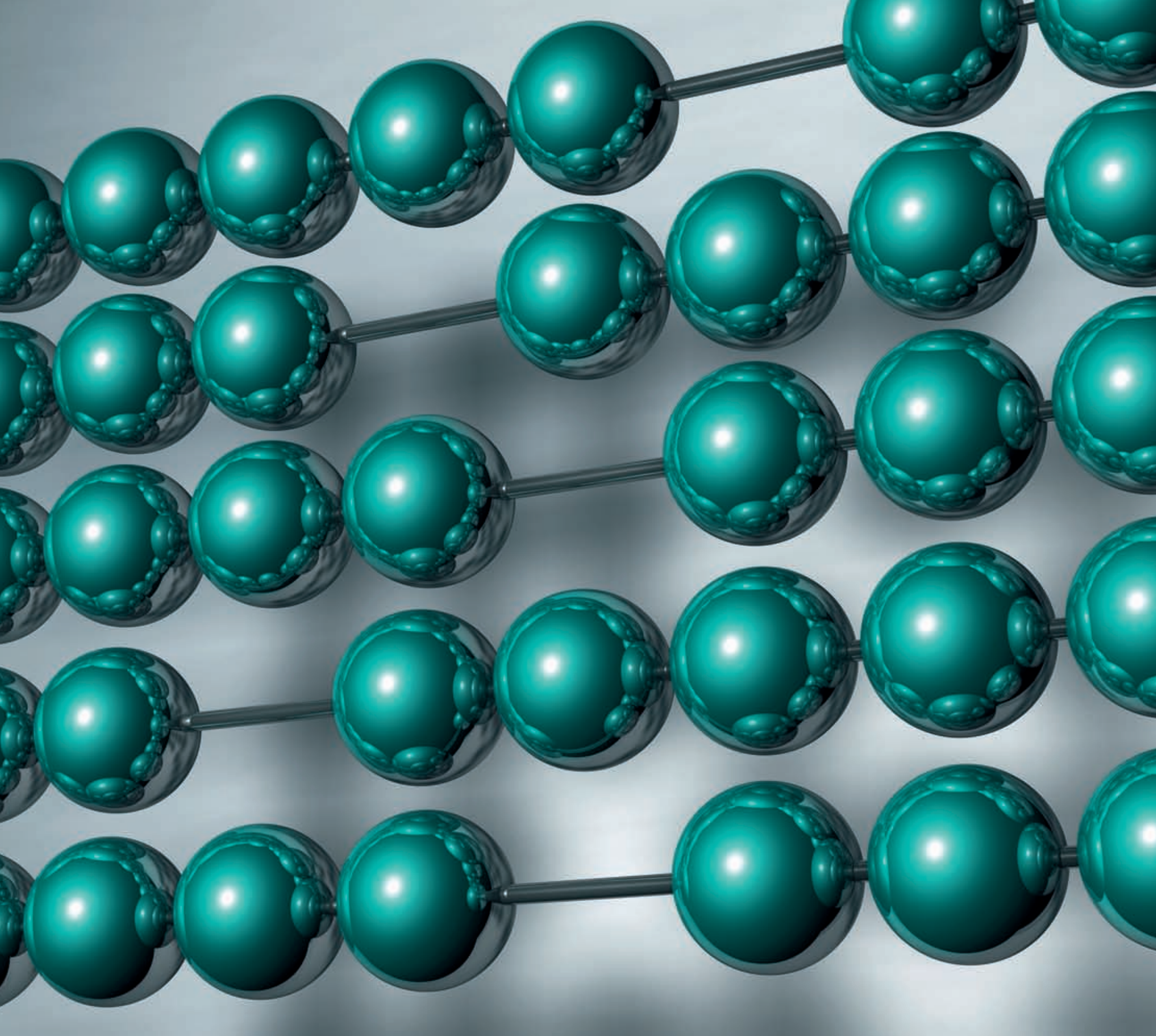
Financial Accounting

Fifth Edition

Anne Britton & Chris Waterston



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FINANCIAL ACCOUNTING

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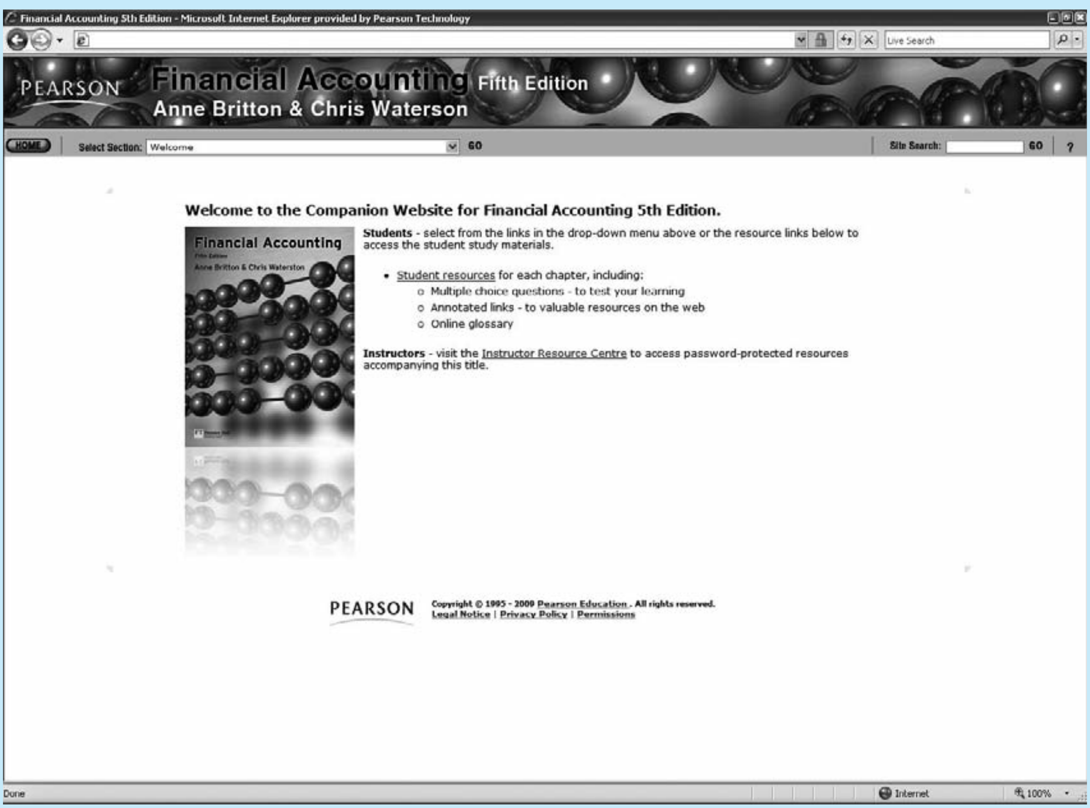

- insurance paid £3,600 relating to the period 1 October 20X4 to 30 September 20X5, insurance is likely to increase by 10% per annum thereafter.

Identify all accruals and prepayments for the period in question and the amounts to be transferred to the income statement.

Bad debts and provision for bad debts

5 Creating a provision for bad debts uses which accounting concept? Explain your choice.

6 When bad debts are eliminated from accounts a provision for bad debts is no longer necessary. Discuss.

7 As at the year end 31.12.X5 the following debts out of a total debtors' figure of £54,500 are found to be bad:

A. Bloggs	£780
B. Swift	£320
P. Trent	£1,500 – 50p in the £ is payable.

The balance sheet as at 31.12.X4 showed a provision for bad debts for the business of £2,100. The provision for bad debts as at 31.12.X5 is estimated to be 5% of debtors' balances. Show the bad debts account, provision for bad debts account and the balance sheet as at 31.12.X5.

8 At the year end the following debts, out of a total debt figure of £45,680, are found to be bad:

- David £450
- Alex £650
- Sand £240 but 10p in the pound payable.

It is also estimated that a further provision for bad debts of 4% of debtors is required.

Show the amount of bad debts to be written-off, the provision for bad debts and the balance for debtors to be shown in the balance sheet of the business.

