



FINANCIAL STATEMENTS-II

You have learnt that Income Statement i.e. Trading & Profit and Loss Account and Position Statement i.e., Balance Sheet are two financial statements, which are prepared by every business concern at the end of a period. Income statement shows the Net Profit or Net loss as the case may be for that period and Position Statement presents the financial position of the business on the specific date. These statements are prepared on the basis of Trial Balance and other information. It is possible that there are certain items of income or expenses which do not pertain to the accounting period for which Trial Balance is prepared or other such items which have accrued but have not been accounted for and hence are not reflected in Trial Balance. Both these types of incomes and expenses are to be fully accounted for, only then the above stated two statements will show the true and fair position of the business. These are called ‘adjustments’. In this lesson we shall learn about accounting treatment of some of the adjustments and incorporation of these adjustments in financial statements.



OBJECTIVES

After studying this lesson you will be able to:

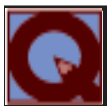
- recognise the need for accounting adjustments;
- explain the adjustments as to closing stock, outstanding and pre-paid expenses, accrued income and income received in advance;
- interest on capital and drawings, depreciation, provision for bad and doubtful debts;
- incorporate the adjustments in Trading Account and Profit & Loss Account and Balance Sheet.

15.1 NEED FOR ACCOUNTING ADJUSTMENTS

You have already learnt that every business entity prepares Trading and Profit & Loss Account and Balance Sheet, the two financial statements, at the end of an accounting period which is generally one year. It needs to be ensured that such items of income and expenditure which do not pertain to the said accounting period, should not to be included. If some of these items have been included in the financial statements these must be excluded by making necessary adjusting entry. Similarly, there can be items which are left out and are needed to be accounted for. Adjustment entry will also be made for them. This is necessary in order to calculate the correct profit or loss and to show true and fair financial position of the business. For example, a firm closes its books on March 31, every year, Suppose it has not paid rent of the shop for the month of March. This will not be reflected in Trial Balance and hence it needs to be accounted for as it relates to the year for which accounts are being prepared. Similarly, suppose annual insurance premium has been paid up to June, 30. It means premium for three months has been paid in advance. This is included in the item of insurance appearing in the Trial Balance. This amount paid in advance needs to be excluded. This process of exclusion or inclusion of items into books of accounts at the time of preparing financial statements is called adjustments. These are to be incorporated to arrive at the true and fair position of the business.



Notes

**INTEXT QUESTION 15.1**

Fill in the blanks with suitable word/words.

- (i) Trading and Profit & Loss Account shows the or
- (ii) Adjustments are necessary to show the correct and of a business concern.
- (iii) Items of income and expenditure which do not pertain to the accounting period should be
- (iv) Items of income & expenditure which relate to the accounting period but are left out should be

15.2 ADJUSTMENTS AND THEIR INCORPORATION

The number and nature of adjustments differ from organisation to organisation. It depends upon the volume and nature of activities in the organisation, However, certain adjustments are common in all types of



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organisations. Moreover, while making adjustments you will have to follow the general principle of double entry i.e. the amount is to be debited to one account and credited to another account. Thus in the financial statements the item to be adjusted should appear at two places one representing the debit and the other representing the credit.

Let us now discuss some of the items of adjustment and its accounting treatment in financial statements. These are as under :

1. Closing Stock
2. Outstanding Expenses.
3. Prepaid Expenses
4. Accrued Income.
5. Income received in advance
6. Interest on Capital
7. Interests on Drawings
8. Depreciation.
9. Further Bad Debts.
10. Provision for Bad and Doubtful Debts.

Let us take up these adjustments one by one:

1. Closing Stock : Closing Stock is the stock of goods remaining unsold at the end of the accounting year. Ordinarily this does not appear in the Trial Balance. Hence, this needs to be incorporated in financial statements. This appears on the credit side of the Trading Account as well as Assets side of the Balance Sheet.

