Accounting for Provisions, Prepayments and Accruals

Chapter 10

Prudence concept

The prudence concept has two elements.

1. That one should never anticipate profits.
2. Provide for all possible losses.

The intention of the prudence concept is to see that all asset values and profit figures are realistic rather than optimistic or pessimistic.

The essence of the concept is to insist that revenue or profit not be accounted for until the business is virtually certain to get it, but that a loss in an asset value is accounted for as soon as it is probable or likely.

Bad debt

A bad debt is one where you are almost certain that you will not receive the monies or assets owed to you.

Action	Account	Reason / explanation
DEBIT	Bad debts account	This is an expense account (like rent, rates etc) which is charged to the profit and loss account .
CREDIT	The individual debtor account	By crediting this account the debt is cancelled and the account closed, thus the overall debtors figure is reduced.

Bad debt recovered

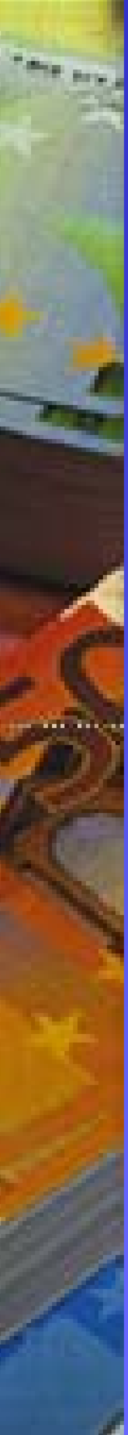
Occasionally a debt that has been written off as bad will be paid and should be treated as a bad debt recovered.

There are two transactions involved, firstly the bad debt must be reinstated then the payment must be accounted for.

Action	**Account**	**Reason / explanation**
DEBIT	The individual debtor's account	The amount involved must be reinstated in this account.
CREDIT	Bad debts recovered account	This is a revenue account which will be added to gross profit in the profit & loss account.

Then

DEBIT	Bank account	This recognises the receipt of the money.
CREDIT	The individual debtor account	By crediting the individual debtor's account the debt is cleared by the payment.

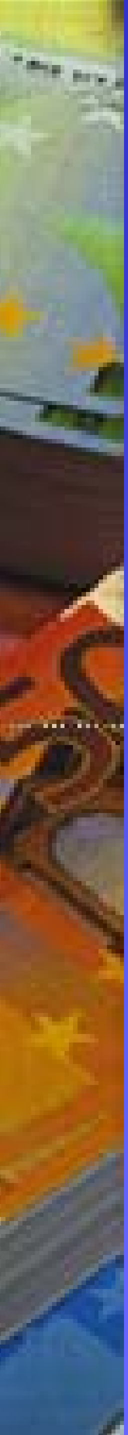


Provision for bad debts

The Prudence concept helps ensure the information provided in the accounts is a complete and realistic representation.

Where businesses have high levels of credit sales and high debtor balances a certain percentage of debtors may not pay debts.

A business, acting prudently, should make a provision for this loss now, to ensure debtors are shown at a realistic level and profits are not overstated.



Provision for bad debts

D & A Stores, provides credit which can be applied for by customers who must pass strict credit risk assessment checks. Trade debtors figure at the end the financial year amounted to €56,410. From past experience the sales ledger/credit sale manager knows that the business will not receive the full amount. The amount received may average at 98% of the amount outstanding.

In this case the D & A may provide for bad debts at 2% of debtors amounting to €1,128 (€56,410 x 2%).

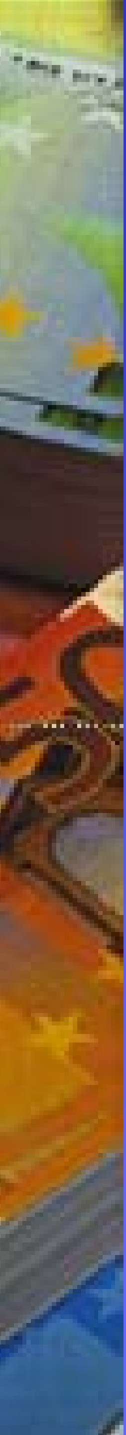
Accounting for bad debt provisions

Action	Account	Reason / explanation
DEBIT	Profit and Loss account	This is the process of charging to the profit and loss account the *estimate* of the *possible* loss in future revenue
CREDIT	Provision for bad debts account	This account will appear in the balance sheet as a a deduction from debtors with-in current assets.

