achieving balance

- It is surprising that many candidates are unable to handle certain adjustments properly in the exam. This article explains how to treat the main possible post trial balance 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):

<table>
<thead>
<tr>
<th>Inventory/stock</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$</td>
</tr>
<tr>
<td>31 Dec Income statement</td>
<td>38,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Inventory/stock</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$</td>
</tr>
<tr>
<td>31 Dec Income statement</td>
<td>38,000</td>
</tr>
</tbody>
</table>

There will sometimes be a requirement to adjust inventory/stock 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 inventory/stock 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:

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income statement/profit and loss account</td>
<td>$</td>
</tr>
<tr>
<td>Wages (136,000 + 3,800)</td>
<td>139,800</td>
</tr>
<tr>
<td>Insurance (4,000 - 600)</td>
<td>3,400</td>
</tr>
</tbody>
</table>

**Balance sheet**

Current assets
- Inventory/stock
- Receivables/debtors
- Prepayments 600
- Cash

Current liabilities
- Trade payables/creditors
- Accruals 3,400
The underlying ledger accounts

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td></td>
<td>Income statement</td>
<td>139,800</td>
</tr>
<tr>
<td>Balance</td>
<td>136,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance carried down</td>
<td>3,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>139,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance brought down</td>
<td>3,800</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td></td>
<td>Income statement</td>
<td>3,400</td>
</tr>
<tr>
<td>Balance</td>
<td>4,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance carried down</td>
<td>600</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance brought down</td>
<td>600</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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 $8% Loan stock/debentures $100,000
- Cr 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):

<table>
<thead>
<tr>
<th>Cost</th>
<th>Accumulated depreciation</th>
<th>Net book value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>800,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>390,000</td>
<td>260,000</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>210,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>$1,400,000</strong></td>
<td><strong>$440,000</strong></td>
<td><strong>$960,000</strong></td>
</tr>
</tbody>
</table>

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):

<table>
<thead>
<tr>
<th>Plant and machinery – cost</th>
<th>$</th>
<th>Plant and machinery – accumulated depreciation</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance brought down 360,000</td>
<td>Balance carried down 390,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash 30,000</td>
<td>Balance carried down 390,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance brought down 390,000</td>
<td>Balance carried down 390,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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:

\[
\begin{array}{ccc}
\text{Dr} & \text{Cr} \\
\text{Trade receivables/debtors} & 180,000 \\
\text{Allowance for receivables/debtors} & 4,000 \\
\end{array}
\]

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:

\[
\begin{array}{ccc}
\text{} & \text{} & \text{} \\
\text{Trade receivables/debtors} & 180,000 \\
\text{Less: Allowance for receivables/debtors} & 4,000 & 176,000 \\
\end{array}
\]

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

\[
\begin{array}{ccc}
\text{} & \text{} & \text{} \\
\text{Trade receivables/debtors (180,000 - 4,000)} & 176,000 \\
\end{array}
\]

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:

\[
\begin{array}{ccc}
\text{Income statement/profit and loss account} & \text{} & \text{} \\
\text{Increase in allowance for receivables/debtors} & 1,400 \\
\text{} & \text{} & \text{} \\
\text{Balance carried down} & 5,400 & 5,400 \\
\text{Balance brought down} & 4,000 & 4,000 \\
\text{Balance brought down} & 1,400 & 1,400 \\
\text{} & \text{} & \text{} \\
\text{Balance brought down} & 5,400 & 5,400 \\
\text{} & \text{} & \text{} \\
\text{Bad debts (figures invented)} & \text{} & \text{} \\
\text{Transfers in from receivables/sales ledger} & 18,500 & 18,500 \\
\text{Income statement/profit and loss account} & 18,500 & 18,500 \\
\text{} & \text{} & \text{} \\
\text{Allowance for receivables/debtors (using figures above)} & \text{} & \text{} \\
\text{Balance carried down} & 5,400 & 5,400 \\
\text{Income statement/profit and loss account} & 1,400 & 1,400 \\
\text{Balance brought down} & 5,400 & 5,400 \\
\text{} & \text{} & \text{} \\
\text{Bad debts recovered} \\
\text{Sometimes, a debt written off in one year is actually paid in the next year – a debit to cash and a credit to bad debts recovered. The credit balance on the account is then transferred to the credit of the income statement/profit and loss account (added to gross profit or included as a negative in the list of expenses). This is better than crediting the recovery to the bad debts account, because that would obscure the expense from bad debts for the year.}
\]

Neil Stein is former examiner for Paper 1.1

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: