CHAPTER-22
FINANCIAL STATEMENTS AND WITH ADJUSTMENTS

In order to ascertain the true profit or loss of the business for a particular year, it is necessary that all expenses and incomes relating to that year are taken into consideration. For example, if we want to ascertain the Net Profit for the year ended on 31st March and rent for the month of March has not yet been paid, it would be proper to include such rent along with the other expenses of the year. Similarly, it often happens that certain incomes, like interest, dividend, commission etc. are earned but not received during the year. Adjustment for such incomes must be made in the current year itself, so that the Profit and Loss Account may disclose the correct amount of Net Profit or Loss and the Balance Sheet may present the true financial position of the business. Simply stated, while preparing Final Accounts it must be detected whether there is a transaction.

(I) Which has been omitted to be recorded in the books, or
(II) Which has been wrongly recorded in the books, or
(III) Which only one aspect has been recorded in the books. Entries passed for such transactions are called 'adjustment entries.

Objectives or Need of Adjustments

1. To ascertain the true Net Profit or loss of the business.
2. To ascertain the true financial position of the business.
3. To make a record of the transactions omitted from the books.
4. To rectify the errors committed in the books of accounts.
5. To make a record of such expenses which have accrued but have not been paid.
6. To make a record of such incomes which have accrued but have not been received.
7. To provide for depreciation and other provisions.

It must be remembered that while preparing Final Accounts the items which are given inside the Trial Balance are written only once either in Trading Account or in Profit and Loss Account or in the Balance Sheet. On the other hand, the items which are given outside the Trial Balance (known as adjustments) are to be written twice because the double entry in respect of all these adjustments is to be completed in the final accounts itself.

Explanation of important adjustments

1. **Closing Stock:-** The amount of goods unsold at the end of the year is called Closing Stock. It is valued at **Cost Price or Realisable Value, whichever is less**. For example, certain goods were purchased for ₹ 1,00,000 but at present its realisable value is ₹ 1,20,000. It will be valued at ₹ 1,00,000 and not at ₹ 1,20,000. But suppose, if the realisable value of the same goods is ₹ 90,000, it will be valued only at ₹ 90,000. The basic principle underlying

the valuation of closing stock is that anticipated losses should be taken into account, but all unrealized gains should be ignored.

Closing stock is incorporated in the books by means of the following entry:-

Closing Stock A/c	Dr,
To Trading A/c	
(Closing Stock brought into books)	

Treatment in Final Accounts: - Generally, the closing stock is given outside the Trial Balance. This is so because closing stock is valued at the end of the year after the accounts have been closed. As such, Closing Stock will be shown at two places, i.e., on the Credit side of the Trading A/c and on the Assets side of the Balance Sheet.

If the Closing Stock appears inside the Trial Balance, it will be shown only on the Assets side of the Balance Sheet. Because this means that the entry to incorporate the closing stock in the books has already been passed and it has already been deducted out of "Purchases Account' given in the Trial Balance.

2. **Outstanding Expenses or Expenses Due but not Paid:-**These are the expenses which have been incurred during the year but have been left unpaid on the date of preparation of final accounts. In other words, the benefit of such expenses has been derived during the year but the payment of which has not yet been made. For example, the firm pays Rent @ ₹ 1,000 per month. If during the accounting year ending on 31st March, only 11 months Rent amounting to ₹ 11,000 has been paid, Rent for one month ₹ 1,000 will remain outstanding at the end of the year.

Treatment in Final Accounts:- Outstanding Expenses added to the concerned expenses on the debit side of Trading or Profit and Loss Outstanding Expenses on the one hand, will be Account and on the other hand, will also be shown on the Liabilities side of the Balance Sheet. Outstanding Expenses Account is a Personal Account because 1t represents those persons to whom the payment is to be made.

3. **Prepaid Expenses or Unexpired Expenses or Expenses paid in Advance:**

These are the expenses which have been paid in advance for the next year during the current year itself. In other words, the benefit of such payments will be available in the next accounting year.