Example – creating bad debt provision

Gibson Retailing Ltd, have a financial year end 31 December. At 31 December 2002 the total figure for debtors amounted to €150,000 after accounting for bad debts during the year. Management now think it is prudent to provide for bad debts to the amount of 1.5 per cent of the debtors figure based on past experience.

Show the transactions required to create the relevant provision and the effect on the profit and loss accounts and the balance sheet.



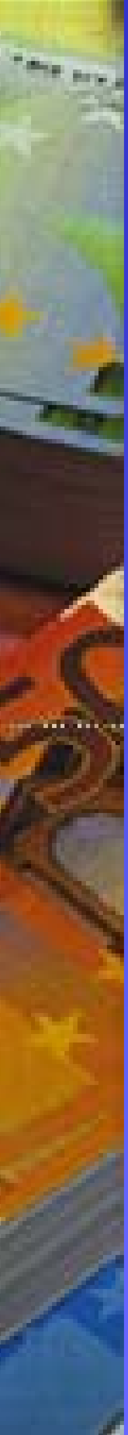
Solution – creating bad debt provision

Dr	Provision for Bad Debts Account	€			Cr €
31/12/02	Bal c/d	2,250	31/12/02	P&L a/c	2,250
			11/1/03	Bal b/d	2,250

Dr	Profit and Loss Account (31 December 2002) €	Cr €
Provision for bad debts (created)	2,250	

Balance Sheet Extract (31 December 2002)

Current assets	€	€
Debtors	150,000	
Less provision for bad debts	(2,250)	147,750



Example – increasing bad debt provision

At 31 December 2003 total debtor's for Gibson Retailing amounted to €200,000. During the year some debtors amounting to €10,000 were written off as bad, however this was not accounted for and their balances are included in the total debtors figure of €200,000. At 31 December 2003 management decided to maintain the provision for bad debts at the level of 1.5 per cent of debtors.

Prepare the relevant accounts showing extracts from the profit and loss account and the balance sheet for 2003.

Solution – increasing bad debt provision

Total Debtors Account

Dr		€			Cr €
31/12/03	Total debtor balances	200,000		Bad debts a/c	10,000
			31/12/03	Bal c/d	190,000
		200,000			200,000

Bad Debts Account

Dr		€			Cr €
31/12/03	Debtors	10,000	31/12/03	P&L a/c	10,000

Provision for Bad Debts Account

Dr		€			Cr €
			1/1/03	Bal b/d	2,250
31/12/03	Bal c/d (1.5% of €190,000)	2,850	31/12/03	P&L a/c	600
		2,850			2,850

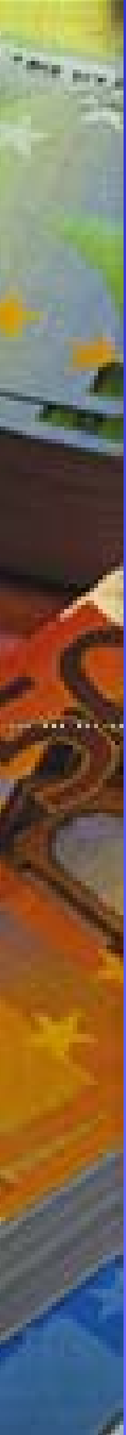
Explanation	€	
New provision	2,850	
Old provision	2,250	
Difference therefore	600	increase required

Profit and Loss Account (31 December 2003)

	€		€
Bad debts (written off)	10,000		
Provision for bad debts (increase)	600		

Balance Sheet Extract (31 December 2003)