The adjustment entry will be:

Closing Stock A/c Dr
 To Trading A/c

(Closing stock transferred to trading A/c)

The effect of the adjustment entry on financial statements is as under :

Trading A/c

Dr		Cr	
Particulars	Amount Rs	Particulars	Amount Rs
		Closing stock



Notes

Balance sheet

Liabilities	Amount Rs	Assets	Amount Rs
		Closing stock

In case closing stock has already been accounted for it will form part of the Trial Balance and hence there is no need of making any adjustments in the Trading A/c. The adjusted closing stock will be on the asset side of the Balance Sheet.

2. Outstanding Expenses

Expense which is related to the current accounting period but not yet paid is known as Outstanding Expense. Suppose the accounts are closed on 31st December every year. Salary for the month of December is due but not paid. It is an example of salary outstanding. Similarly, there are some other items like Rent outstanding, Wages outstanding etc. In case of Salaries Outstanding following adjustment entry will be made :

Salary A/c Dr.
 To Salary Outstanding A/c
 (Salary outstanding for the month of December)

In financial statements it will be recorded as :

Profit & Loss A/c

Dr.		Cr.	
Particulars	Amount Rs	Particulars	Amount Rs
Salaries			
Add: salary outstanding			

Balance Sheet

Liabilities	Amount Rs	Assets	Amount Rs
Salary outstanding			



Notes

In financial statements

Profit and Loss A/c

Dr.		Cr.	
Particulars	Amount Rs	Particulars	Amount Rs
		Rent received	
		Less: rent received in advance	

Balance sheet

Liabilities	Amount Rs	Assets	Amount Rs
Rent received in advance			



INTEXT QUESTIONS 15.2

Fill in the blanks with suitable terms :

- (i) Expenses related to the current accounting period but have not been paid are known as
- (ii) Part of expenses paid if relates to the next accounting year, it is called
- (iii) Income earned but not received till the end of the accounting year is termed as
- (iv) income if received before it becomes due is called

15.3 OTHER ADJUSTMENTS

6. Interest on capital

As per business entity concept capital of the proprietor is a liability for the business. Like other loans interest can be paid on capital also. In case it is decided to allow interest on capital, adjustment entry will be as follows :

Interest on Capital A/c	Dr
To Capital A/c	
(Interest allowed on capital)	



In financial statements it is shown as under:

**Profit & Loss A/c
for the year ended on**

Dr.		Cr.	
Particulars	Amount Rs	Particulars	Amount Rs
Interest on capital			

Notes

**Balance sheet
As on**

Liabilities	Amount Rs	Assets	Amount Rs
Capital			
Add : Interest on Capital			

7. Interest on drawings

Interest may also be charged on money withdrawn by the proprietor for household use. Following journal entry is made.

Capital A/c	Dr
To Interest on Drawings A/c	
(Interest on Drawings charged)	

In financial statements, it will be shown as :

Profit & Loss A/c

Dr.		Cr.	
Particulars	Amount Rs	Particulars	Amount Rs
		Interest on Drawings	

Balance sheet

Liabilities	Amount Rs	Assets	Amount Rs
Capital			
Less : interest on drawings			



Notes

8. Depreciation

The value of fixed assets such as Plant and Machinery, Furniture and Fixtures, Land & Building, Motor Vehicles etc. goes on reducing year after year due to wear and tear, obsolescence or for any other reason.

As the fixed assets are used for earning revenue the amount by which the value of a fixed asset decreases is an item of expense, similar to other expenses. This is called depreciation. It should be charged to the Profit and loss Account. The value of such assets should also be shown in the Balance Sheet at the reduced value by the amount of depreciation:

The adjustment entry for depreciation will be

Depreciation A/c Dr
 To Asset (by name) Account

It will be shown in the Profit and Loss A/c and Balance sheet as under :

Profit & Loss A/c

Dr		Cr
Particulars	Amount Rs	Particulars
		Amount Rs
Depreciation on Plant & Machinery Motor Vehicle (etc)		

Balance sheet

Liabilities	Amount Rs	Assets	Amount Rs
		Plant & Machinery
		Less: Depreciation
		Motor Vehicle
		Less Depreciation

Note: In case amount of depreciation has been calculated before closing of accounts, it will appear in the debit column of the Trial Balance. It will be shown only on the debit of profit & Loss A/c and further adjustment is not required in the Balance Sheet.