Treatment in Final Accounts:-Prepaid Expenses on the one hand, will bededucted from the concerned expenses on the debit side of Trading or Profit and Loss Account and on the other hand, will also be shown on the Assets side of the Balance Sheet. Prepaid Expenses is a Personal Account because it represents those persons to whom the payment has been made in advance.

4. **Depreciation:-**Depreciation is the loss or fall in the value of fixed assets due to their constant use and expiry of time.

Treatment in Final Accounts: - Depreciation on the one hand, will be shown on the debit side of the Profit and Loss Account because it is a loss or expense and on the other hand, will also be deducted from the value of the concerned asset on the Assets side of the Balance Sheet.

5. **Accrued Income or Income Receivable:-**It is quite common that certain items of income such as interest on securities, commission, rent etc., are earned during the current year but have not been actually received by the end of the current year. Such incomes are known as 'Accrued Income' or 'Earned Incomes.

Treatment in Final Accounts:- Such Incomes on the one hand, will be shown on the credit side of the Profit & Loss Account and on the other hand, will be shown on the Assets side of the Balance Sheet because the amount is yet to be received.

6. **Unearned Income or Income Received in Advance**:-It may also happen that a certain income is received in the current year but the whole amount of it does not belong to the current year. Such portion of this income which belongs to the next year is known as 'Unearned Income' or 'Income received but not earned'.

Treatment in Final Accounts: - Such incomes on the one hand, will be deducted from the concerned income on the Credit side of Profit & Loss Account and on the other hand, will also be shown on the Liabilities side of the Balance Sheet.

7. **Interest on Capital**:-Usually, in order to ascertain the true efficiency of the business, interest at a normal rate is charged on the capital invested by the proprietor in the business. Profits remaining after charging such interest may be considered as the real profits earned by the business enterprise. Capital invested by the proprietor is treated as a loan to the business earning interest at a fixed rate. If this amount had not been invested in the business, it would even then have earned some interest outside. As such, the proprietor wants interest for his capital and profit for the risk undertaken by him. For example, if 6% interest is to be allowed on the capital of ₹ 10,00,000 the adjusting entry for this will be as follows:

Adjustment Entry:

Interest on Capital A/C Dr. 60,000

To Capital A/c (Interest allowed on Capital) 60,000

Treatment in Final Accounts: Interest on capital is an expense for the business and hence it is shown on the debit side of Profit & Loss Account. At the same time, it is a gain to the proprietor and hence is added to his capital.

8. **Interest on Drawings**: - Occasionally, the proprietor draws cash or goods for his personal use. Such withdrawals are termed as Drawings. If the firm pays interest on capital, it is fully justified that it should also charge interest on the drawings.

Treatment in Final Accounts:-Interest on Drawings is a gain to the business and hence it is shown on the credit side of Profit & Loss Account. At the same time, it is an expense from the proprietor's view and hence will be deducted from the capital on the Liabilities side of the Balance Sheet.

9. **Interest on Loan:-** Generally, item of 'Loan' appears on the credit side of the Trial Balance. It means that the amount has been borrowed from some person or from the bank etc. Loan is a Liability of the firm and the interest on such loan will be an expense. If up-to-date interest has not been paid on the Loan, the unpaid interest will have to be calculated and will be treated just like outstanding expenses.

On the contrary, if the item of 'Loan' appears on the debit side of Trial Balance, it will mean that the amount has been lent to outsiders. It will be an asset in this interest on such loan will be an income for the firm.

Treatment in Final Accounts:- Assuming that the Loan appears on the credit side of the Trial Balance, interest on it will be an expense and hence will be recorded on the debit side of Profit & Loss Account. Outstanding amount of such interest will also be added to Loan Account on the Liabilities side of the Balance Sheet

10. **Bad Debts:** Persons to whom goods have been sold on credit are known as Debtors'. Sometimes due to the dishonesty, death or insolvency of a debtor, full amount is not recovered from him. When it becomes certain that a particular amount will not be recovered it is known as 'Bad-debts. Bad-debt is undoubtedly a loss to the firm and is therefore written on the debit side of the Profit & Loss Account. If Bad-debts are given in the adjustments, they will also be shown at one more place i.e. deducted from debtors on the assets side of the Balance Sheet.

