

Level2 Semester 2 Time constrained Work

The accounting of Fixed Assets and Bad debts

Fixed asset accounting

Depreciation, disposals and the effect of changing the estimated useful life of an asset and revaluations are dealt with in this article. Generally, it is best to keep three accounts to record fixed assets – for cost, accumulated depreciation and disposals.

Cost account

Purchases of assets are debited to the account, and the cost of items sold / scrapped is transferred to the disposal account as necessary. The balance on the account is then the cost of assets held. If assets are revalued, the account is adjusted (see below), and renamed as fixed assets – cost / valuation.

Accumulated depreciation account

This account has a credit balance on it representing the total depreciation provided so far on the assets held.

Entries to the account include:

- periodic depreciation charge – credit
- transfer out to the disposal account of depreciation relating to assets disposed of – debit
- adjustment on revaluation (see below).

Disposal account

This is where we work out the profit or loss on the sale of an asset. First of all, cost and accumulated depreciation are transferred in from their accounts (cost to the debit and depreciation to the credit), introducing the net book value into the account. Proceeds of sale are credited, and the resulting balance is the profit (if credit) or loss (if debit) to be transferred to profit and loss account.

Example 1 covers these entries (taken from Q2 of the June 2002 Paper 1.1 examination).

Example 1

The following balances appeared in the balance sheet of Addax Limited at 31 March 2001.

	£
Plant and equipment – cost	840,000
Accumulated depreciation	370,000

In the year ended 31 March 2002 the following transactions took place:

1. Plant which cost £100,000 with a written down value of £40,000 was sold for £45,000 on 10 December.
2. New plant was purchased for £180,000 on 1 October 2001.

It is the policy of the company to charge depreciation at 10 per cent per year on a straight line basis, with a proportionate charge in the year of acquisition and no charge in the year of sale. None of the plant was over 10 years old at 31 March 2001.

Required: Prepare ledger accounts recording these transactions. A cash account is not required.

Answer

Plant and equipment – cost

		£		£
2001			2001	
1 Apr	Balance	840,000	10 Dec	Transfer disposal
				100,000
2002			2002	
1 Oct	Cash	180,000	31 Mar	Balance
				920,000
		1,020,000		1,020,000

Plant and equipment – depreciation

2001		£	2001		£
10 Dec	Transfer – disposal	60,000	1 Apr	Balance	370,000
2002			2002		
31 Mar	Balance	393,000	31 Mar	Profit and loss a/c (74,000+ 9,000)	83,000
		453,000			453,000
Plant and equipment – disposal					
2001		£	2001		£
10 Dec	Transfer – cost	100,000	10 Dec	Transfer – depreciation	60,000
				Cash	45,000
2002					
31 Mar	Profit and loss account	5,000			
		105,000			105,000

Changes to estimated useful life

FRS 15 requires the useful economic lives of tangible fixed assets to be reviewed at the end of each period and revised if there are significant differences in expectations. IAS 16 has a similar requirement.

The accounting required here is simple – the carrying value (cost less depreciation to date) at the date of the change is depreciated over the revised life. Accumulated depreciation before the date of the change continues to be deducted from the cost of the asset, along with new depreciation as it arises.

Revaluations

Bookkeeping for revaluations is often easy, but more advanced problems can be tricky. Here is a simple example. We have some land that cost £1,000,000 and want to revalue it to £1,200,000.

Land Account

	Dr £	Cr £
Balance	1,000,000	
Revaluation reserve	200,000	
	1,200,000	

Problems arise when the asset to be revalued is being depreciated. The main point to understand is that after the revaluation we start depreciation using the revalued amount. In other words, depreciation already provided on the asset being revalued must be transferred out to the revaluation account as part of the revaluation process.

Example 2

We have a building that cost £500,000 on which depreciation of £100,000 has been provided. We want to revalue it to £700,000 as at the current balance sheet date.

Discussion

The net book value of the asset is £400,000. The revaluation will increase this by £300,000 to £700,000.