Depreciation

9 Identify the factors involved in the calculation of depreciation for a non-current asset.

10 Are the following statements TRUE or FALSE? Explain your answer fully.

(a) Depreciation is the amount necessary to reduce the asset to its net realisable value at the year end.

(b) Depreciation is the assessment of the amount of an asset used up in generating revenue for a period.

(c) The amount of depreciation charged by two businesses using an identical asset will be the same.

(d) Motor vehicles are always depreciated using the reducing balance method and buildings using the straight line method.

(e) The straight line method of depreciation allocates an equal charge for depreciation to each period of use.

(f) If depreciation is omitted from the accounts, profit for the year will be overstated.

11 The following non-current assets are bought by C. Brewer for use in her business on 1.1.X0.

	Cost	*Estimated useful life*	*Estimated residual value at end of useful life*
	(£)	(years)	(£)
Building	60,000	50	10,000
Vehicle	12,000	10	300
Equipment	9,000	10	800

Buildings and equipment are to be depreciated using the straight line method, vehicles reducing balance of 25%.

The vehicle is sold for £6,500 on 1.12.X2 and an item of equipment costing £1,500 for £1,200 on the same date. Assume that the residual value of the item of equipment sold was estimated to be £100 at its date of purchase. Assume a full year's depreciation in the year of purchase and none in the year of sale.

Show the asset accounts, provision for depreciation accounts, sale of asset accounts and extracts from the income statement and balance sheet in respect of these assets for the years ended 31.12.X0, 31.12.X1, 31.12.X2.

12 Currant commenced business on 1.10.X2 purchasing fixtures and fittings for £25,000 and a van for £16,000. The fixtures and fittings were estimated to have a useful life of eight years and a residual value of £1,800. Further fittings were purchased on 1.11.X5 for £15,200 with nil residual value.

During December 20X6 the van was involved in an accident and the insurance assessors considered it a write-off. A cheque for £3,200 was received in December from the insurers in full settlement. Another van was purchased on 5 January 20X7 at a cost of £18,500. Depreciation policy of Currant is to charge a full year in the year of purchase and none in the year of sale, and to depreciate fixtures and fittings on a straight line basis and vehicles by 25% reducing balance.

Prepare the ledger accounts for the two years ending 30.9.X6 and 30.9.X7 for each non-current asset together with related provision for depreciation and the sale of asset accounts. Show the balance sheet extract for fixed assets as at the two year ends.

13 Provide a definition of depreciation as it is used in accounting.

14 What information is needed in respect of an asset in order in order to make an assessment of depreciation for that asset.

15 The following non-current assets are owned by Black for use in his business:

	Cost	*Estimated useful life*	*Estimated residual value at end of useful life*
	(£)	(years)	(£)
Building	400,000	40	250,000
Vehicle	110,000	6	6,000
Equipment	80,000	8	1,000

All assets were bought on 1 January 20X0 and the depreciation policy of Black is as follows:

- Buildings 1% straight line.
- Equipment and vehicles 10% reducing balance.

Show the depreciation charges for the year ended 31 December 20X0 and 31 December 20X1 and comment on the depreciation policy of Black.

16 The income statement of Tosuso shows a profit of £10,870 for the period ended 31 December 200X. However, this income statement has been drawn up before adjustments have been made for the following:

- Non-current assets of £54,000 are to be depreciated on a straight line basis over ten years. Residual value is assumed to be £5,400.
- Bad debts of £6,700 have been identified for the period.
- The provision for bad debts, which is set at 5% of debtors balance, is shown in the balance sheet as £3,000. Debtors at the year end amount to £63,000 before the bad debt of £6,700 is written off.
- Accruals of £1,500 for electricity and prepayments of £4,500 for rent of office space.

Required
Show the adjustments to be made to the income statement to account for the above and recalculate the profit for the period.

Answers to these questions can be found at the back of this book.

7

Preparation of statement of comprehensive income and statement of financial position from trial balance and adjustments

Objectives

By the end of this chapter you should be able to:

- **Prepare a statement of comprehensive income from a trial balance after taking account of several adjustments.**
- **Prepare a statement of financial position from a trial balance after several adjustments.**

Introduction

This chapter aims to bring together your knowledge of Chapters 5 and 6 so that you can prepare statements of comprehensive income and statements of financial position at the period end of a business after taking account of all the period-end adjustments necessary to the ledger accounts. These period-end adjustments will ensure that the final statements prepared will be in accordance with concepts and conventions of accounting that were identified in Chapter 4. Use will be made of the extended trial balance technique in compiling these final statements. At this stage we are still only dealing with accounts of a sole trader business.

First, though, a recap of Chapters 5 and 6:

- Ledger accounts are required for all assets, liabilities, expenses and income within a business.
- These ledger accounts are written up using double entry – the duality concept.
- At a period end, ledger accounts are balanced.

- Expense and income accounts are transferred to the statement of comprehensive income which is a double entry account.
- Any other balances remaining in the ledgers are shown on a statement of financial position.
- To prepare accounts in accordance with accounting concepts and conventions several adjustments need to be made to the ledger accounts before transfers are made to the statement of comprehensive income.
- These adjustments take account of accruals and prepayments so that expenses used up are matched to the revenue they generate.
- Adjustments are required for bad debts and provision for bad debts to comply with prudence and accepted accounting practice.
- A depreciation adjustment for non-current assets that are used up in generating revenue is also required.

This chapter will consist of two examples that will demonstrate adjustments required to the ledgers at the period end, the extraction of a trial balance at this stage, and the preparation of a statement of comprehensive income and statement of financial position for the period. Work through these examples carefully as you will then be expected to complete a similar activity yourself. Our examples will conclude with a technique called an **extended trial balance**, which is a working paper from which the adjustments to the double entry accounts will be made. This speeds up the process of producing a statement of comprehensive income and a statement of financial position without having to wait for all the ledger accounts to be adjusted. This can be a useful technique for students in examinations. Remember that in Chapter 6, Activity 6.14, we asked you to prepare non-current asset adjustments without using ledger accounts. Note that the ledgers will eventually have to be amended for the period-end adjustments whether or not we use an extended trial balance.

Extended example

Example 7.1

The following trial balance was extracted from the ledgers of a sole trader, Mai Wong, as at 31.12.X5:

	Dr	*Cr*
Sales		45,000
Purchases	15,000	
Inventory 1.1.X5	2,300	
Wages	5,200	
Office expenses	900	
Heating and lighting	850	
Telephone	450	
Rent	2,200	
Fixtures and fittings	7,550	
Vehicles	8,500	
Provision for depreciation 1.1.X5:		
Fixtures and fittings		755

Example 7.1 continued

Capital		8,805
Accounts receivable	1,300	
Accounts payable		1,150
Insurance	650	
Motor expenses	210	
Drawings	10,400	
Bank and cash	200	
	55,710	55,710

The following **period-end adjustments** are required:

- Office expenses to be accrued, £50.
- Heating and lighting to be accrued, £150.
- Rent paid in advance, £200.
- Insurance paid in advance, £80.
- Fixtures and fittings to be depreciated at 10% of cost and vehicles 20% of cost.
- An item of fixtures was sold during the year for £90. The item had been bought on 1.1.X3 for £120. The sale proceeds were credited to the sales account.
- Closing inventory is valued at £1,950.
- £90 of the motor expenses relates to items for Mai Wong's own use.

Show the adjustments necessary to the ledger accounts to account for the above and the transfers to the statement of comprehensive income for the year.

OFFICE EXPENSES ACCOUNT

31.12.X5	Balance b/d	900			
31.12.X5	Balance c/d (1)	50	31.12.X5	Statement of (2) comprehensive income	950
		950			950
			1.1.X6	Balance b/d (1)	50

Entry 1 is the accrual of £50 for the year and the corresponding carry-down of the balance to the following year.

Entry 2 shows the charge to the statement of comprehensive income for the year, which is the £900 cash paid plus £50 accrual. This accrual is to ensure matching of expenses used up to the revenue generated.

HEATING AND LIGHTING ACCOUNT

31.12.X5	Balance b/d	850			
31.12.X5	Balance c/d (1)	150	31.12.X5	Statement of comprehensive income	1,000
		1,000			1,000
			11.X6	Balance b/d	150