

adjustments to financial statements

relevant to CAT Scheme Paper 6 and Professional Scheme Paper 1.1

achieving balance

■ Exam questions on financial statements will often present a trial balance (or list of balances) together with a number of adjustments to be made when preparing an income statement/profit and loss account and balance sheet.

It is surprising that many candidates are unable to handle these adjustments properly in the exam. This article explains how to treat the main possible adjustments, including:

- inventory/stock
- accruals and prepayments
- interest
- depreciation
- bad debts and allowances for receivables/debtors.

The most important point, which must be understood at the outset, is that all these adjustments have an impact on both the income statement/profit and loss account and in the balance sheet. If the trial balance balances, your answer must balance, and therefore any changes to the trial balance must balance. Having said that, it is more important to complete the question within the time allowed, without spending time on getting the balance sheet to balance.

INVENTORY/STOCK

This is a fairly familiar adjustment. The cost of goods sold consists of opening inventory plus purchases, minus closing inventory. The closing inventory is thus a deduction (credit) in the income statement/trading account, and a current asset (debit) in the balance sheet.

The ledger account behind the adjustment causes problems for some candidates. This is how the inventory/stock account will look at the time the trial balance is being prepared. The entry is the transfer from the income statement for the closing inventory of the previous year (figures invented):

Inventory/stock	
2004	\$
31 Dec Income statement	38,000

In the current year, last year's closing inventory is this year's opening inventory. It must be transferred out to this year's income statement, before the entry for the new closing inventory is made:

Inventory/stock			
2004	\$	2005	\$
31 Dec Income statement	38,000	31 Dec Income statement	38,000
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2005			
31 Dec Income statement	45,000		

Questions requiring the preparation of financial statements will always give you the closing inventory/stock figure. However, there will sometimes be a requirement to adjust it to allow for damaged or slow-moving items. IAS 2, *Inventories* and SSAP 9, *Stocks and Long-term Contracts* both require inventories/stock to be included at the lower of cost and net realisable value. It may therefore be necessary to reduce the given figure to reflect a net realisable value below cost for the items detailed.

ACCRUALS AND PREPAYMENTS

The income statement/profit and loss account has to include the expenses relating to the period, whether or not they have been paid. The figures in the trial balance will usually be the amounts paid in the period, and they need adjusting for outstanding amounts and amounts paid which relate to other periods to obtain the income statement charge.

Unpaid balances relating to the period should be included in the balance sheet as current liabilities. If the expense has been paid in advance, the amount prepaid is included in the balance sheet as a current asset. In the income statement/profit and loss account, the total expense is needed with a working showing the detail. Don't show two figures in the outer column for the same expense heading. For example, the trial balance shows:

	\$
Wages	136,000
Insurance	4,000

At 31 December 2005, wages owing amounted to \$3,800, and insurance paid in advance was \$600. This is presented as follows:

	\$
Income statement/profit and loss account	
Wages (136,000 + 3,800)	139,800
Insurance (4,000 - 600)	3,400

Balance sheet

Current assets	
Inventory/stock	-
Receivables/debtors	-
Prepayments	600
Cash	-
Current liabilities	
Trade payables/creditors	-
Accruals	3,400

The underlying ledger accounts

Wages

	\$		\$
Balance	136,000	Income statement	139,800
Balance carried down	<u>3,800</u>		
	<u>139,800</u>	Balance brought down	<u>3,800</u>

Insurance

	\$		\$
Balance	4,000	Income statement	3,400
		Balance carried down	<u>600</u>
Balance brought down	<u>4,000</u> 600		<u>4,000</u>

Similar adjustments may be needed for income, such as rent receivable. Be careful here. Income received in advance is a liability and should be included alongside accruals for unpaid expenses, thereby changing the heading to 'Accruals and deferred income'. Income in arrears is an asset which should be included with prepayments using the heading 'Prepayments and accrued income'.

INTEREST

Interest payable is really another accrual but there are one or two special points. First, the question may not give explicit instructions to accrue for interest. The trial balance may contain:

	Dr	Cr
	\$	\$
8% Loan stock/debentures		100,000
Interest on loan stock/debentures	4,000	

Candidates are expected to note that only half the loan interest has been paid, and accrue for the other \$4,000. Examiners generally indicate in some way that the loan stock/debentures have been in issue for the whole year if they want this adjustment to be made. Second, the interest is a current liability and the loan stock/debentures are a non-current liability. Present them appropriately and don't combine them.

DEPRECIATION

Depreciation is a slightly more complex adjustment. Depreciation spreads the cost of non-current/fixed assets fairly over assets' useful lives, so that a charge against profit appears in the income statement/profit and loss account each year.

Methods of depreciation

There are two main methods of depreciation which are tested in basic level examinations:

- straight line method – a percentage of cost (or cost less residual value) is charged each year
- reducing balance method – a percentage is charged on the written down value (cost less accumulated depreciation to date).

Depreciation policies

Some businesses adopt a policy of charging a full year's depreciation in the year the asset was purchased, and none in the year of its sale. Others take proportionate depreciation for the number of months of ownership of the asset in the year. The first requirement, therefore, is to read the question carefully to find out what has to be done for each non-current/fixed asset.

Income statement/profit and loss account

The current year's depreciation charge is calculated and appears as an expense. Do not include the accumulated depreciation. The accumulated depreciation is the total depreciation charged during an asset's life (assuming no revaluation) and as such previous costs will have been charged against profits in earlier periods.