In the balance sheet we want:

	Dr £	Cr £
Building at valuation	700,000	
Less: depreciation	nil	700,000

Ledger accounts

We'll cheat slightly first of all, and have an account for the net book value of the asset instead of separate cost and depreciation accounts. The entries will be:

Buildings Account

Dr £	Cr £
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Balance	400,000
Revaluation reserve	300,000
	700,000

Suppose you've already got two accounts for cost and depreciation from previous entries:

Buildings – cost

	Dr		Cr
	£		£
Balance	500,000		

Buildings – accumulated depreciation

	Dr	Cr
	£	£
Balance		100,000

All you have to do is transfer out the balances relating to the revaluation:

Buildings – valuation

	Dr		Cr
	£		£
Balance	500,000		
Revaluation reserve	200,000		
	700,000		

Buildings – accumulated depreciation

	Dr	Cr
	£	£
Revaluation reserve		100,000
Balance		100,000

The result is as before. Please now refer to Example 3.

Example 3
 Figures as before in Example 2, but the building is to be revalued to £460,000. This time the cost goes down from £500,000 to £460,000, but there is an overall upward revaluation of £60,000. Following the same steps as before, the following figures can be calculated:

Buildings – valuation

	£		£
Balance	500,000	Revaluation reserve	40,000
	460,000	Balance	460,000

Buildings – accumulated depreciation

	£		£
Revaluation reserve	100,000	Balance	100,000

Can it get more complicated? Yes, when we have to provide for depreciation on revalued assets.

There are three possibilities:

Time of revaluation	Depreciation
1 Revaluation is at the beginning of the year	Base depreciation on the revalued amount, spread out over the remainder of the useful life as at beginning of the year
2 Revaluation is at the end of the year	Base depreciation for year just ended on the original value
3 Revaluation occurs during the year	Depreciation must be calculated in two parts: <ul style="list-style-type: none"> • from the beginning of the year to the date of revaluation – based on original value and life, pro rata for the period to be covered

- from the date of revaluation to the end of the year – based on the revalued amount, spread over the remainder of the useful life as at the date of revaluation

A worked example

Q Limited has a building which cost £100,000 on 1 January 1992. It is being depreciated at five per cent per year on a straight line basis, with a proportionate charge in years of purchase, sale or revaluation.

The building is to be revalued to £190,000:

- at 1 January 2002
- at 31 December 2002
- at 30 June 2002.

Discussion

Ten years' depreciation will have been provided up to 31 December 2001, so the accumulated depreciation at that date will be £50,000.

Answer a: at 1 January 2002

Building – cost / valuation

2002		£	£
1 Jan	Balance	100,000	
	Revaluation reserve	90,000	
		190,000	

Building – accumulated depreciation

2002		£	2002		£
1 Jan	Revaluation reserve	50,000	1 Jan	Balance	50,000
31 Dec	Balance	19,000	31 Dec	Profit and loss a/c	19,000
		19,000		10% x £190,000	19,000

The balance sheet at 31 December 2002 will include:

	£	£
Building at valuation	190,000	
Less: depreciation	19,000	171,000
Revaluation reserve		140,000

Answer b: at 31 December 2002

Buildings – cost / valuation

2002		£	£
1 Jan	Balance	100,000	
	Revaluation reserve	90,000	
		190,000	

Buildings – accumulated depreciation

2002		£	2002		£
31 Dec	Revaluation reserve	55,000	1 Jan	Balance	50,000
		55,000	31 Dec	Profit and loss a/c	5,000
					55,000

The balance sheet at 31 December 2002 will include:

	£	£
Buildings at valuation	190,000	190,000
Less: depreciation	nil	
Revaluation reserve		145,000

At 1 January 2003 nine years remain of the original life, so depreciation for 2003 will be $1/9 \times £190,000$

or £21,111.