Notes

The adjustment entry will be as under :

Profit & loss A/c Dr
 To Provision for Doubtful Debts A/c
 (Provision for doubtful debts created)

In the Profit and Loss A/c and Balance sheet it will be shown as under:

Profit & Loss A/c

Dr		Cr
Particulars	Amount Rs	Particulars
		Amount Rs
Bad Debts		
Add: Provision for Doubtful debts		

**Balance Sheet
as on**

Liabilities		Assets	
	Amount Rs		Amount Rs
		Debtors	
		Less: Provision For Bad Debts	

Such Provision is created on Debtors at a given rate say 5%. In case there is further bad debts, provision for bad and doubtful Debts will be calculated on the amount of debtors after deducting from it the amount of further Bad Debts.

Over the years businessman might have experienced that a certain percentage of the debts created due to credit sales go bad every year. So a provision for bad and doubtful debt is made on the debtors of a year at a fixed percentage say 5%. This percentage may change if the circumstances have changed. For example, it may be less if the businessman has become selective in selling goods on credit.

Provision for bad and doubtful debt is maintained at every year at a fixed percentage of the debtors. Last year balance is carried forward in the current year. This may be called old provision of bad and doubtful debts. Current



years bad debts or/and further bad debts is adjusted towards this provision and more provision is created, which may be called new provision for bad debts.

Arithmetically it is shown in the Profit and Loss A/c as follows :

**Profit and Loss A/c
for the year ending on**

Dr		Cr	
Particulars	Amount Rs	Particulars	Amount Rs
Bad Debts			
Add Further Bad Debts			
Add new provision for Bad and Doubtful Debts			
Less : old reserve for Bad and Doubtful Debts			

In case the balance amount of provision for bad and doubtful debts carried forward from last year is more than the amount of bad debts, amount of further Bad Debts and the amount of new provision for bad debts combined together, the excess balance will be credited to Profit and Loss A/c.

The amount of provision for Bad and Doubtful Debts is an item of liability. But usual practice is to show it as deducted from the amount of book debts/ sundry debtors in the assets side of the Balance Sheet.

The above can best be explained by the following example :

Items appearing in the Trial Balance of a sole trader on 31st Dec, 2006.

Particulars	Dr Balance	Cr Balance
Sundry Debtors	24600	
Provision for Bad and Doubtful Debts		1000
Bad Debts	700	

Additional Information

Further bad debts amounted to Rs 600. Make a provision for Bad and Doubtful debts on Debtors @5%.

Show the above items and adjustments in the financial statements as on that date.

Notes



Notes

**Profit and Loss A/c
for the year ended 31st Dec., 2006**

Dr		Cr	
Particulars	Amount Rs	Particulars	Amount Rs
Bad Debt	700		
Further Bad Debts	600		
Add New Provision for Bad and Doubtful Debts	1200		
	<u>2500</u>		
Less old provision for Bad and Doubtful Debts	(1000)		
	1500		

Balance Sheet

As on 31st Dec., 2006

Liabilities	Amount Rs	Assets	Amount Rs
		Sundry Debtors	24600
		Less : further Bad Debts	<u>600</u>
			24000
		Less provision for Bad Debts @ 5%	1200
			22800

Summarised view of Adjustment entries

Adjustment	Adjustment entry	Treatment in Trading and Profit & Loss A/c	Treatment in Balance Sheet
1. Closing stock	Closing stock A/c To Trading A/c	Dr	Shown on the credit side of Profit & Loss A/c
2. Outstanding expenses	Expenses A/c To Outstanding expenses A/c	Dr	Added to respective expenses on the debit side



Notes

(ii) Wages Outstanding

Wages A/c

To

(iii) Insurance Premium paid for six months in advance

Unexpired Insurance A/c

To

(iv) Commission received but not yet earned

Commission A/c

To

Illustration 1

From the following Trial Balance of M.B. Garments as on 31st December, 2006, prepare Trading A/c and Profit & Loss A/c for the year ended 31st December, 2006 and Balance Sheet as on that date :