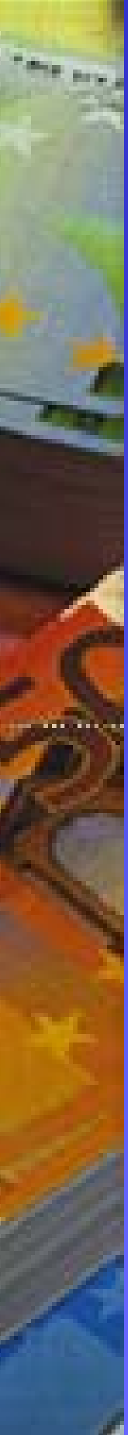
Current assets	€	€
Debtors	190,000	
Less provision for bad debts	(2,850)	187,150



Example – decreasing bad debt provision

In 2004 D & A debtors amounted to €170,000 at the year end 31 December 2004. Management wish to maintain the provision for bad debts to the amount of 1.5 per cent of debtors.

Prepare the relevant accounts showing extracts from the profit and loss account and the balance sheet for 2004.



Solution – decreasing bad debt provision

Provision for Bad Debts Account

		€			€
31/12/04	P&L a/c	300	1/1/04	Bal b/d	2,850
31/12/04	Bal c/d (170,000 x 1.5%)	2.550			
		2,850			2,850
			1/1/05	Bal b/d	2,550

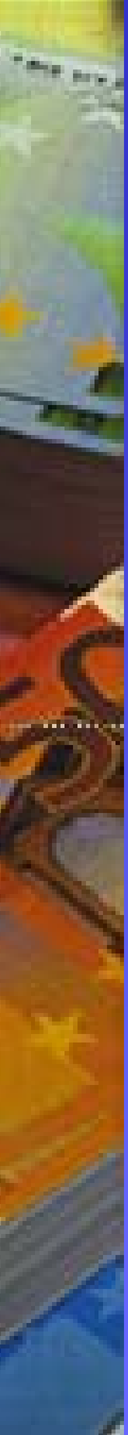
Explanation	€	
New provision	2,550	
Old provision	2,850	
Difference therefore	300	reduction required

Profit and Loss Account (31 December 2004)

	€		€
		Provision for bad debts (reduced)	300

Balance Sheet Extract (31 December 2004)

Current assets	€	€
Debtors	170,000	
Less provision for bad debts	(2,550)	167,450

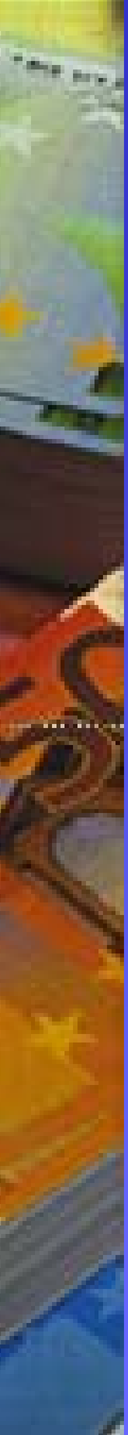


Provision for discount

For businesses offering discounts for early payment, it is possible that some of the debtors at the end of a period will receive a discount for early payment.

Following the prudence concept, a provision for discount should be provided for.

The accounting treatment is similar to that for bad debts.



Example – provision for discount

The accounts of Electrical Sales Limited are being finalised for year ended 31 December 2004. Outstanding debtors total €100,000. The provision for bad debts account currently has a balance of €5,500. Management wish to maintain the provision for bad debts at 5% of debtors and wish to introduce a provision for discount of 1%.