Treatment in Final Accounts: Bad-Debts of ₹ 10,000 given in adjustments will be added to the Bad-Debts of ₹ 8,000 on the debit side of the Profit & Loss Account and the amount of ₹ 10,000 will also be deducted from Debtors on the Assets side of the Balance Sheet.

PROFIT & LOSS A/C

Particulars	₹	Particulars	₹
To Bad-debts 8,000 Add: Further Bad-debts 10,000	18000		

BALANCE SHEET as at 31st March, 2017

Liabilities	Amount ₹	Assets		Amount ₹
		Sundry Debtors Less: Bad-debts	2,00,000 10,000	1,90,000

11. **Provision for Bad and Doubtful Debts:** - Even after deducting the amount of actual bad-debts from the debtors, the list of debtors at the end of the year may include some debts

which are either bad or doubtful. As the amount of actual loss on account of current year bad-debts would be known only in the next year when the amount is realised from debtors, a provision is created to cover any possible loss on account of bad-debts likely to occur in future. Such a provision is created at a fixed percentage on debtors every year and is called 'Provision for Bad and Doubtful Debts'. The term 'Provision should be used instead of 'Reserve' because the aim is not strengthen the financial position of the business but to cover an expected future loss.

Treatment in Final Accounts:- The amount of Provision for Doubtful Debts on the one hand, is shown on the debit side of the Profit and Loss Account and on the other hand, is deducted from Sundry Debtors on the assets side of the Balance Sheet, so that the debtors may appear at their realisable value in the Balance Sheet.

(2) Interest on Bank Loan of ₹ 5,000 at 10% p.a. amounts to ₹ 500, whereas the Trial Balance shows that interest of ₹ 300 has been paid. It follows, therefore, that interest of ₹ 200 is still outstanding.

12. **Provision for Discount on Debtors: -** It is a normal practice in the business to allow cash discount to those debtors from whom the payment is received promptly or within a fixed period. Discount thus allowed will be an expense of the business and is therefore debited to the Profit & Loss Account. Since there will be certain debtors who will make early payment in the next accounting year and will be allowed such discount, a provision for such discount is created in the current year itself. The process of creating a provision for discount is the same as for the provision for doubtful debts.

The following entry will be passed for this purpose:-

Profit & Loss A/c Dr.

To Provision for Discount on Debtors A/C

(Provision for discount created on good Debtors)

Treatment in Final Accounts:- Such provision is shown on the debit side of the Profit & Loss Account and is also deducted from Sundry Debtors on the Assets side of the Balance Sheet.

Note:-It should be noted that discount will be allowed only to those debtors who will make prompt payment. As such, the provision for discount is calculated on good debtors left after deducting further bad-debts given in adjustments and the provision for doubtful debts required to be made at the end of year. In other words, first of all, further bad-debts given in adjustments will be deducted from Debtors and then provision for doubtful debts will be calculated on the balance of Debtors and lastly, provision for discount will be calculated on the remaining amount of Debtors.

Deferred Revenue Expenditure: There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number ofyears. Such expenditures are termed as 'Deferred Revenue Expenditures'. The benefit of such an expenditure generally lasts between 3 to 7 years. As such, the whole of such expenditure is not debited to the Profit and Loss

Account of the current year but spread over the years for which the benefit is likely to last. Thus, only a part of such expenditure is taken to Profit & Loss Account every year and the unwritten off portion is allowed to stand on the assets side of the Balance Sheet.

Method of Calculating the Commission: This Commission may be based:

(a) On profits before charging such Commission.
(b) On profits after charging such Commission.

