

# Accruals and prepayments and other adjustments for financial statements

By Sarah Azhar

# Adjustments needed

Let's look at two businesses which pay rent for buildings in Oxford. The rent for each building is £6,000 a year.

1- Business A pays £5,000 in the year. At the year end it owes £1,000 for rent.

- Rent expense used up = £6,000
- Rent paid for = £5,000

2- Business B pays £6,500 in the year.

This figure includes £500 paid in advance for the following year.

- Rent expense used up = £6,000
- Rent paid for = £6,500

A profit and loss account for 12 months needs 12 months' rent as an expense = £6,000. This means that in both 1 and 2 the double entry accounts will have to be adjusted.

## 28.3

## Accrued expenses

Assume that rent of £4,000 per year is payable at the end of every three months. The rent was paid on time in March, but this is not always the case.

Amount	Rent due	Rent paid
£1,000	31 March 20X5	31 March 20X5
£1,000	30 June 20X5	2 July 20X5
£1,000	30 September 20X5	4 October 20X5
£1,000	31 December 20X5	5 January 20X6

## Rent

20X5		£
Mar	31	Cash
		1,000
Jul	2	"
		1,000
Oct	4	"
		1,000

The rent for the last quarter was paid on 5 January 20X6 and so will appear in the books of the year 20X6 as the result of a double entry made on that date.

# Accrued expenses

- The expense for 20X5 is obviously £4,000 as that is the year's rent, and this is the amount needed to be transferred to the profit and loss account.
- If £4,000 was put on the credit side of the rent account (the debit being in the profit and loss account) the account would be out of balance by £1,000 because the payment due on 31 December 20X5 was not made until 5 January 20X6.
- If we posted £4,000 to profit and loss on 31 December, we would have £4,000 on the credit side of the account and only £3,000 on the debit side

# Accrued expenses

				Rent			
20X5			£	20X5			£
Mar	31	Cash	1,000	Dec	31	Profit and loss	4,000
Jul	2	"	1,000				
Oct	4	"	1,000				

This cannot be right. To make the account balance the £1,000 rent owing for 20X5, but paid in 20X6, must be carried down to 20X6 as a credit balance because it is a liability on 31 December 20X5. Instead of rent owing it could be called rent accrued or just simply an 'accrual'.

# Accrued expenses

Rent					
20X5		£	20X5	£	
Mar 31	Cash	1,000	Dec 31	Profit and loss	4,000
Jul 2	"	1,000			
Oct 4	"	1,000			
<b>Dec 31</b>	<b>Accrued c/d</b>	<b><u>1,000</u></b>			
		<b><u>4,000</u></b>			<b><u>4,000</u></b>
			20X6		
			Jan 1	Accrued b/d	1,000

The balance c/d has been described as 'accrued c/d', rather than as 'balance c/d'. This is to explain what the balance is for. It is for an **accrued expense**.

# Prepaid expenses

Insurance for a business is at the rate of £840 a year, starting from 1 January 20X5. The business has agreed to pay this at the rate of £210 every three months. However, payments were not made at the correct times. Details were:

Amount	Insurance due	Insurance paid
£210	31 March 20X5	£210 28 February 20X5
£210 £210	30 June 20X5 30 September 20X5	£420 31 August 20X5
£210	31 December 20X5	£420 18 November 20X5

The insurance account in the ledger for the year ended 31 December 20X5 is:

Insurance					
20X5		£	20X5	£	
Feb 28	Bank	210	Dec 31	Profit and loss	840
Aug 31	"	420			
Nov 18	"	420			

# Prepaid expenses

- The last payment of £420 is not just for 20X5. It can be split as £210 for the three months to 31 December 20X5 and £210 for the three months ended 31 March 20X6.
- For a period of 12 months the cost of insurance is £840 and this is, therefore, the figure needing to be transferred to the profit and loss account.
- If £840 is posted to the debit of profit and loss at 31 December 20X5, the insurance account will still have a debit balance of £210. This is a benefit paid for but not used up at the end of the period.
- It is an asset and needs carrying forward as such to 20X6, i.e. as a debit balance. Items like this are called prepaid expenses, 'prepayments', or 'amounts paid in advance'.

# Prepaid expenses

## Insurance

			£				£
20X5				20X5			
Feb 28	Bank	210		Dec 31	Profit and loss	840	
Aug 31	"	420					
Nov 18	"	420		" 31	Prepaid c/d	210	
		<u>420</u>				<u>210</u>	
		<u>1,050</u>				<u>1,050</u>	
20X6							
Jan 1	Prepaid b/d	210					

# Revenue owing at the end of period

There may be different kinds of revenue, all of which have not been received by the end of the period, e.g. rent receivable.

# Revenue owing at the end of period

## Example

Our warehouse is larger than we need. We rent part of it to another business for £1,800 per annum. Details for the year ended 31 December were as follows:

Amount	Rent due	Rent received
£450	31 March 20X5	4 April 20X5
£450	30 June 20X5	6 July 20X5
£450	30 September 20X5	9 October 20X5
£450	31 December 20X5	7 January 20X6

The Rent Receivable Account entries for 20X5 will appear as:

Rent Receivable			
	20X5		£
	Apr 4	Bank	450
	Jul 6	Bank	450
	Oct 9	Bank	450

# Revenue owing at the end of period

- The rent received of £450 on 7 January 20X6 will be entered in the accounting records in 20X6.
- Any rent paid by the business would be charged as a debit to the profit and loss account. Any rent received, being the opposite, is transferred to the credit of the profit and loss account, as it is a revenue.
- The amount to be transferred for 20X5 is that earned for the 12 months, i.e. £1,800.
- The rent received account is completed by carrying down the balance owing as a debit balance to 20X6. The £450 owing is an asset on 31 December 20X5.