Name of the Account	Dr amount Rs	Cr amount Rs
Capital		80000
Cash in hand	570	
Cash at bank	5600	
Purchases	43200	
Sales		78000
Wages	10400	
Power	4730	
Carriage inward	2040	
Carriage outward	3200	
Stock (1.1.2006)	5660	
Land & Building	40000	
Machinery	20000	
Salaries	4000	
Insurance	600	
Sundry Debtors	28000	
Sundry Creditors		10000
	168000	168000


Notes

Following adjustments are to be accounted for:

- (i) Stock on 31.12.2006 Rs. 10000.
- (ii) Machinery to be depreciated @10% p.a. and Building to be depreciated @ 2% p.a.
- (iii) Salaries for the month of December outstanding were Rs. 1200.
- (iv) Insurance Premium was paid for one year ending 30th June, 2007.

Make journal entries for the adjustments and prepare Trading and Profit & loss A/c and the Balance Sheet.

Solution

Date	Particulars	Dr. Amount Rs	Cr Amount Rs
2006			
Dec 31	Closing stock A/c ...Dr To Trading A/c (Closing stock taken to Trading A/c)	10000	10000
Dec 31	Depreciation A/c ...Dr. To Machinery A/c To Land & Building A/c (Depreciation on machinery @ 10% p.a. and on land & Building @ 2% p.a. charged)	2800	2000 800
Dec 31	Salaries A/c ...Dr. To Salary Outstanding A/c (Salary due but not paid for December, 2006)	1200	1200
Dec 31	Prepaid Insurance A/c ...Dr. To Insurance A/c (Insurance paid in advance accounted for)	300	300



Notes

Trading A/c

For the year ended 31st Dec, 2006

Dr		Cr	
Particulars	Amount Rs	Particulars	Amount Rs
Stock	5660	Sales	78000
Purchase	43200	Closing stock	10000
Wages	10400		
Power	4730		
Carriage Inward	2040		
Gross Profit transferred to Profit & loss A/c	21970		
	88000		88000

Profit & Loss A/c

For the year ended 31st Dec. 2006

Dr		Cr	
Particulars	Amount Rs	Particulars	Amount Rs
Carriage outward	3200	Gross Profit transferred from Trading A/c	21970
Salaries	4000		
Add : Salary Outstanding	1200		
Insurance	600		
Less : prepaid insurance	300		
Depreciation on Machinery	2000		
Land & building	800		
Net Profit transferred to capital A/c	10470		
	21970		21970

Balance sheet

As at 31st Dec., 2006

Liabilities	Amount Rs	Assets	Amount Rs
Salary Outstanding	1200	Cash in hand	570
Sundry Creditors	10000	Cash at Bank	5600
Capital	80000	Sundry debtors	28000
Add: net profit	10470	Closing stock	10000
		Prepaid Insurance	300
		Land & Building	40000
		Less depreciation	(800)
		Machinery	20000
		Less depreciation	(2000)
	101670		101670



Notes

Illustration 2

From the following Trial Balance of Mustafa & Co., prepare Trading and Profit and loss A/c for the year ending on 31st Dec. 2006 and Balance Sheet as on that date after making necessary journal entries for adjustments.

	Dr. Balance (Rs.)		Cr. Balance (Rs.)
Land and Building	60000	Capital	150000
Plant and Machinery	40000	Sundry Creditors	30000
Bill Receivables	8000	Sales	120000
Stock on 1.1.2006	40000	Reserve for Bad and Doubtful Debts	4500
Purchases	51000	Loan (12% p.a.)	10000
Wages	20000	Commission Received	2000
Coal, Gas & Coke	5800		
Salaries	5000		
Rent	2800		
Cash at bank	25000		
Sundry Debtors	45000		
Repairs	1800		
Bad Debts	5500		
Sales Returns	2000		
Furniture and Fixture	4000		
Interest on Loan	600		
	3,16,500		3,16,500



Notes

Adjustments

1. Closing stock valued at Rs. 30000.
2. Depreciate Plant & Machinery @ 5% and Furniture & Fixture @ 10%.
3. Provide for Bad and Doubtful Debts @ 5%.
4. Outstanding Wages Rs. 1000, Rent Rs. 500 and interest on loan outstanding Rs 600.
5. Commission accrued Rs. 1000.

Solution.