(a) On profits before charging such Commission:- Suppose, the profit earned by the firm before allowing the Manager's Commission is Rs.22,000 and the Manager is entitled to a Commission of 10% on Net Profit before charging his Commission, the Commission will be calculated as follows:

Manager's Commission = 22,000 × $\frac{10}{100}$= 2,200

(b) On profits after charging such Commission : Suppose, the profit earned by the firm before allowing the Manager's Commission is 22,000 and the Manager is entitled to a Commission of 10% on Net Profit remaining finally after charging his Commission, the Commission will be calculated as follows:

Manager's Commission = 22,000 × $\frac{10}{110}$= 2,000

In other words, it means that out of every Rs.110 of profit, the Commission will be Rs.10.

VERY SHORT ANSWER QUESTION

7. **Why is closing stock valued at lower of cost or realisable value ?**
   Ans It is based on the principal of prudence (or conservatism) according to which all anticipated losses should be taken into account , but all unrealized gains should be ignored.
8. **What are outstanding expenses?**
   Ans: These are the expenses which have been incurred the during the year but have been left unpaid on the date of preparing the final accounts
9. **What journal entry will be passed for outstanding salary ?**
   Ans : Salary A/c Dr.
   To Outstanding Salary A/c
10. **What adjustment is made of outstanding expenses while preparing final accounts?**
    Ans : On the one hand , they will be added to the concerned expenses on the debit side of Trading or profit and Loss Account on the other hand , will also be shown on the Liabilities side of the Balance Sheet .
11. **What is the need for providing outstanding expenses in final account ?**

Ans: Outstanding expenses are provided as per the accrual concept of accounting according to which all expenses for the year , where paid or not , should be recorded .

12. **What are prepaid expenses ?**
    Ans : These are the expenses which have been paid in advance for the next period during the current period itself . In other words, benefit of such payment will be available in the next accounting period .
13. **What journal entry will be passed for prepaid insurance ?**
    Ans: Prepaid Insurance A/c Dr.
    To Insurance A/c
14. **What treatment is made of prepaid expenses while preparing final accounts?**
    Ans : Prepaid Expenses on the on hand , will be deducted from the concerned expenses on the debit side of Trading or Profit and Loss Account and on the other hand , will also be shown on the Assets of the Balance Sheet
15. **Accrued income and income due but not received are same .Do you agree ?**
    Ans :Yes
16. **What is the need for provided as er the accrual incomes in the final accounts?**
    Ans These are provided as per the accrual concept of accounting according to which all incomes earned during the year should be recognised , whether received for not.
17. **Which account is debited for creating provision for doubtful debts ?**
    Ans : Profit and Loss Account .
18. **Under which accounting concept provision is made for doubtful debts?**
    Ans :Prudence Concept .
19. **Provision for discount on debtors is made before making provision for doubtful debts ,. Do you agree?**
    Ans : No , Provision for discount on debtors is calculated after deduction provision for doubtful debts from debtors.
20. **Give two example of revenue expenditure**
    Ans: (i) Purchase of Goods , (ii) Salary , Rent etc.
21. **What are deferred revenue expenditures ?**
    Ans: There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number of years . Such expenditures are termed as 'Deferred Revenue Expenditures' . Such as heavy expenditure on advertisement .
22. **Cost of obtaining licence to carry out business is Capital Expenditure or Revenue Expenditure ?**
    Ans : Capital Expenditure because it is taken only at the time of starting a business.
23. **How would you treat goods given aways as charity while preparing financial statements of an organisation.**
    Ans : Deducted from Purchases in Treading Account and Shown on Dr. Side of Profit & Loss Account .

Objective Type Questions

A. **State whether the following statement are true or false :-**

1. Assets side of Balance Sheet represent debit balance .
2. Suspense Account appearing in the Trial Balance is Shown in the Balance Sheet.
3. Accrued income appearing in the Trial Balance is shown in P & L A/c
4. Bank Overdraft is a contingent liability .
5. Goods given away as charity are deducted from purchases and are shown on the Debit side of P & L A/c.
6. Prepaid rent is personal account
7. Interest on drawing is an income for the business .
8. Life insurance Premium is treated as drawings .

   Ans: True : i , ii , v , vi , viii.