# Revenue owing at the end of period

## Rent Receivable

20X5		£	20X5		£		
Dec	31	Profit and loss	1,800	Apr	4	Bank	450
				Jul	6	Bank	450
				Oct	9	Bank	450
				<b>Dec</b>	<b>31</b>	<b>Accrued c/d</b>	<b>450</b>
			<u>1,800</u>				<u>1,800</u>
20X6							
Jan	1	Accrued b/d	450				

# Expenses and revenue account balances and the balance sheet

- The amounts owing for expenses could be called expense creditors, expenses owing or accrued expenses. However, we'll use the term 'accruals'. They represent very current liabilities – they will have to be paid in the very near future.
- The items prepaid could be called prepaid expenses or payments in advance, but we'll call them 'prepayments'. Similarly to accruals, they represent very current assets as they should be received very soon.
- Amounts owing for rents receivable or other revenue owing are a special case. If you look back at the T-account, you'll see that they are described as 'accrued'. However, they are not accrued expenses, as they represent amounts receivable. They are, therefore, accrued income.

# Expenses and revenue account balances and the balance sheet

## Balance Sheet as at 31 December 20X5 (extract)

	£	£	£
Current assets			
Stock		xxx	
Debtors		450	
Prepayments (400 + 210)		610	
Bank		xxx	
Cash		<u>xxx</u>	
		x,xxx	
<i>Less Current liabilities</i>			
Trade creditors	xxx		
Accrued expenses	<u>1,000</u>		
		( <u>xxx</u> )	
Net current assets			x,xxx

# Expenses and revenue accounts covering more than one period

The following details are available:

- (A) On 31 December 20X4, three months' rent amounting to a total of £3,000 was owing.
- (B) The rent chargeable per year was £12,000.
- (C) The following rent payments were made in the year 20X5:  
6 January £3,000; 4 April £3,000; 7 July £3,000; 18 October £3,000.
- (D) The final three months' rent for 20X5 is still owing.

# Expenses and revenue accounts covering more than one period

Rent									
20X5			£		20X5			£	
Jan	6	Bank	(C)	3,000	Jan	1	Accrued b/d	(A)	3,000
Apr	4	Bank	(C)	3,000	Dec	31	Profit and loss	(B)	12,000
Jul	7	Bank	(C)	3,000					
Oct	18	Bank	(C)	3,000					
<b>Dec</b>	<b>31</b>	<b>Accrued c/d</b>	<b>(D)</b>	<b><u>3,000</u></b>					
				<u>15,000</u>					<u>15,000</u>
					20X6				
					Jan	1	Accrued b/d		3,000

# Expenses and revenue accounts covering more than one period

Where different expenses are put together in one account, it can get even more confusing. Let us look at where rent and rates are joined together. Here are the details for the year ended 31 December 20X5:

- (A) Rent is payable of £6,000 per annum.
- (B) Rates of £4,000 per annum are payable by instalments.
- (C) At 1 January 20X5, rent of £1,000 had been prepaid in 20X4.
- (D) On 1 January 20X5, rates of £400 were owed.
- (E) During 20X5, rent of £4,500 was paid.
- (F) During 20X5, rates of £5,000 were paid.
- (G) On 31 December 20X5, rent of £500 was owing.
- (H) On 31 December 20X5, rates of £600 had been prepaid.

# Expenses and revenue accounts covering more than one period

## Rent and Rates

20X5				£	20X5				£
Jan	1	Rent prepaid b/d	(C)	1,000	Jan	1	Rates owing b/d	(D)	400
Dec	31	Bank: rent	(E)	4,500	Dec	31	Profit and loss a/c	(A) + (B)	10,000
Dec	31	Bank: rates	(F)	5,000					
<b>Dec</b>	<b>31</b>	<b>Rent accrued c/d</b>	<b>(G)</b>	<b><u>500</u></b>	<b>Dec</b>	<b>31</b>	<b>Rates prepaid c/d</b>	<b>(H)</b>	<b><u>600</u></b>
				<u>11,000</u>					<u>11,000</u>
20X6					20X6				
Jan	1	Rates prepaid b/d	(H)	600	Jan	1	Rent accrued b/d	(G)	500

# Distinctions between various kinds of capital

- **Capital invested:** This means the total monetary value of everything brought into the business by the proprietors from their outside interests. The amount of capital invested is not disturbed by the amount of profits made by the business or losses incurred.
- **Capital employed:** If all the assets were added together and the liabilities of the business deducted, the answer would be that the difference is the amount of money employed in the business. This is the same as the closing balance of the capital account. It is also sometimes called 'net assets' or 'net worth'.
- **Working Capital:** This is a term for the excess of the current assets over the current liabilities of a business and is the same as 'net current assets'.

# Financial statements in the services sector

**J Plunkett, Solicitor**  
**Profit and Loss Account for the year ending 31 December 20X5**

	£	£
Revenue:		
Fees charged		87,500
Insurance commissions		<u>1,300</u>
		88,800
Less Expenses:		
Wages and salaries	29,470	
Rent and rates	11,290	
Office expenses	3,140	
Motor expenses	2,115	
General expenses	1,975	
Depreciation	<u>2,720</u>	
		(50,710)
Net profit		<u><u>38,090</u></u>