Paul Robbins training and consultancy

Advanced Bookkeeping

Lesson 2 – Irrecoverable Debts Allowance for Doubtful Debts, Accruals and Prepayments

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Irrecoverable Debts

- For a VAT registered business, the following entries need to be made in the Main Ledger accounts to write off an irrecoverable debt:
- **Debit** – Irrecoverable Debts *[net amount]*
- **Debit** – VAT Control Account *[VAT amount]*
- **Credit** – Trade Receivables (SLCA) *[gross amount]*
- Also need to record the gross amount of the irrecoverable debt written off in the subsidiary Sales Ledger account for that customer and close their account

Irrecoverable Debts

- At the end of the financial year the balance on the Irrecoverable Debts account is transferred to the Statement of Profit or Loss as an **expense**
- **Debit** – Statement of Profit or Loss
- **Credit** – Irrecoverable Debts
- Writing off irrecoverable debts is an example of the **Prudence Concept**

Allowance for Doubtful Debts

- Allowance for Doubtful Debts is where a business estimates what proportion of its receivables will become irrecoverable debts in that accounting period
- It is **not** the same as writing off irrecoverable debts – it is uncertain which specific debts will need to be written off at this stage
- Irrecoverable debts written off relate to specific debts which will not be paid

Allowance for Doubtful Debts

- The Trade Receivables (SLCA) balance is the starting point for calculating the Allowance for Doubtful Debts
- Irrecoverable Debts written off should firstly be deducted from the Trade Receivables balance if this has not already been done
- The Trade Receivables balance should then be multiplied by the percentage of debtors who it is expected will not pay – this will be given to you in exam questions – but in reality is based on past experience or industry averages

Allowance for Doubtful Debts

- Two Main Ledger accounts used for recording Allowance for Doubtful Debts:
- **Allowance for Doubtful Debts [Adjustment]** – records the amount to create, increase or decrease the allowance each year
- **Allowance for Doubtful Debts [SoFP]** – records the accumulated allowance for doubtful debts on the Statement of Financial Position

Accounting for Doubtful Debts

- The business estimates the percentage of its Trade Receivables which it expects will not be paid and calculates the Allowance for Doubtful Debts after writing off any irrecoverable debts
- The business records the Allowance for Doubtful Debts in the Main Ledger:
- **Debit** – Statement of Profit or Loss (expense)
- **Credit** – Allowance for Doubtful Debts [Adjustment]
- **Debit** – Allowance for Doubtful Debts [Adjustment]
- **Credit** – Allowance for Doubtful Debts [SoFP] (liability)

Accounting for Doubtful Debts

- Adjustments to the Allowance for Doubtful Debts may need to be made in subsequent accounting periods due to:

- **Policy change** – the percentage being used to calculate the Allowance for Doubtful Debts increasing or decreasing

- **Arithmetical adjustment** – the balance of Trade Receivables increasing or decreasing

Accounting for Doubtful Debts

- Bookkeeping entries to record an **increase** in the Allowance for Doubtful Debts:

- **Debit** – Statement of Profit or Loss (charges additional expense)

- **Credit** – Allowance for Doubtful Debts [Adjustment]

- **Debit** – Allowance for Doubtful Debts [Adjustment]

- **Credit** – Allowance for Doubtful Debts [SoFP] (increases liability)

Accounting for Doubtful Debts

- Bookkeeping entries to record a **decrease** in the Allowance for Doubtful Debts:
- **Debit** – Allowance for Doubtful Debts [Adjustment]
- **Credit** – Statement of Profit or Loss (reduces expense previously charged)
- **Debit** – Allowance for Doubtful Debts [SoFP] (reduces liability)
- **Credit** – Allowance for Doubtful Debts [Adjustment]

Accruals and Prepayments

- Ensure that the Financial Statements of a business show the correct **income** and **expenditure** for each year rather than just the money paid and received
- Also makes sure that the business shows the correct profit or loss for the year
- Relates to the **Accruals Concept**

Accrued Expenses

- Expense which relates to a financial year but is still unpaid and unrecorded at the end of that financial year
- Added onto the expenses paid in the financial year – expenses increase which reduces profit – accrued expenses are a **liability** in the SoFP
- **Debit** – Expense Account (SoPoL)
- **Credit** – Accrued Expenses (SoFP)