Balance sheet

The balance sheet shows the cost, accumulated depreciation (the figure in the trial balance plus the current year's charge from the income statement), and net book value. The easiest way to present this is as a table, as follows (figures invented):

	Cost	Accumulated depreciation	Net book value
	\$	\$	\$
Buildings	800,000	80,000	720,000
Plant and equipment	390,000	260,000	130,000
Motor vehicles	<u>210,000</u>	<u>100,000</u>	<u>110,000</u>
	<u>1,400,000</u>	<u>440,000</u>	<u>960,000</u>

Workings may have to be shown separately to explain the build-up of the figures.

The underlying ledger accounts

It would be possible to use just one account for each non-current/fixed asset, showing cost and depreciation. However, they are usually kept separate, in order to present the separate figures in the balance sheet as shown above. This results in (figures invented):

Plant and machinery – cost			
	\$		\$
Balance brought down	360,000	Balance carried down	390,000
Cash	<u>30,000</u>		
	<u>390,000</u>		<u>390,000</u>
Balance brought down	390,000		

Plant and machinery – accumulated depreciation			
	\$		\$
Balance carried down	260,000	Balance brought down	221,000
		Income statement	<u>39,000</u>
	<u>260,000</u>		<u>260,000</u>
		Balance brought down	260,000

Notes

The trial balance would have contained the debit balance of \$360,000 cost, and the credit balance of \$221,000, for the accumulated depreciation at the beginning of the period. The inclusion of the current year's charge increases the credit to \$260,000.

A third account is required to handle disposals. When a non-current/fixed asset is sold, the cost and accumulated depreciation relating to the asset are transferred out of the accounts to a disposal account. The proceeds of sale are credited to the account, and the balance on the account is then the profit or loss on the sale, to be transferred to the income statement/profit and loss account.

BAD DEBTS AND ALLOWANCE FOR RECEIVABLES/DEBTORS

These adjustments probably cause most difficulty for candidates in an examination.

Bad debts

Writing off a bad debt means taking a customer's balance in the receivables/sales ledger and transferring it to the income statement as an expense, because the balance has proved irrecoverable. There are two separate exam possibilities here:

- bad debts appear as an item in the trial balance. This means the debts have already been written off. In other words, receivables/debtors have already been reduced. All that is necessary is to put the figure in the income statement/profit and loss account as an expense
- bad debts appear as an adjustment outside the trial balance. Two entries are now needed. The amount goes into the income statement as an expense and is deducted from the receivables/debtors figure in the balance sheet.

Allowance for receivables/debtors

This allowance is set up in order to include a realistic value for receivables/debtors in the balance sheet, without actually writing off the debt. The balance is left in the receivables/sales ledger so that collection procedures continue, but the receivables/debtors in the balance sheet are valued as if the amount is not to be recovered. The trial balance shows:

	Dr	Cr
	\$	\$
Trade receivables/debtors	180,000	
Allowance for receivables/debtors		4,000

This means that the business already has an allowance, taken from the income statement/profit and loss account in previous years. If nothing more is to be done, this should show in the balance sheet, under current assets:

	\$	\$
Trade receivables/debtors	180,000	
Less: Allowance for receivables/debtors	<u>4,000</u>	176,000

Alternatively, if preparing a company balance sheet for publication, it should show:

Trade receivables/debtors (180,000 - 4,000)	176,000
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The figures in brackets are a working, not part of the balance sheet. Continuing the example, it is more likely that the question will require the allowance to be adjusted. Let us say that the allowance is to be increased to \$5,400. Given that there is already \$4,000, \$1,400 should be taken out of this year's income statement/profit and loss account. The result is:

Income statement/profit and loss account

	\$
Increase in allowance for receivables/debtors	1,400

Remember that it is only the increase or decrease in the allowance that goes into the income statement/profit and loss account.

Balance sheet

	\$	\$
Trade receivables/debtors	180,000	
Less: Allowance for receivables/debtors	<u>5,400</u>	174,600

The underlying ledger accounts

There are several ways of dealing with bad debts, and allowances for receivables debtors, in ledger accounts. One way is to have both in one account. However, for examination purposes, it may be easier to have two accounts, one for debts written off and one for the allowance:

Bad debts (figures invented)

	\$		\$
Transfers in from receivables/sales ledger	18,500	Income statement /profit and loss account	18,500
	<u>18,500</u>		<u>18,500</u>

Allowance for receivables/debtors (using figures above)

	\$		\$
Balance carried down	5,400	Balance brought down	4,000
	<u>5,400</u>	Income statement/ profit and loss account	1,400
			<u>5,400</u>
		Balance brought down	5,400

Bad debts recovered

Sometimes, a debt written off in one year is actually paid in the next year – a debit to cash and a credit to bad debts recovered. The credit balance on the account is then transferred to the credit of the income statement/profit and loss account (added to gross profit or included as a negative in the list of expenses). This is better than crediting the recovery to the bad debts account, because that would obscure the expense from bad debts for the year.

A FINAL NOTE ON DIVIDENDS (UK ONLY)

Until recently, proposed dividends were included as liabilities in UK balance sheets, and dividends paid and proposed were required by the Companies Act 1985 to be shown as a deduction at the end of the profit and loss account. FRS 21, *Events after the balance sheet date* brought the UK into line with international practice (IAS 10).

Now, proposed equity dividends are not normally to be recognised as liabilities or included in the profit and loss account. Statutory Instrument 2947 of 2004 amended the Companies Act so that the total of dividends paid in the year (and reserve movements) is now shown by note rather than as part of the profit and loss account. The note can be conveniently shown immediately under the profit and loss account. Dividends actually paid in the year are debited to the profit and loss account reserve in the example balance sheet as shown below. A company's trial balance at 31 December 2005 shows:

	Dr	Cr
	£m	£m
Profit and loss account 1 January 2005	38	
Dividends paid in 2005		
Final 2004		2
Interim 2005		1

The profit for the year comes to £5m
The balance sheet will show:

	£m
Profit and loss account (38 - 2 - 1 + 5)	40

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