

Account name	Ledger balances		Adjustments		Statement of profit or loss		Statement of financial position	
	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £
Opening inventory	12,500				12,500			
Purchases	105,000				105,000			
Sales revenue		155,000				155,000		
Administration expenses	6,200				6,200			
Wages	23,500				23,500			
Rent paid	750			75	675			
Telephone	500		100		600			
Interest paid	4,500				4,500			
Travel expenses	550				550			
Premises at cost	100,000						100,000	
Shop fittings at cost	20,000						20,000	
Sales ledger control	10,500						10,500	
Bank	5,450						5,450	
Cash	50						50	
Capital		75,000						75,000
Drawings	7,000						7,000	
Loan from bank		50,000						50,000
Purchases ledger control		14,500						14,500
Value Added Tax		2,000						2,000
Closing inventory: statement of profit or loss				10,500		10,500		
Closing inventory: statement of financial position			10,500				10,500	
Accruals				100				100
Prepayments			75				75	
Depreciation charge								
Irrecoverable debts								
Allowance for doubtful debts								
Allowance for doubtful debts: adjustment								
Profit/loss for the year					11,975			11,975
	296,500	296,500	10,675	10,675	165,500	165,500	153,575	153,575

ACCRUALS AND PREPAYMENTS OF INCOME

Just as expenses can be accrued or prepaid at the end of a financial year, income amounts can also be accrued or prepaid.

accrual of income

Here, income of a business is due but unpaid at the end of the financial year. For example, commission might have been earned, but the payment is received after the end of the financial year to which it relates. In the extended trial balance and financial statements, accrual of income is:

- added to the income amount in the trial balance before it is listed in the statement of profit or loss
- shown as an asset in the year end statement of financial position

A journal entry – see Chapter 11 – is made at the end of the financial year for accruals of income.

prepayment of income

Here, the income of a business has been paid in advance by the payer. For example, the rent received account for this financial year could include an advance payment received from a tenant in respect of the next financial year. In the extended trial balance and financial statements, prepayment of income is:

- deducted from the income amount in the trial balance before it is listed in the statement of profit or loss
- shown as a liability in the year end statement of financial position

As with expenses, the objective of taking note of accruals and prepayments of income is to ensure that the money amounts relate to the period covered by the statement of profit or loss.

A journal entry – see Chapter 11 – is made at the end of the financial year for prepayments of income.

Important note: do not net off accruals of income and expenditure or prepayments of income and expenditure – it is not good accounting practice and each should be shown separately in the statement of financial position.

PRIVATE EXPENSES AND GOODS FOR OWN USE

Adjustments also have to be made in the financial statements for the amount of any business facilities that are used by the owner for private purposes. These adjustments are for private expenses and goods for own use.

private expenses

Sometimes the owner of a business uses business facilities for private purposes, eg telephone, or car. The owner will agree that part of the expense shall be charged to him or her as drawings, while the other part represents a business expense.

For example, the balance of the telephone account is £600 at the year-end, and the owner agrees that this should be split as one-quarter private use, and three-quarters to the business. The bookkeeping entries to record such adjustments are:

- **debit** drawings account
- **credit** telephone account
- **debit** statement of profit or loss
- **credit** telephone account

The telephone account will be completed at the end of the year as follows:

Dr		Telephone account			Cr
20-4		£	20-4		£
31 Dec	Balance b/d	600	31 Dec	Drawings	150
			31 Dec	Statement of profit or loss	450
		600			600

When using a trial balance to produce the financial statements, private expenses should be adjusted by deducting from the expense account and adding to drawings.

A journal entry – see Chapter 11 – is made at the end of the financial year for private expenses.

goods for own use

When the owner of a business takes some of the goods in which the business trades for his or her own use, the double-entry bookkeeping is:

- **debit** drawings account
- **credit** purchases account

Note that:

- Where a business is VAT-registered, VAT must be accounted for on goods taken by the owner.
- An alternative method of accounting for goods for own use is:
  - **debit** drawings account
  - **credit** sales account

This method is preferred by HM Revenue & Customs for tax purposes; however, either is acceptable for the purpose of financial accounting – which method is used will depend on the custom and practice of the business.

When using a trial balance to produce the financial statements, goods for own use should be adjusted by adding to drawings and deducting from purchases (or adding to sales).

A journal entry – see Chapter 11 – is made at the end of the financial year for goods for own use.

INCOME AND EXPENDITURE ACCOUNTING

In this chapter we have made adjustments for accruals and prepayments to ensure that the statement of profit or loss shows the correct amount of income and expenses for the financial year, ie what should have been paid, instead of what has actually been paid. In doing this we are adopting the principle of **income and expenditure accounting**. If we simply used the trial balance figures, we would be following the principle of **receipts and payments accounting**, ie comparing money coming in, with money going out: this will usually give a false view of the profit for the year.

