Accounting Foundations

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9 Accruals and Prepayments

At the end of a financial year the owner of a business might be behind with their rent. The rent money owed at the end of the year is an *accrual*.

At the end of a financial year the owner of a business might have paid part of their next year's business rates bill in advance. The rates paid in advance at the end of the year are a *prepayment*.

We see how to record accruals and prepayments in the accounts.

9.1 Accruals

Accruals are money for benefits received, or services provided, but not paid for by the end of an accounting period.

Benefits Received

Our business operates from rented premises and the rent is £12,000 per annum. By the end of our accounting year we have paid £10,000 but we still owe £2,000.

Our Rent Paid Account in the nominal ledger might look like this.

DR		Rent Paid			CR
		£			£
During Year	Bank	10,000			

We need to show the full amount due (£12,000) in the Trading and Profit and Loss Account (otherwise our net profit would be erroneously inflated). So, we write

DR		Rent Paid			CR
		£			£
During Year	Bank	10,000	End of Year	To P&L a/c	12,000
End of Year	Balance c/d	2,000			
		12,000			12,000
			Start of Next Year	Balance b/d	2,000

We transfer the whole £12,000 to the Trading and Profit and Loss Account. And we transfer the *balance* of the Rent Account to our Balance Sheet as a liability since it is money we owe.

DR	Trading and Profit and Loss Account for Period Ending 31 Dec			CR
		£		£
Trading A/c	Purchases		Sales	
	Gross Profit c/d			
Profit & Loss A/c	**Rent Paid**	**12,000**	Gross Profit b/d	
	Rates			
	Insurance			
	Wages			
	Electricity			
	Stationery			
	Net Profit to Capital A/c			

Balance Sheet at end of Dec

Liabilities	£	*Assets*	£
Capital		Cash	
Plus Gross Profit		Bank Balance	
Less Expenses		Premises	
		Shop Fittings	
Creditors		Debtors	
Rent Owing	**2,000**		

Services Provided

Ok. We rent out an office for £5,000 per year. By the end of our financial year we have received just £4,000 of the rent due. So we are still owed £1,000.

DR	Rent Received				CR
		£			£
			During Year	Cash	4,000

But £5,000 is due and it is this £5,000 that we must transfer to the Trading and Profit and Loss Account.

DR	Rent Received				CR
		£			£
End of Year	P & L A/c	5,000	During Year	Cash	4,000
			End of Year	Balance c/d	1,000
		5,000			5,000
Start of Next Year	Balance b/d	1,000			

The amount due is transferred to the Profit and Loss Account and the balance of £1,000 is shown on the balance sheet. The tenant owes us £1,000, which is an asset.

Now, if the tenant had paid us £6,000 (£1,000 in advance) we would still transfer the actual amount due to the Profit and Loss Account, and the balance of £1,000 would be shown as a liability on our balance sheet because we owe the tenant the money.

9.2 Prepayments

A prepayment is money paid out for goods or services to be received in a later accounting period.

Suppose we pay part of our next year's business rates in advance. The rates per year are £10,000 but during *this* financial year we have, in fact, paid £12,000. Our Rates Account at the end of the year might look like this.

DR		Rates		CR
		£		£
Bank		12,000		

We need to show what we *should* have paid (not what we actually paid) in the Trading and Profit and Loss Account otherwise our net profit would be erroneously reduced. So we write

DR		Rates			CR
		£			£
During Year	Bank	12,000	End of Year	To P&L A/c	10,000
			End of Year	Balance c/d	2,000
		12,000			2,000
Start of Next Year	Balance b/d	2,000			

Effectively, we are owed the £2,000 and so the balance would appear on the assets side of our balance sheet.

Examples 9.1

1 At 31 December 2011 general expenses owing amounted to £50. During 2012 £400 was paid for general expenses, and at 31 December 2012 £25 was still owed for general expenses.

We have arrears at both the beginning and the end of the accounting period. We calculate the amount to show in the Profit and Loss Account by constructing a General Expenses Account.

At 31 December 2011 general expenses owing amounted to £50.

DR		General Expenses			CR
		£			£
			31 Dec 2011	Balance b/d	50

We bring the balance down and, allowing space above it, the position at the end of 2012 is recorded.

... at 31 December 2012 £25 was still owing for general expenses.

