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Financial Statements —With Adjustments

LEARNING OBJECTIVES

After studying this Chapter, you should be able to understand :

- Meaning and Need of Adjustments
- Important Adjustments
  1. Closing Stock
  2. Outstanding Expenses
  3. Prepaid Expenses
  4. Depreciation
  5. Accrued Income
  6. Unearned Income
  7. Interest on Capital
  8. Interest on Drawings
  9. Interest on Loan
  10. Bad-debts
  11. Provision for Bad and Doubtful Debts
  12. Provision for Discount on Debtors
  13. Abnormal Loss
  14. Charity in the Form of Goods
  15. Goods Distributed as Free Samples
  16. Drawings in Goods
  17. Deferred Revenue Expenditure
  18. Manager's Commission on Net Profit
  19. Capital Expenditure treated as Revenue Expenditure
  20. Goods Sold and Despatched but Omitted to be Recorded
  21. Goods Purchased but Omitted to be Recorded
  22. Sale of Goods on Approval Basis

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 alongwith 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) Of 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 transferred to Trading A/c)

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 on the one hand, will be added to 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 Liabilities side of the Balance Sheet. Outstanding Expenses Account is a Personal Account because it represents those persons to whom the payment is to be made.

Example :— Extracts of Trial Balance as at 31st March, 2012

Name of Accounts	Dr. Balances	Cr. Balances
	₹	₹
Wages paid	2,20,000	
Salary paid	55,000	

Adjustments :— Wages ₹20,000 and Salary ₹5,000 are outstanding.

SOLUTION :— Adjustment Entries :—

(1) Wages A/c	Dr.	20,000	
To Outstanding wages A/c			20,000
(Wages due)			
(2) Salary A/c	Dr.	5,000	
To Outstanding Salary A/c			5,000
(Salary due)			

Effects on Final Accounts :—

Dr. TRADING A/C Cr.

	₹		₹
To Wages 2,20,000 *Add* : Outstanding wages 20,000	2,40,000		

Dr. PROFIT & LOSS A/C Cr.

	₹		₹
To Salary 55,000 *Add* : Outstanding Salary 5,000	60,000		

BALANCE SHEET

Liabilities	*Amount*	*Assets*	*Amount*
	₹		₹
Outstanding Wages	20,000		
Outstanding Salary	5,000		

Note :— If outstanding expenses have been mentioned inside the Trial Balance, they will be shown on the liabilities side only because it means that it has already been added to the concerned expenses. Outstanding Expenses Account is a Representative Personal Account and always shows a credit balance.

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 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 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.

Example :— EXTRACTS OF TRIAL BALANCE
as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Insurance Account	20,000	

Adjustment :— Prepaid Insurance amounted to ₹5,000

SOLUTION :— **Adjustment Entry** :—

Prepaid Insurance A/c	Dr.	5,000	
To Insurance A/c			5,000
(Insurance paid in Advance)			

Effects on Final Accounts :—

Dr. PROFIT & LOSS A/C Cr.

		₹		₹
To Insurance	20,000			
Less : Prepaid Insurance	5,000	15,000		

BALANCE SHEET

Liabilities	*Amount*	*Assets*	*Amount*
	₹		₹
		Prepaid Insurance	5,000

Note :— If Prepaid Expenses have been mentioned inside the Trial Balance, they will be shown on the Assets side only because it means that it has already been deducted out of the concerned expenses. Prepaid Expenses Account is a Representative Personal Account and always shows a debit balance.

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.

Example :—

EXTRACTS OF TRIAL BALANCE *as at 31st March, 2012*

	Dr. (₹)	Cr. (₹)
Machinery	5,00,000	
Furniture	80,000	

Adjustments :— Machinery is to be depreciated @ 10% p.a. and furniture @ 20% p.a.

SOLUTION :— Adjustment Entry :—

Depreciation A/c	Dr.	66,000	
To Machinery A/c			50,000
To Furniture A/c			16,000
(Depreciation charged)			

Effects on Final Accounts :—

Dr. PROFIT & LOSS A/C Cr.

		₹		₹
To Depreciation on :	Machinery	50,000		
	Furniture	16,000		

BALANCE SHEET

Liabilities	*Amount* ₹	*Assets*		*Amount* ₹
		Machinery	5,00,000	
		Less : Dep.	50,000	4,50,000
		Furniture	80,000	
		Less : Dep.	16,000	64,000

ILLUSTRATION 1.

From the following Trial Balance of Sh. Rama Nand Sagar, prepare Trading and Profit & Loss Account for the year ended 31st March, 2012 and a Balance Sheet as at that date :—

Dr. Balances	₹	*Cr. Balances*	₹
Opening Stock	20,000	Sales	2,70,000
Purchases	80,000	Purchase Return	4,000
Sales Return	6,000	Discount	5,200
Carriage Inwards	3,600	Sundry Creditors	25,000
Carriage Outwards	800	Bills Payable	1,800
Wages	42,000	Capital	75,000
Salaries	27,500		
Plant & Machinery	90,000		
Furniture	8,000		
Sundry Debtors	52,000		
Bills Receivable	2,500		
Cash in Hand	6,300		
Travelling Expenses	3,700		
Lighting (Factory)	1,400		
Rent and Taxes	7,200		
General Expenses	10,500		
Insurance	1,500		
Drawings	18,000		
	3,81,000		3,81,000

Adjustments :—

(1) Stock on 31st March, 2012 was valued at ₹24,000 (Market Value ₹30,000).
(2) Wages outstanding for March, 2012 amounted to ₹3,000.
(3) Salaries outstanding for March, 2012 amounted to ₹2,500.
(4) Prepaid insurance amounted to ₹300.
(5) Provide depreciation on Plant and Machinery at 5% and on Furniture at 20%.

			Less : Depreciation	1,600	6,400
Less : Drawings	1,62,700 18,000	1,44,700	Plant & Machinery	90,000	
			Less : Depreciaiton	4,500	85,500
		1,77,000			1,77,000

Note :— (1) Closing Stock is valued at Cost or Realisable Value, whichever is less.

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 Incomes' 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.

Example :— EXTRACTS OF TRIAL BALANCE

as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Commission Received		15,000

Adjustment : Commission earned but not received ₹3,000.

SOLUTION :— Adjustment Entry :—

Accrued Commission A/c	Dr.	3,000	
To Commission Received A/c			3,000
(Commission receivable)			

Effects on Final Accounts :—

Dr. PROFIT & LOSS A/C Cr.

	₹		₹
		By Commission 15,000 *Add :* Accrued Commission 3,000	18,000

BALANCE SHEET

Liabilities	*Amount*	*Assets*	*Amount*
	₹		₹
		Accrued Commission	3,000

Note :— If Accrued Incomes have been mentioned inside the Trial Balance, they will be shown on the Assets side only because it means that it has already been included in the concerned account of income. Accrued Income Account is a Representative Personal Account and always shows a Debit Balance.

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.

Example :—

EXTRACTS OF TRIAL BALANCE
as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Rent Received		39,000

Adjustment :— Rent received but not earned ₹3,000.

SOLUTION :— Adjustment Entry :—

Rent Received A/c	Dr.	3,000	
To Rent received in Advance A/c			3,000
(Adjustment entry for unearned rent)			

Effects on Final Accounts :—

Dr. PROFIT & LOSS A/C Cr.

	₹			₹
		By Rent	39,000	
		Less : Unearned Rent	3,000	36,000

BALANCE SHEET

Liabilities	*Amount*	*Assets*	*Amount*
	₹		₹
Unearned Rent	3,000		

Note :— If 'Unearned Incomes' have been stated inside the Trial Balance, they will be shown on the Liabilities Side only because it means that it has already been deducted out of the concerned income. Unearned Income Account is a Representative Personal Account and always shows a Credit Balance.

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			60,000
(Interest allowed on Capital)			

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.

Example :— EXTRACTS OF TRIAL BALANCE

as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Capital A/c		5,00,000
Drawings A/c	80,000	

Adjustment :— Charge ₹3,000 as interest on drawings.