   False : iii , iv .

B. State with reasons whether each of the following statement is true or false

1. A Profit and Loss Account is a point statement whereas a Balance Sheet is period statement .
2. Outstanding Wages gives in the Trial Balance are transferred to Trading Account
3. Closing Stock given in the Trail Balance is shown only in the Balance Sheet.
4. Goodwill is a fictitious asset
5. Balance Sheet is an Account
6. The provision for discount on debtors is calculated after deducting the provision for doubtful debts from debtors.
7. Any expenditure intended to benefit the current period is calculated after deducting the provision for doubtful debts from debtors.
8. Repaired to second hand machinery before it is put to use are capitalised .
9. Deferred Revenue Expenditure is current year's revenue expenditure to be paid in the later years .

Ans:

1. False: A profit and loss account is a period statement because it depicts the result of operations of whole period. Balance Sheet is a point statement because if reflects the financial position of an enterprise at a specified point of time.

2. False: Outstanding Wages given in trial balance means that they have already been added in the wages. Hence, they will be shown only one of the liability side of Balance sheet.

3. True: When closing stock is given in trial balance it denotes that it has already been deducted out of purchase given in Trial Balance. Hence, it will be shown only one of the assets side of Balance Sheet.

4. False: Goodwill is an intangible asset and not a fictitious asset. The reason is that it has a value and can be sold for a price.

5. False: Balance Sheet is a statement and not an account. It has no debit or credit sides. It is only a statement showing the financial position of the firm on a particular date.

6. True: The reason is that the discount will be allowed only to those debtors who will make prompt payment. Hence, provision for discount is calculated on good debtors arrived at after deducting the provision for doubtful debts.
7. True: The benefit of revenue expenditure is received during the current year itself and it does not result in the acquisition of capital asset which may increase the earning capacity of the business in future.
8. True: All expenses incurred on an asset before it is put to use are capital expenditure.
9. False: Deferred Revenue Expenditure is paid in the Current Year but the benefit of it is likely to be derived over a number of years.

C. Choose the Best Alternate:

1. Income tax paid by a sole trader is reflected in his financial statements:
   a. On the debit side of the Trading Account
   b. On the debit side of the Profit and Loss Account
   c. As an asset in the Balance Sheet
   d. As way of deduction from capital in the Balance Sheet
2. Which of the following statements is correct:
   a. King's International – P& L A/c as on 31st March, 2017
   b. King's International – P& L A/c for the year ended 31st March
   c. King's International – P& L A/c for the year ended 31st March,2017
   d. King's International – P& L A/c for the current year (2016-2017)
3. Accrued income is:
   a. A Liability
   b. Revenue
   c. An Asset
   d. An Expense
4. If closing stock appears in Trial Balance,then it will be appearing in:
   a. Trading Account
   b. Balance Sheet
   c. Profit & Loss Account
   d. Trading A/c & Balance Sheet
5. Type of Accounting shown in Balance Sheet are………
   a. Nominal and Personal
   b. Real and Nominal
   c. Real and personal
   d. Real, Nominal and Personal
6. Closing Stock is shown in Financial Statements at:
   a. Cost price
   b. Reliasable Value
   c. Cost price or Reliasable Value whichever is greater
   d. Cost price or Reliasable Value whichever is less
7. Heavy amount spent for the advertisement of new company product is
   a. Revenue Expenditure

   b. Deferred Revenue Expenditure
   c. Capital Expenditure
   d. Either (a) or (c)
8. Income tax in case of sole trader is treated as
   a. Personal expenses
   b. Debtors expenses
   c. Business expenses
   d. None of the above
9. A machine was purchased in Bihar. During transit the machine was damaged and the cost of repairs incurred is Rs. 20,000. This expense is treated as:
   a. Capital expense
   b. Revenue expense
   c. Deferred Revenue expense
   d. None of these

Ans. 1. (d) 2. (c) 3. (c) 4. (b) 5. (c) 6. (d) 7. (b) 8. (a) 9. (a)