DR		General Expenses			CR
		£			£
			31 Dec 2011	Balance b/d	50
31 Dec 2012	Balance c/d	25			

The total amount of cash actually paid during the year is recorded as a debit (because its double entry would be a credit in a Cash or Bank Account).

During 2012 £400 was paid for general expenses ...

DR		General Expenses			CR
		£			£
31 Dec 2012	Cash/Bank	400	31 Dec 2011	Balance b/d	50
31 Dec 2012	Balance c/d	25			

Since both sides of the account must balance, we can calculate the amount to be transferred to the Profit and Loss Account.

$$400 + 25 = 50 + X \;\omega\; X = 375$$

DR		General Expenses			CR
		£			£
31 Dec 2012	Cash/Bank	400	31 Dec 2011	Balance b/d	50
31 Dec 2012	Balance c/d	25	31 Dec 2012	To P & L A/c	375
		425			425
			31 Dec 2012	Balance b/d	25

2 At 31 December 2011 rents received were in arrears by £150. In other words, we are owed £150. During 2012 we received £850 from tenants, of which £100 was paid in advance for 2013.

As before, we build a General Expenses Account step by step to determine the amount to be transferred to the profit and Loss Account.

At 31 December 2011 rents received were in arrears by £150.

DR		General Expenses			CR
		£			£
1 Jan 2012	Balance b/d	150			

At 31 December 2012 we had received an advanced payment of £100 for 2013.

DR		General Expenses			CR
		£			£
1 Jan 2012	Balance b/d	150			
31 Dec 2012	Balance c/d	100			

During 2012 we received £850 from tenants, ...

DR		General Expenses			CR
		£			£
1 Jan 2012	Balance b/d	150	31 Dec 2012	Cash/Bank	850
31 Dec 2012	Balance c/d	100			

From which we can deduce the amount due for 2012.

150 + X + 100 = 850 ω X = 600

DR		General Expenses			CR
		£			£
1 Jan 2012	Balance b/d	150	31 Dec 2012	Cash/Bank	850
31 Dec 2012	To P & L A/c	600			
31 Dec 2012	Balance c/d	100			
		850			850
			31 Dec 2012	Balance b/d	100

The £100 credit says we owe the tenant £100.

Exercise 9.1

1 Prepare trading and profit and loss accounts, and a balance sheet, for M Brace, from the trial balance at 31 December, and the additional information shown below.

Trial Balance as at 31 December

	DR £	CR £
Capital 1 Jan		25,840
Office Furniture	5,632	
Creditors		5,658
Bank Overdraft		646
Land and Buildings	15,400	
Equipment	2,800	
Vehicles	3,000	
Stock 1 Jan	8,800	
Debtors	5,852	
Purchases	42,870	
Sales		62,438
Rent Received		1,000
Wages	8,608	
Rates and Insurance	548	
Light and Heat	370	
Sundry Admin Expenses	638	
Selling Expenses	1,064	
	95,582	95,582

Additional information to be considered.

1. Balance owing for wages for the last few days of the accounting year is £190.
2. Insurance premium prepaid is £64.
3. The stock at 31 December is valued at £14,400.

2 The trial balance shown below was extracted from the books of N Terre at 31 December.

Trial Balance as at 31 December

	DR £	CR £
Capital 1 Jan		48,894
Office Furniture	4,296	
Debtors and Creditors	15,378	10,924
Purchases and Sales	124,202	163,484
Rent and Rates	1,760	
Lighting and Heating	492	
Salaries and Wages	16,536	
Stock in hand 1 Jan	18,548	
Insurance	344	
General Expenses	1,866	
Bank Balance	3,164	
Vehicles	16,000	
Vehicle Expenses	2,216	
Premises	20,000	
Rent Received		1,500
	224,802	224,802

The matters shown below are to be taken into account.

1. Stock in hand at 31 December is £19,768
2. Rates paid in advance at 31 December is £80.
3. Rent receivable due at 31 December is £500.
4. Lighting and heating due at 31 December is £170.

Construct a trading and profit and loss account and a balance sheet at 31 December for N Terre.

We have seen how to take account of accruals and prepayments. **Next** we look at depreciation.

Bibliography

HARRISON W *Stage One Financial Accounting* Northwick Publishers 1986 pp 83 .. 95