Accrued Expenses – Example

- Electricity account has a debit balance of £900 at the end of the financial year
- An invoice for electricity of £300 is received early in the new financial year which relates to the last three months of the previous financial year
- Record the accrual and calculate the total electricity expense for the year:
- **Debit** – Electricity Account £300
- **Credit** – Accrued Expenses £300
- Total electricity expense for the year in the SoPoL is £900 + £300 = **£1,200**

Prepaid Expenses

- Expense which is paid in one financial year but the use of the expense relates to the following financial year – it is effectively paid in advance
- Deducted from expenses paid in the financial year – reduces expense and increases profit – prepaid expenses are an **asset** in the SoFP
- **Debit** – Prepaid Expenses (SoFP)
- **Credit** – Expense Account (SoPoL)

Prepaid Expenses – Example

- Car Insurance account has a debit balance of £3,000 at the end of the financial year ended 31/12/15
- This includes car insurance paid of £1,500 for the period from 01/07/15 to 30/06/16
- Record the prepayment and calculate the Car Insurance expense for the year:
- **Debit** – Prepaid Expenses £750 (working: 6/12 months x £1,500)
- **Credit** – Car Insurance Account £750
- Total Car Insurance expense for the year in SoPoL is £3,000 – £750 = **£2,250**

Accrued Income

- Income which is due to a business but has still not been received at the end of the financial year – accrued income is an **asset** of the business

- This relates to additional income rather than ‘normal’ credit sales which are already adjusted for through having receivables

- **Debit** – Accrued Income (SoFP)

- **Credit** – Income Account (SoPoL)

- Income accounts include Rent Received and Commission Received

Accrued Income – Example

- A business rents out a room for £650 per month which is invoiced monthly in arrears
- The Rent Received account for the year ended 31/12/15 does not include rental income for December 2015 as it has not yet been invoiced
- Record the accrued income in respect of December 2015:
- **Debit** – Accrued Income (SoFP) £650
- **Credit** – Rent Received (SoPoL) £650

Prepaid Income

- Income which is received in advance of the income being earned – prepaid income is a **liability** of the business

- Deducted from income received in the financial year – reduces income and decreases profit

- **Debit** – Income Account (SoPoL)

- **Credit** – Prepaid Income (SoFP)

Prepaid Income – Example

- A business rents out a room for £650 per month where rent has been paid upfront for the six months ended 31/03/16
- The financial year for the business ended on 31/12/15
- <u>Record the prepaid income for the financial year ended 31/12/15:</u>
- **Debit** – Rent Received £1,950 (working: 3 months x £650)
- **Credit** – Prepaid Income £1,950

Goods for Owner's Own Use

- Business owners can take goods out of the business for their own use – also some business expenses have an element of private use
- Since these costs do not relate to the business the costs should <u>not</u> be included in the Financial Statements but be treated as **drawings**
- <u>To record goods taken out of the business for the owner's personal use:</u>
- **Debit** – Drawings Account *(gross amount)*
- **Credit** – Sales Account *(net amount)*
- **Credit** – VAT Control Account *(VAT amount)*

Goods for Owner's Own Use – Example

- The owner of a clothing shop takes a shirt from the business for their own use which cost the business £60 including standard rate VAT
- Record the bookkeeping entries that the owner needs to make:
- **Debit** – Drawings Account £60
- **Credit** – Sales Account £50
- **Credit** – VAT Control Account £10
- The owner has effectively made a sale to themselves

Private Use of Business Expenses

- The business owner should calculate the proportion of the expense which relates to private use – the remainder will relate to business use

- <u>To record the private use of business expenses:</u>

- **Debit** – Drawings Account *(with private use amount)*

- **Credit** – Expense Account *(with private use amount)*

- **Debit** – Statement of Profit or Loss *(with business use amount)*

- **Credit** – Expense Account *(with business use amount)*

Private Use – Example

- A sole trader uses a business owned car for both business and private journeys – they estimate that their private use of the car is 25%
- At the end of the year the balance on the Motor Expenses account is £2,400
- Record the bookkeeping entries for the private and business use of the car:
- **Debit** – Drawings Account £ 600 (private use)
- **Credit** – Motor Vehicles Account £ 600 (private use)
- **Debit** – Statement of Profit or Loss £1,800 (business use)
- **Credit** – Motor Vehicles Account £1,800 (business use)