Solution – provision for discount

Provision for Bad Debts Account

		€			€
31/12/04	P&L a/c	500	1/1/04	Bal b/d	5,500
31/12/04	Bal c/d (100,000 x 5%)	5,000			
		5,500			5,500
			1/1/05	Bal b/d	5,000

Explanation	€	
New provision	5,000	
Old provision	5,500	
Difference therefore	500	reduction required

Provision for Discount Account

		€			€
31/12/04	Bal c/d	950	31/12/04	P&L a/c	950
			1/1/05	Bal b/d	950

Explanation	€
Debtors	100,000
Less provision bad debts	(5,000)
	95,000

Provision for discount is 95,000 x 1% = 950
created for first time whole amount transferred to P&L

Profit and Loss Account (31 December 2004)

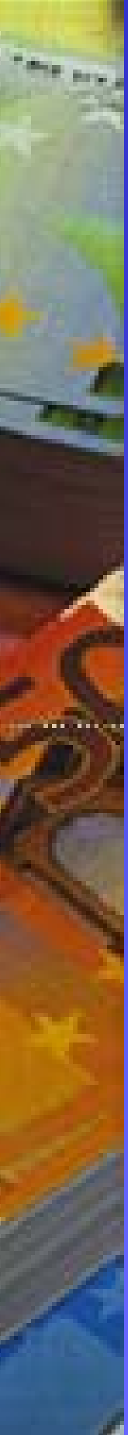
	€		€
Provision for discount (created)	950	Provision for bad debts (reduced)	500

Balance Sheet Extract (31 December 2004)

Current assets	€	€
Debtors	100,000	
Less provision for bad debts	(5,000)	
Less provision for discount	(950)	94,050

Accruals concept

1. When calculating net profit expenses should be matched against related revenues. In other words expenses should be matched on a time basis.
2. Net profit is the difference between revenues earned (not necessarily received) and expenses charged (not necessarily paid). Expenses in the profit and loss account should represent the total benefit derived from the service during the year not just the amount that was paid for.



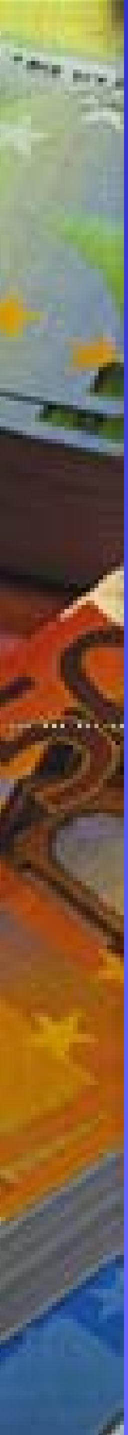
Accrued and prepaid expenses

If some expenses have not been billed for (invoiced) prior to the accounting year end the organisation should estimate the amount outstanding for the year and put a special adjustment, known as an accrual, in the accounts to comply with the accruals concept.

If part of an expense already paid includes some amount relating to a future period an adjustment known as a prepayment should be made.

Accrual

An accrual represents monies unaccounted for by a business for services rendered and are unpaid by the accounting period end.

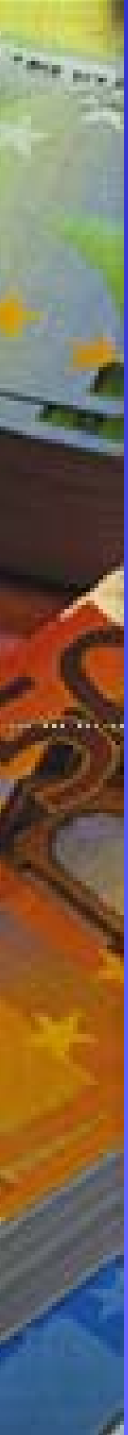


Example – accrued expense

Video Express pays its telephone bill every two months in the middle of the third month. The accounting year-end is 31 December. The following telephone bills were received relating to the year 2002 and the dates they are paid.

Bill period	Amount €	Date paid
Jan / Feb	700	15/3/02
March/ April	600	15/5/02
May /June	500	15/7/02
July Aug	200	15/9/02
Sept / Oct	500	15/11/02
Nov / Dec	600	15/1/03
	3,100	

Show how the telephone account, profit and loss account and balance sheet are affected by the accrual.