The principle of income and expenditure accounting is applied in the same way to purchases and sales, although no adjustments are needed because of the way in which these two are handled in the accounting records. For purchases, the amount is entered into the accounts when the supplier's invoice is received, although the agreement to buy will be contained in the legal contract which exists between buyer and seller. From the accounting viewpoint, it is receipt of the supplier's invoice that causes an accounting entry to be made; the subsequent payment is handled as a different accounting transaction. A business could have bought goods, not paid for them yet, but will have a purchases figure to enter into the statement of profit or loss – the suppliers will soon be wanting payment!

Sales are recorded in a similar way – when the invoice for the goods is sent, rather than when payment is made. This applies the principle of income and expenditure accounting. In this way, a business could have made a large amount of sales, which will be entered in the statement of profit or loss, but may not yet have received any payments.

accruals principle of accounting

The way in which financial statements are adjusted to take note of accruals and prepayments is recognised in the accruals principle of accounting – this is discussed in more detail in Chapter 8.

Chapter Summary

- Financial statements are prepared on the income and expenditure basis, rather than the receipts and payments basis.

- Adjustments should be made at the end of the financial year in respect of accruals and prepayments.

- In the financial statements, accrued expenses are:
  - added to the expense from the trial balance
  - shown as a liability in the statement of financial position

- Prepaid expenses are:
  - deducted from the expense from the trial balance
  - shown as an asset in the statement of financial position

- An accrual of income is:
  - added to the income amount from the trial balance
  - shown as an asset in the statement of financial position

- A prepayment of income is:
  - deducted from the income amount from the trial balance
  - shown as a liability in the statement of financial position

- Adjustments also need to be made in the financial statements for:
  - private expenses
  - goods for own use

- A journal entry – see Chapter 11 – must be made for all adjustments for accruals and prepayments and for private expenses and goods for own use. The journal entry records the amounts in a book of prime entry and gives the bookkeeper the authority to record the transactions in the double-entry accounts.

- Accruals and prepayments are an application of the accruals principle of accounting – see Chapter 8.

Key Terms

accrual of expenses	an amount due, or the calculation of an amount due, in an accounting period which is unpaid at the end of that period
prepayment of expenses	a payment made in advance, or the calculation of an amount paid in advance, of the accounting period to which it relates
accrual of income	income of a business due in an accounting period which is unpaid at the end of that period
prepayment of income	income of a business which has been paid in advance of the accounting period to which it relates
goods for own use	where the owner of a business takes some of the goods in which the business trades for his/her own use
income and expenditure accounting	recording the amounts that should have been received and paid during an accounting period
receipts and payments accounting	recording the actual amounts that have been received and paid during an accounting period, without taking note of accruals and prepayments

Activities

Extended trial balance format: a blank photocopiable pro-forma of the extended trial balance is included in the Appendix – it is advisable to enlarge it up to full A4 size. The layout can also be downloaded from www.osbornebooks.co.uk.

5.1 Wages accrued are shown as:

(a) an asset on the statement of financial position

(b) a debit balance in wages account

(c) income on the statement of profit or loss

(d) a credit balance in wages account

Answer (a) or (b) or (c) or (d)

5.2 Rates prepaid are shown as:

(a) a liability on the statement of financial position

(b) an expense on the statement of profit or loss

(c) debit balance in rates account

(d) credit balance in rates account

Answer (a) or (b) or (c) or (d)

5.3 John Harrington runs an import/export business. At the end of his financial year, on 31 December 20-7, the vehicle expenses account is as follows:

Dr		**Vehicle expenses account**			Cr
20-7		£	20-7		£
31 Dec	Balance b/d	1,680			

John Harrington tells you that 25 per cent of vehicle expenses represents his private motoring expenses. He asks you to transfer the amount to his drawings account, before transferring the remainder to the statement of profit or loss. Show the vehicle expenses account after these transactions have been entered.

5.4 Explain how the following would be dealt with in the statement of profit or loss, and statement of financial position of a business with a financial year end of 31 December 20-1:

(a) Wages and salaries paid to 31 December 20-1 amount to £55,640. However, at that date £1,120 is owing: this amount is paid on 4 January 20-2.

(b) Rates totalling £3,565 have been paid to cover the period 1 January 20-1 to 31 March 20-2.

(c) A computer is rented at a cost of £150 per month. The rental for January 20-2 was paid in December 20-1 and is included in the total payments during 20-1 which amount to £1,950.

5.5 This Activity is about accounting for accruals and prepayments and preparing a trial balance.

You are working on the accounts of a business for the year ended 31 March 20-7. In this Activity you can ignore VAT.