SOLUTION :— Adjustment Entry :—

Drawings A/c	Dr	3,000	
To Interest on Drawings A/c			3,000
(Interest charged on 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.

Dr. PROFIT & LOSS A/C Cr.

	₹		₹
		By Interest on Drawings	3,000

BALANCE SHEET

Liabilities		*Amount*	*Assets*	*Amount*
		₹		₹
Capital	5,00,000			
Less : Drawings	80,000			
	4,20,000			
Less : Interest on Drawings	3,000	4,17,000		

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 case and 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.

Example :— EXTRACTS OF TRIAL BALANCE

as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Loan from bank @ 12% p.a.		5,00,000

Adjustment :— Interest on Loan is due for the whole year.

SOLUTION :— Adjustment Entry :—

Interest on Loan A/c	Dr.	60,000	
To Outstanding Interest A/c			60,000
(Outstanding interest on Loan)			

Effects on Final Accounts :—

Dr. PROFIT & LOSS A/C Cr.

	₹		₹
To Interest on Loan	60,000		

BALANCE SHEET

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Loan from Bank 5,00,000 *Add* : Outstanding Interest 60,000	5,60,000		

ILLUSTRATION 2.

From the following Trial Balance of Sh. Ved Vyas, prepare Trading and Profit & Loss Account for the year ended 31st March, 2012 and Balance Sheet as at that date :

	Dr. (₹)	Cr. (₹)
Purchases and Sales	2,75,000	5,20,000
Returns Inwards	15,000	
Returns Outwards		9,000
Carriage	12,400	
Wages and Salaries	58,600	
Trade Expenses	2,200	
Rent		13,000
Insurance	2,000	
Audit Fees	1,200	
Debtors and Creditors	1,10,000	62,100
B/R and B/P	3,300	2,200
Printing and Advertising	5,500	
Commission		1,000
Opening Stock	36,000	
Cash in hand	12,800	
Cash at Bank	26,800	
Bank Loan		20,000
Interest on Loan	1,500	
Capital		2,50,000
Drawings	15,000	
Fixed Assets	3,00,000	
	8,77,300	8,77,300

Adjustments :—

1. Stock at the end ₹60,000.
2. Depreciate Fixed Assets by 10%.
3. Commission earned but not received amounts to ₹400.

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.

Example :— EXTRACTS OF TRIAL BALANCE

as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Bad-Debts	8,000	
Sundry Debtors	2,00,000	

Adjustment :— Write off further Bad-debts ₹10,000.

SOLUTION :— Adjustment Entry :—

Bad-debts A/c	Dr.	10,000	
To Sundry Debtors A/c			10,000
(Further Bad-debts written off)			

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.

Dr. PROFIT & LOSS A/C Cr.

		₹		₹
To Bad-debts	8,000			
Add : Further Bad-debts	10,000	18,000		

BALANCE SHEET *as at 31st March, 2012*

Liabilities	*Amount*	*Assets*		*Amount*
	₹			₹
		Sundry Debtors	2,00,000	
		Less : Bad-debts	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 to 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.

Example :— EXTRACTS OF TRIAL BALANCE

as at 31st March, 2012

	Dr. (₹)	Cr. (₹)
Debtors	60,000	

Adjustment :— Create a provision for Bad and Doubtful Debts @ 5% on Debtors.

SOLUTION :— Adjustment Entry :—

Profit and Loss A/c	Dr.	3,000	
To Provision for Bad and Doubtful Debts A/c			3,000
(The creation of provision at 5% on Debtors)			

Dr. PROFIT & LOSS A/C Cr.

	₹		₹
To Provision for Bad and Doubtful Debts	3,000		

BALANCE SHEET
as at 31st March, 2012

Liabilities	*Amount* ₹	*Assets*		*Amount* ₹
		Debtors	60,000	
		Less : Provision for Bad and Doubtful Debts	3,000	57,000

In the above illustration, the provision of ₹3,000 created in 2012 will be carried forward to the next year and will be shown on the credit side of the Trial Balance of the year 2013. This provision of ₹3,000 is termed as 'New Provision' in the year 2012 and the same provision of ₹3,000 will be termed as 'Old Provision' in the year 2013. In 2013 when the bad-debts actually occur, the bad-debts will be met from this Old Provision. At the end of 2013, a fresh provision (New Provision) is made again on the amount of Debtors at a fixed percentage.

The amount of Bad-debts is added to the amount of New Provision on the debit side of Profit & Loss Account and the amount of Old Provision will be deducted from the total of the two. The amount of Old Provision will be given on the credit side of the Trial Balance or in other words, the amount of provision which is given on the credit side of the Trial Balance will be treated as Old Provision.

As the New Provision is given in adjustments, it will also be deducted from Debtors on the assets side of Balance Sheet in order to complete its double entry.

Example :— EXTRACTS OF TRIAL BALANCE
as at 31st March, 2012

	Dr. ₹	Cr. ₹
Bad-Debts Account	800	
Provision for Doubtful Debts 1-4-2011		2,500
Debtors	80,000	

Adjustment : Create a provision for Doubtful Debts @ 5% on Debtors. Pass Journal Entries and show the necessary Ledger Accounts and Balance Sheet.

SOLUTION : JOURNAL

				Dr. (₹)	Cr. (₹)
2012 March 31	Provision for Doubtful Debts A/c	Dr.		800	
	To Bad-debts A/c				800
	(Bad-debts transferred to old provision)				

March 31	Profit & Loss A/c[1]	Dr.	2,300	
	To Provision for Doubtful Debts A/c			2,300
	(Net amount charged from P & L A/c)			

Note : (1) Net Amount chargeable from P & L A/c :—

	₹
Bad-Debts	800
Add : New Provision required at 5% on ₹80,000	4,000
	4,800
Less : Old Provision	2,500
This amount is to be shown on the Debit of P & L A/c	2,300

Dr. BAD-DEBTS ACCOUNT Cr.

2012		₹	2012		₹
March 31	To Balance b/d (As per Trial Balance)	800	March 31	By Provision for Doubtful Debts A/c	800

Dr. PROVISION FOR DOUBTFUL DEBTS ACCOUNT Cr.

2012		₹	2011		₹
March 31	To Bad-Debts A/c	800	April 1	By Balance b/d (Old Provision)	2,500
			2012		
March 31	To Balance c/d (New Provision 5% on ₹80,000)	4,000	March 31	By Profit & Loss A/c (Balancing figure)	2,300
		4,800			4,800
			2012		
			April 1	By Balance b/d	4,000

Dr. PROFIT & LOSS A/C Cr.

		₹		₹
To Provision for Doubtful Debts A/c:				
Bad-debts	800			
Add : New Provision	4,000			
	4,800			
Less : Old Provision	2,500	2,300		

BALANCE SHEET

Liabilities	*Amount*	*Assets*		*Amount*
	₹			₹
		Debtors	80,000	
		Less : New Provision (5% on ₹80,000)	4,000	76,000

ILLUSTRATION 3.

From the following trial balance, you are required to prepare Trading and Profit & Loss A/c for the year ending 31st March, 2001 and a Balance Sheet as at that date :

	₹		₹
Opening Stock	25,000	Sales	7,00,000
Furniture	16,000	Creditors	72,500
Purchases	5,55,300	Bank Overdraft	50,000

Carriage Inwards	4,700	Provision for Bad and Doubtful Debts	2,100
Bad Debts	1,800	Discount	500
Wages	52,000	Capital	2,00,000
Debtors	80,000	Purchase Returns	20,000
Sales Returns	15,000		
Rent	24,000		
Miscellaneous Expenses	3,400		
Salaries	68,000		
Cash	8,900		
Drawings	14,000		
Buildings	1,60,000		
Advertising	10,000		
Interest on Bank Overdraft	7,000		
	10,45,100		10,45,100

Adjustments :

(*i*) Closing Stock is valued at ₹36,000.

(*ii*) Private purchases amounting to ₹5,000 have been debited to Purchases Account.

(*iii*) Make a provision for Bad and Doubtful Debts at 5% on debtors.