Adjustment entries

Date	Particulars	Amount Rs	Amount Rs
2006 Dec 31	Closing Stock A/c Dr. To Trading A/c (Closing stock taken into account)	30,000	30,000
	Depreciation A/c Dr. To Plant & Machinery To Furniture & Fixture (Depreciation charged @ 5% on Plant & Machinery & @10% on Furniture)	2400	2000 400
	Profit & loss A/c Dr. To Reserve for Doubtful Debts (Reserve for Doubtful Debts created)	2250	2250
	Wages A/c Dr Rent A/c Dr To Outstanding Expenses A/c (Outstanding expenses provided for)	1000 500	1500
	Commission Accrued A/c Dr. To commission received (Commission accrued taken into consideration)	1000	1000
	Interest on loan A/c Dr To Interest on loan Outstanding A/c (Interest on loan due but not paid)	600	600

**Trading and Profit & Loss A/c of M/s Mustafa & Co.
for the year ended on 31.12.2006**

Dr		Cr	
Particulars	Amount	Particulars	Amount
Opening Stock	40000	Sales	120000
Purchases	51000	Less : Sales	(2000)
Wages	20000	Returns	118000
Add : Outstanding	1000	Closing Stock	30000
	21000		
Coal, Gas & Coke	5800		
Gross Profit c/d	30200		
	148000		148000
Salaries	5000	Gross Profit	30200
Rent	2800	b/d	
Add : Outstanding	500	Commission	
	3300	Received	2000
Repairs	1800	Add : Accrued	
Bad Debts	5500	Commission	1000
Add : New Reserve	2250		3000
	7750		
Less : Old Reserve	(4500)		
	3250		
Interest on Loan	600		
Add : Interest Outstanding	600		
	1200		
Depreciation			
Plant & Machinery	2000		
Furniture & Fixture	400		
	2400		
Net Profit Transferred to			
Capital A/c	16250		
	33,200		33,200



Notes

**TERMINAL QUESTIONS**

1. Answer following questions in brief.
 - (a) Why adjustments are needed?
 - (b) Why outstanding expenses are treated as liabilities?
 - (c) What is the difference between accrued income and unearned income?
2. Write journal entries for following adjustments :
 1. Wages outstanding
 2. Depreciation on Furniture
 3. Interest on Investment accrued but not received
 4. Insurance Premium paid in advance
3. Why reserve for doubtful debts is created?
4. From the following trial balance of M/s V.B. Fertilizers prepare Trading & Profit and Loss Account for the year ending 31st December, 2006 and Balance Sheet as on that date. Also make Journal entries for the adjustments :

Particulars	Dr. Balance	Particulars	Cr Balance
Stock (1.1.2006)	13800	Capital	65000
Purchases	52000	Bills payable	18000
Wages	4000	Sales	74400
Return inward	2400	Return outward	1500
Land & Building	40000	Discount	450
Plant & machinery	24500	Creditors	6500
Bills receivable	12000	Interest	600
Debtors	5500	Bad debts Reserve	250
Cash in hand & at Bank	8750	Loan	8000
Rent (office)	2200	Commission	700
Bad Debts	400		
Insurance	1500		
Freight inward	1400		
Fuel & Power	2450		
Furniture	4500		
	175400		175400

Adjustments

1. Stock on 31.12.2006 Rs. 25000.
2. Write off depreciation on furniture 10% and on plant & machinery 20%.

**Notes**



Notes

3. Provide for wages outstanding Rs 650 and rent outstanding Rs. 200. Prepaid insurance amounted to Rs. 300.
 4. Further bad debts amounted to Rs. 100. Make a provision for bad & doubtful debts @ 5% on debtors.
 5. Interest on capital to be allowed @ 6%.
5. On 1st April, 2006 reserve for Bad Debts shows a balance of Rs. 3200 Bad debts during the year as per ledger were Rs.2100. Debtors amounted to Rs 7000. After closing of the ledger, it was found that there were bad debts of Rs. 800. It was decided to create a reserve for doubtful debts on creditors @6%.
- Make necessary journal entries and show the items in Profit & loss account and Balance Sheet.
6. From the following trial balance of Pranaya as at 31st December, 2006, prepare Trading and Profit & loss account for the year ended 31st December, 2006 and a Balance Sheet as on that date after making necessary adjustments. Also Give journal entries for the adjustments