Solution – accrued expense

Telephone Account 2002

		€			€
15 Mar	Bank	700			
15 May	Bank	600			
15 July	Bank	500			
15 Sept	Bank	200	31 Dec	P&L a/c	3,100
15 Nov	Bank	500			
31 Dec	Bal c/d	600			
		3,100			3,100
			1 Jan	Bal b/d	600

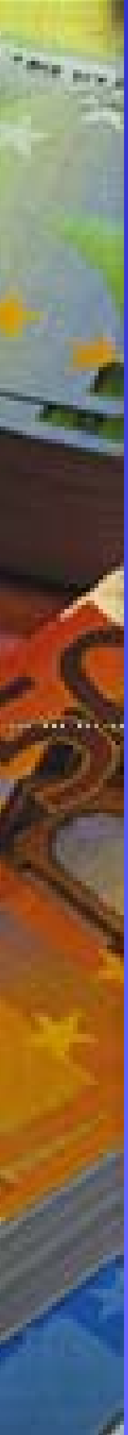
Note: The closing balance is a credit balance and thus comes down on the credit side representing a liability.

Profit and Loss Account for the Year 2002

Expenses	€	
Telephone	3,100	

Balance Sheet Extract

Current liabilities	€
Accruals	600



Prepayment

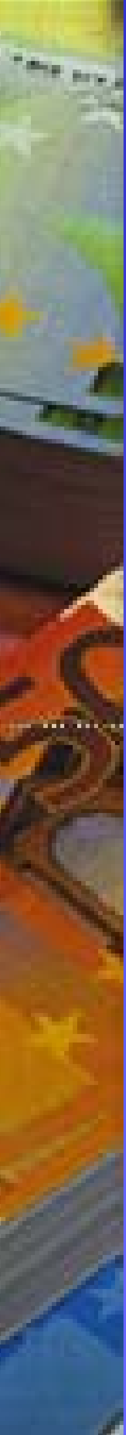
A prepayment is effectively an amount paid during the accounting period for a service which has not been provided by the accounting year-end.

Example – prepaid expense

Shop Local a retail outlet has decided to rent an adjoining unit. An agreement is reached to pay €3,000 a quarter, payable in advance commencing on 1 May. The business's year-end is 31 December. The following are the details of rent charged and paid during the year.

Bill period	Amount Paid €	Date paid
May, June, July	3,000	1//5/03
Aug, Sept, Oct	3,000	1/8/03
Nov, Dec, Jan	3,000	1/11/03

Show how the rent payable account, profit and loss account and balance sheet are affected by the prepayment.



Solution – prepaid expense

Rent Account 2003

		€			€
1 May	Bank	3,000			
1 Aug	Bank	3,000	31 Dec	P&L a/c	8,000
1 Nov	Bank	3,000	31 Dec	Bal c/d	1,000
		9,000			9,000
1 Jan	Bal b/d	1,000			

Note: The closing balance is a debit balance and thus comes down on the debit side representing an asset.

Profit and Loss Account for the Year 2003

Expenses	€	
Rent	8,000	

Balance Sheet Extract

Current asset	€
Prepayment	1,000

Example – prepaid revenue

The Break-away Hotel rents out part of its premises to a newsagent/convenience shop for which its charges an annual rent of €30,000 paid quarterly in advance. The business's year-end is 31 December and the following are the details of rent charged and paid during the year.

Bill period	**Amount due**	**Amount received**	**Date paid**
Jan Feb March	7,500	7,500	1//1/02
April May June	7,500	7,500	1/4/02
July Aug Sept	7,500	7,500	1/7/02
Oct Nov Dec	7,500	9,500	1/10/02
	30,000	32,000	

Show how the rent receivable account, profit and loss account and balance sheet are affected by the prepayment.

Solution – prepaid revenue

Rent Receivable Account

		€			€
31 Dec	P&L a/c	30,000	1 Jan	Bank	7,500
			1 Apr	Bank	7,500
			1 July	Bank	7,500
31 Dec	Bal c/d	2,000	1 Oct	Bank	9,500
		32,000			32,000
			1 Jan	Bal b/d	2,000

Note: The closing balance is a credit balance and thus comes down on the credit side representing a liability for the business.

Profit and Loss Account for the Year 2002

	€		€
Expenses		Gross Profit	
		Rent receivable	30,000

Balance Sheet Extract

Current liability	€
Rent receivable prepayment	2,000