Answer c: at 30 June 2002

Buildings – cost / valuation

2002	£	£
1 Jan Balance	100,000	
30 Jun Revaluation reserve	90,000	
	190,000	

Buildings – accumulated depreciation

2002	£	2002	£
30 Jun Revaluation reserve	52,500	1 Jan Balance	50,000
31 Dec Balance	10,000	30 Jun Profit and loss a/c	2,500
		31 Dec Profit and loss a/c (W1)	10,000
	62,500		62,500

Working 1

Depreciation, six months to 31 December 2002:
 $\frac{1}{2} \times £190,000 \div 9 \frac{1}{2}$ years 10,000

The balance sheet at 31 December 2002 will include:

	£	£
Buildings at valuation	190,000	
Less: depreciation	10,000	180,000
Revaluation reserve		142,500

Depreciation for 2003 will be $£190,000 \div 9 \frac{1}{2}$ or £20,000.

Accounting for bad and doubtful debts

This is a somewhat simpler problem. Three things have to be recorded:

1 Writing off a bad debt

If a balance in the sales ledger proves irrecoverable, it can no longer be included as an asset and it must be written off as an expense in the profit and loss account. The entry is easy:

Debit: Bad debts account

Credit: Debtor's sales ledger account

At the end of the period the total of the debits to bad debts account appears in the profit and loss account as an expense.

2 Bad debts recovered

If cash for a debt that has been written off is received in a later accounting period the entry is:

Debit: Cash

Credit: Bad debts recovered account

It could be an idea in practice to make an entry to the sales ledger, so that it can be seen from the account that the customer did eventually pay.

In this instance, the entries could be:

Debit: Cash

Credit: Debtor's sales ledger account

Debit: Debtor's sales ledger account

Credit: Bad debts recovered account

It is best not to mix bad debts written off and bad debts recovered on the same account. This could obscure the total that the business is losing from bad debts.

3 Provision for doubtful debts

There are three possible types of balance in a sales ledger – good debts, bad debts and doubtful debts. We don't need to do anything with the good debts but we need to write off the bad debts, leaving the balances we hope to collect, but which we are worried about. We certainly don't want to write these doubtful debts off, because this would probably mean that collection procedures would cease.

Nevertheless, we may want to calculate our profit in the event that they do eventually prove to be irrecoverable.

To do this we set up a provision for the estimated loss we shall suffer through non-payment of these balances.

Provisions may be specific, related to individual debts, or general, usually a percentage of total debtors. In practice they are often specific, because they are then allowable as a deduction for tax purposes, whereas general provisions are usually not allowable. In examinations, general provisions are more frequently found.

The entry to set up a provision is:

Debit: Profit and loss account

Credit: Provision for doubtful debts account (or bad and doubtful debts account – see below).

The debit to profit and loss account reduces the profit, and the provision is deducted from the debtors in the balance sheet. Once you have a provision, bad debts can be debited against it as they arise.

Each period, you have to review the provision for doubtful debts and increase it or reduce it as required. Note that it is only the increase or decrease in the provision that goes to the profit and loss account, not the provision itself. When the provision is initially set up, the movement is, of course, from zero to the amount required.

The closing balance of the provision is always deducted from debtors in the balance sheet.

Finally, we want to show in the profit and loss account the total expense from bad debts written off and doubtful debts provided for. It may therefore be convenient to use just one account entitled 'bad and doubtful debts'. The opening and closing provisions appear in the balance sheet and the difference is the profit and loss account entry – normally a debit (expense) but possibly a credit if there is a large reduction in the provision. Example 4 adopts this approach.

Example 4

At 31 December 2001, X Limited had a provision for doubtful debts of £10,000, appearing as a balance on the bad and doubtful debts account.

At 31 December 2002 trade debtors amounted to £280,000 and on reviewing the balances it was decided to write off debts totalling £17,000 and to adjust the provision to five per cent of the debtors.

Show the bad and doubtful debts account for 2002.

Bad and doubtful debts

2002	£	2002	£
31 Dec Debtors	17,000	1 Jan Balance	10,000
Balance	13,150	31 Dec Profit and loss a/c	20,150
	30,150		30,150

The closing provision is calculated on the debtors as reduced by the debts written off – five per cent of £263,000 is £13,150, and the £20,150 transferred to the profit and loss account is the balancing figure, made up of £17,000 debts written off plus the £3,150 movement in the provision.