(*iv*) A new sign-board costing ₹4,000 is included in Advertising.

(*v*) Depreciate furniture and fittings by 10%.

SOLUTION : TRADING AND P

Following points should be noted in respect of Bad-Debts Provision :—

(1) If provision for doubtful debts is given in adjustments, it is called 'New Provision'. In this case, it will be recorded at two places. On the one hand, it will be added in Bad-debts on the debit side of the P & L A/c and on the other hand, will also be deducted from Debtors on the assets side of the Balance Sheet.

(2) If provision for doubtful debts is given inside the Trial Balance, it is called 'Old Provision'. In this case, it will be recorded only at one place, *i.e.*, deducted from the total of Bad-debts and New Provision on the debit side of P & L A/c.

When Bad Debts are Given in Adjustments :— Sometimes, Bad-debts are given in adjustments. In such a case, on the one hand, these further Bad-debts will be written on the debit side of the P & L A/c and on the other hand, will also be deducted from debtors on the assets side. New Provision in this case, will be calculated on the amount of debtors which remain after deducting the amount of Bad-debts therefrom.

Example :—

The following balances appeared in the Trial Balance of M/s Kapil Traders as at 31st March 2006 :

	₹
Sundry Debtors	3,05,000
Bad Debts	5,000
Provision for Bad-debts	20,000

The partners of the firm agreed to record the following adjustments in the books of the firm. Further Bad-debts ₹3,000; maintain provision for Bad-debts 10%. Show journal entries and the Bad-debts Account, Provision Account, Debtors Account, Profit and Loss Account and Balance Sheet.

SOLUTION :

JOURNAL

				Dr. (₹)	Cr. (₹)
	Bad-debts A/c	Dr.		3,000	
	To Sundry Debtors A/c				3,000
	(Further Bad-debts)				
	Provision for Doubtful Debts A/c	Dr.		8,000	
	To Bad Debts A/c				8,000
	(Bad debts adjusted against the provision)				
	Profit and Loss A/c[1]	Dr.		18,200	
	To Provision for Doubtful Debts A/c				18,200
	(Net amount charged from P & L A/c)				

Note : (1) Net Amount chargeable from P & L A/c :—

	₹
Bad-Debts (5,000 + 3,000)	8,000
Add : New Provision : 10% on (3,05,000 – 3,000)	30,200
	38,200.
Less : Old Provision	20,000
	18,200

BAD-DEBTS ACCOUNT

Dr. Cr.

2006		₹	2006		₹
March 31	To Balance b/d	5,000	March 31	By Provision for Doubtful Debts A/c	8,000
March 31	To Sundry Debtors A/c	3,000			
		8,000			8,000

PROVISION FOR DOUBTFUL DEBTS ACCOUNT

Dr. Cr.

2006		₹	2005		₹
March 31	To Bad Debts A/c	8,000	April 1	By Balance b/d (Old Provision)	20,000
March 31	To Balance c/d (New Provision)	30,200	2006 March 31	By Profit & Loss A/c (Balancing figure)	18,200
		38,200			38,200

PROFIT & LOSS ACCOUNT

for the year ended March 31, 2006

Dr. Cr.

		₹		₹
To Provision for Doubtful Debts A/c:				
Bad-debts	5,000			
Add : Further Bad-debts	3,000			
	8,000			
Add : New Provision	30,200			
	38,200			
Less : Old Provision	20,000	18,200		

ILLUSTRATION 6.

The following is the Trial Balance of Amrit Raj as at 31st March, 2012 :—

	Dr. (₹)	Cr. (₹)
Capital		25,000
Building	30,000	
Furniture	2,640	
Scooter	4,000	
Returns inward and outward	2,300	1,600
Stock on 1st April, 2011	8,000	
Purchases and Sales	33,800	56,040
Bad-Debts	300	
Carriage inward	700	
General Expenses	1,200	
Bad-Debts Provision		700
Bank Loan		5,000
Interest on Bank Loan	300	
Commission		900
Insurance and Taxes	2,000	
Scooter Expenses	2,600	
Salaries	4,400	
Cash in hand	2,000	
Debtors and Creditors	3,000	8,000
	97,240	97,240

You are required to prepare the final accounts for the year ending 31st March, 2012 taking into account the following adjustments :—

(*a*) Closing Stock on 31st March, 2012 was valued at ₹4,340.
(*b*) Commission include ₹300 being commission received in advance.