**Trial Balance
as at 31-12-2006**

Name of Account	Dr. Balances (Rs)	Dr. Balances (Rs)
Pranaya's Capital Account		100000
Drawings	24000	-
Plant and Machinery	45000	-
Stock (1 st Jan, 2006)	15000	-
Purchases	85000	-
Return inwards	5000	-
Sundry Debtors	24600	-
Freight and duty	2000	-
Carriage outwards	1600	-
Rent Rates & Taxes	3800	-
Sundry Creditors	-	22000
Postage & Courier Expenses	1800	-
Sales	-	135000
Provision for Bad Debts	-	600
Discount	-	800
Insurance Premium	900	-
Wages	23000	-
Cash in Hand	6200	-
Cash at Bank	20500	-
	258400	258400



Notes

Adjustments

1. Stock on 31st December, 2006 was valued at Rs. 24000.
 2. Write off Rs. 600 as bad debts.
 3. Provision for doubtful debts is to be maintained at 5% on sundry debtors.
 4. Provide depreciation on plant and machinery at 20%. A machine costing Rs. 1500 was purchased on 1st July, 2006.
 5. Wages outstanding amounted to Rs. 1500, and Insurance Prepaid was Rs. 250.
7. The following are the balances extracted from the books of Chinmay Aggarwal on 31st March 2007.

Chinmay's Capital	60000	Stock (1.4.06)	44200
Furniture & Fixtures	5000	Debtors	36000
Bank Overdraft	8400	Rent received	2000
Creditors	27600	Purchases	220000
Business Premises	50000	Sales	300000
Discount (Dr)	3200	Sales Returns	4000
Tax & Insurance	4000	Bills Payable	10000
Salaries	20000		
Commission (Cr.)	2000		
Carriage inward	3600		
Bad Debts	1600		
Motor Vehicle	14400		
Investments	4000		

Following adjustments are to be made :

- (i) Stock on 31 March, 2007 Rs 35000.
- (ii) Write off depreciation on :
 - Business Premises Rs 800
 - Furniture & Fixture Rs 500
 - Motor Vehicle 10% p.a.
- (iii) Interest on bank overdraft Rs. 150.
- (iv) Interest on capital allowed @ 6% p.a.

**Notes**

- (v) Make a provision of 5% on debtors for doubtful debts.
- (vi) Carry forward Rs. 500 for unexpired insurance.

Prepare Trading and Profit & loss A/c for the year ended 31st March, 2007 and Balance Sheet as on that date.

8. Pass necessary journal entries for the following adjustments

1. 1/3rd of the total commission received during the year of Rs.12000 relates to the next year
2. Insurance premium of Rs.8000 is paid for the year ending 30st June. Accounts are closed on 31st March every year.
3. Interest on drawing is charged for the year amounting to Rs. 450.

**ANSWERS TO INTEXT QUESTIONS****Intext Questions 15.1**

- (i) profit, loss
- (ii) profit or loss, financial position
- (iii) excluded
- (iv) accounted for

Intext Questions 15.2

- (i) Outstanding expenses
- (ii) Prepaid expenses
- (iii) Accrued income
- (iv) Income received in advance

Intext Questions 15.3

- I. (i) provision for bad & doubtful debts
- (ii) depreciation
- (iii) bad debts
- (iv) closing stock



- II. (i) To capital account
- (ii) To wages outstanding A/c
- (iii) To insurance premium A/c
- (iv) To commission received in advance A/c

Notes

Answers to Practical Terminal Questions

- 4. (G.P. Rs. 24200; N.P. Rs 12580
Total of Balance Sheet Rs 114830
- 6. G.P. Rs 27500; N.P. Rs 10400
Total Balance Sheet Rs 109900
- 7. G.P. Rs 63200; N.P. Rs 30610
Total balance Sheet : Rs 140360



Activity : Analyse the financial statements of at least four business concerns and record the rate at which depreciation is charged on various fixed assets and provision is made for doubtful debts and find out the reasons of variation.

S.No.	Name of business concern	Rate of Depreciation	Reasons of variation