You have the following information:

Balances as at:	**1 April 20-6** £
Accrual for rent paid	750
Prepayment for administration expenses	250

The bank summary for the year shows payments for rent of £11,250. Included in this figure is £2,250 for the quarter ended 31 May 20-7.

(a) **You are to** prepare the rent paid account for the year ended 31 March 20-7 and close it off by showing the transfer to the statement of profit or loss. Dates are not required.

Rent paid

	£		£

The bank summary for the year shows payments for administration expenses of £10,400. In April 20-7, £175 was paid for administration expenses incurred in March 20-7.

(b) **You are to** prepare the administration expenses account for the year ended 31 March 20-7 and close it off by showing the transfer to the statement of profit or loss. Include dates.

Administration expenses

		£			£

You have the following extract of balances from the general ledger.

(c) **Using your answers** to (a) and (b), and the figures given below, enter amounts in the appropriate debit or credit column for the accounts shown. Do not enter zeros in unused column cells.

Extract from trial balance as at 31 March 20-7

Account	£	£ **Dr**	£ **Cr**
Accrued expenses			
Capital	75,000		
Discount received	680		
Drawings	10,000		
Interest received	200		
Machinery at cost	20,000		
Prepaid expenses			
Sales revenue	115,000		

5.6 This Activity is about accounting for accruals and prepayments and preparing a trial balance.

You are working on the accounts of a business for the year ended 30 June 20-3. In this Activity you can ignore VAT.

You have the following information:

Balances as at:	**1 July 20-2** £
Prepayment for rent received	450
Accrual for vehicle expenses	220

The bank summary for the year shows rent received of £5,850. Included in this figure is £1,350 for the three months ended 31 August 20-3.

(a) **You are to** prepare the rent received account for the year ended 30 June 20-3 and close it off by showing the transfer to the statement of profit or loss. Dates are not required.

Rent received

	£		£

The bank summary for the year shows payments for vehicle expenses of £6,450. In July 20-3, £380 was paid for vehicle expenses incurred in June 20-3.

(b) **You are to** prepare the vehicle expenses account for the year ended 30 June 20-3 and close it off by showing the transfer to the statement of profit or loss. Include dates.

Vehicle expenses

		£			£

You have the following extract of balances from the general ledger.

(c) **Using your answers** to (a) and (b), and the figures given below, enter amounts in the appropriate debit or credit column for the accounts shown. Do not enter zeros in unused column cells.

Extract from trial balance as at 30 June 20-3

Account	£	£ **Dr**	£ **Cr**
Accrued expenses			
Capital	30,000		
Cash	250		
Discount allowed	600		
Prepaid income			
Purchases	15,500		
Sales returns	850		
Vehicles at cost	12,000		

5.7 The following trial balance has been extracted by the bookkeeper of Don Smith, who runs a wholesale stationery business, at 31 December 20-2:

	Dr £	Cr £
Sales ledger control	24,325	
Purchases ledger control		15,408
Value Added Tax		4,276
Capital		30,000
Bank		1,083
Rent and rates	10,862	
Electricity	2,054	
Telephone	1,695	
Salaries	55,891	
Vehicles at cost	22,250	
Office equipment at cost	7,500	
Vehicle expenses	10,855	
Drawings	15,275	
Discount allowed	478	
Discount received		591
Purchases	138,960	
Sales revenue		257,258
Opening inventory	18,471	
	308,616	308,616

Notes at 31 December 20-2:

- closing inventory was valued at £14,075
- rates prepaid £250
- electricity owing £110
- salaries owing £365

You are to prepare the extended trial balance of Don Smith for the year ended 31 December 20-2.

5.8 The following trial balance has been extracted by the bookkeeper of John Barclay at 30 June 20-3:

	Dr	Cr
	£	£
Sales revenue		864,321
Purchases	600,128	
Sales returns	2,746	
Purchases returns		3,894
Office expenses	33,947	
Salaries	122,611	
Vehicle expenses	36,894	
Discount allowed	3,187	
Discount received		4,951
Sales and purchases ledger control	74,328	52,919
Value Added Tax		10,497
Opening inventory	63,084	
Vehicles at cost	83,500	
Office equipment at cost	23,250	
Land and buildings at cost	100,000	
Bank loan		75,000
Bank	1,197	
Capital		155,000
Drawings	21,710	
	1,166,582	1,166,582

Notes at 30 June 20-3:

- closing inventory was valued at £66,941
- vehicle expenses owing £1,250
- office expenses prepaid £346
- goods costing £250 were taken by John Barclay for his own use

You are to prepare the extended trial balance of John Barclay for the year ended 30 June 20-3.