(*c*) Salaries have been paid for 11 months.

(*d*) Bank Loan has been taken at 10% p.a. interest.

(*e*) Depreciate Building by 5% and Scooter by 15%.

(*f*) Write off ₹200 as further Bad-debts and maintain bad-debts provision at 5% on debtors.

(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 caloulated on the balance of Debtors and lastly, provision for discount will be calculated on the remaining amount of Debtors.

Adjustments Relating to Goods

13. **Abnormal Loss** :— Sometimes losses occur due to some abnormal circumstances such as accident, fire, flood, earthquakes etc. Such losses are called Abnormal Losses. These may be divided into two categories :—

(A) **Loss of Goods** :— Following entries will be passed if the goods are destroyed :—

(I)	Loss by Accident A/c	Dr.	
	To Purchases A/c		
	(Loss of goods in accident)		
(II)	Profit & Loss A/c	Dr.	
	To Loss by Accident A/c		
	(Loss by accident transferred to P & L A/c)		

Combined effect of the two entries mentioned above will be that on the one hand, the loss of goods will be deducted from purchases on the Dr. side of Trading Account because it reduces the goods purchased for resale and on the other hand, it will also be shown on the Dr. side of P & L A/c since it is a loss to the business.

In case, the goods are insured and the Insurance Company admits a claim, the Account of Insurance Claim or Insurance Company will be debited for the amount of claim admitted, in place of P & L A/c in the above mentioned entry.

Insurance Claim or Insurance Company A/c	Dr.
To Loss by Accident A/c	
(Loss to be recovered from the Insurance Co.)	

Example :— Goods worth ₹1,00,000 were burnt by fire and a claim of 70% has been accepted by the Insurance Company.

SOLUTION :— Adjustment Entry :—

(I)	Loss by Accident (Fire) A/c	Dr.	1,00,000	
	To Purchases A/c			1,00,000
	(Goods burnt by fire)			
(II)	Insurance Claim or Insurance Company A/c	Dr.	70,000	
	Profit & Loss A/c	Dr.	30,000	
	To Loss by Accident A/c			1,00,000
	(70% of the claim accepted by the Insurance Co.)			

Treatment in Final Accounts :— ₹1,00,000 will be deducted from Purchases on the debit side of Trading A/c; ₹30,000 will be shown on the debit side of Profit and Loss A/c and ₹70,000 will be shown on the Assets side of the Balance Sheet.

As such, the full amount of loss of goods is deducted from purchases. Amount of claim admitted by the Insurance Company is shown on the Assets and the balance will be shown on the debit side of P & L A/c.

(B) Loss of Fixed Assets :—If some fixed asset of the firm is destroyed by some accident such as fire etc. the loss will be shown on the debit side of P & L A/c and also deducted from the value of Asset on the assets side of the Balance Sheet.

ILLUSTRATION 9.

From the following Adjustments and with the help of Trial Balance prepare a Trading A/c, Profit and Loss A/c and Balance Sheet as at 31st March, 2012 :

Dr. Balances	₹	*Cr. Balances*	₹
Insurance charges	2,400	Capital	1,70,000
Salaries & Wages	19,400	S. Creditors	20,000
Cash in hand	200	Sales	1,20,000
Cash at Axis Bank	26,500	Returns Outwards	1,200
Trade Expenses	400	Provision for Doubtful Debts	400
Postage & Telegrams	800	Discount	800
Drawings	6,000	Rent of Premises, Sublet for one year to 30th June 1989	1,200
Plant & Machinery :—			
Balance on 1st April, 2011	1,20,000		
Addition on 1st Oct. 2011	5,000		
Stock on 1st April, 2011	15,000		
Purchases	82,000		
Returns Inward	2,000		
S. Debtors	20,800		
Furniture & Fixtures	5,000		
Freight & Duty	2,000		
Carriage outwards	500		
Rent, Rates & Taxes	4,600		
Printing & Stationery	1,000		
	3,13,600		3,13,600

Adjustments :

(*i*) Stock on 31st March, 2012 was valued at ₹24,000 and stationery unused at the end was ₹250.

(*ii*) The provision for Doubtful Debts is to be maintained at 6% on Sundry Debtors.

(*iii*) Create a provision for discount on Sundry Debtors at 2%.

(*iv*) Write off ₹800 as Bad-debts.

(*v*) Provide depreciation on Plant and Machinery @ 10% p.a.

(*vi*) Insurance is paid up to 30th June, 2012.

(*vii*) A fire occurred on 25th March, 2012 in the Godown and Stock of the value of ₹6,000 was destroyed. It was insured and the Insurance Co. admitted a claim of ₹4,000.

14. Charity in the Form of Goods :— Occasionally, certain amount of goods is given away as charity. The following entry will be passed for it :—

Charity A/c Dr.

To Purchases A/c

(Goods given away as charity)

Treatment in Final Accounts :— On the one hand, the amount will be deducted from Purchases because it reduces the goods purchased for resale and on the other hand, it will also be shown on the debit side of P & L A/c because it is business expense.

15. Goods Distributed as Free Samples :— Sometimes the goods which the business deals in are distributed as free samples for the purpose of advertising these goods. The following adjusting entry should be passed for it :—

Advertisement A/c Dr.

To Purchases A/c

(Goods distributed as free samples)

Treatment in Final Accounts :— It will be deducted from purchases in the Trading A/c and will also be shown on the Debit side of P & L A/c because it is an expense of business.

16. Drawings in Goods :— If the proprietor of the business has taken some goods for his personal use from the business, the entry will be :—

Drawings A/c Dr.

To Purchases A/c

Treatment in Final Accounts :— It will be deducted from Purchases in the Trading Account and will also be deducted from the Capital on the liabilities side of the Balance Sheet as Drawings.

Example :— A manufacturer of cloth took cloth for personal use ₹5,000; distributed as samples cloth worth ₹30,000 and gave to his office staff cloth worth ₹20,000 for their personal use. Give adjusting entry.

SOLUTION :

Drawings A/c	Dr.	5,000	
Advertisement A/c	Dr.	30,000	
Salary A/c	Dr.	20,000	
To Purchases A/c			55,000
(Goods taken away from business for different purposes)			

Implied Interest :—Sometimes, Trial Balance includes 'Loan Account' carrying a specified rate of interest. In such a case, it is necessary to calculate the interest, even if nothing is mentioned in the adjustments about the interest. If no amount of interest is shown in the Trial Balance, the full amount of interest will be treated as outstanding. But if some amount of interest is shown in the Trial Balance, it should be compared with the full amount of interest and the difference, if any, will be treated as outstanding interest.

18. **Manager's Commission on Net Profit** :— Sometimes, in addition to his regular salary, the manager is entitled to a commission on net profit. This is done to induce him to take more interest in the business. Since the Commission is always calculated at the end of the accounting period, it is treated as outstanding expenses and the following adjusting entry is passed for it :

Commission A/c   Dr.
    To Outstanding Commission A/c

Treatment in Final Accounts :— On the one hand, it will be recorded on the debit side of P & L A/c because it is a business expense and on the other hand, shown on the Liabilities side as an outstanding expense.

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 ₹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 :—

$$\text{Manager's Commission} = 22{,}000 \times \frac{10}{100} = ₹2{,}200.$$

(*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 :—

$$\text{Manager's Commission} = 22{,}000 \times \frac{10}{110} = ₹2{,}000.$$

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

ILLUSTRATION 13.

From the following Trial Balance of M/s Arjun and Sons as at 31st Dec. 2007, prepare Trading and Profit and Loss Account and Balance Sheet.

Name of Accounts	Dr. ₹	Cr. ₹
Drawing and Capital	18,000	80,000
Purchases and Sales	82,600	1,55,000
Stock (1.1.2007)	42,000	