Contd.

Current Liabilities		Current Assets	
Sundry creditors	25,000	Stock	40,000
Bills payable	17,000	Sundry debtors	40,000
		Bills receivables	10,000
		Cash at bank	30,800
		Cash in hand	4,800
Total	**2,76,600**	Total	**2,76,600**

Adjustments It is quite possible that the trial balance presented to you for preparation of final accounts is not a final one. In other words, there could be some pending items which call for certain adjustments to different accounts such as salaries yet to be paid, etc. In such cases, it is necessary to carry out the adjustments (given at the end of the trial balance) at the time of preparing final accounts.

Generally, all adjustments given at the end of trial balance have to be recorded twice: (a) once in trading or profit and loss account and (b) in balance sheet. (However, there may be certain adjustment items which may appear twice only in balance sheet[1] or twice in trading and profit and loss account[2]. But they are exceptional items.

The adjustments can be of different types. They are:

(a) Accrual of expenses (outstanding or unpaid expenses)
(b) Prepaid or unexpired expenses (paid in advance)
(c) Provision for depreciation (charge depreciation)
(d) Provision for bad debts
(e) Increasing or decreasing provisions for bad debts
(f) Provision for discount on debtors
(g) Provision for discount on creditors
(h) Appreciation in assets such as investments
(i) Creating reserve out of profits
(j) Commission payable to manager as a percentage of profits
(k) Accrued income or income receivable
(l) Income received in advance or unearned income
(m) Interest on capital
(n) Interest on drawings

Now let us discuss these in detail.

(a) *Accrual of expenses (Outstanding or unpaid expenses)* In case of outstanding expenses, it must be added to the concerned account in trading or profit and loss account. Again this item should be shown in the balance sheet as a liability.

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1. For example, if it is given in adjustments that a credit purchase of furniture for Rs 10,000 from Y is not recorded in the books, this adjustment appears on the assets side of the balance sheet as addition to furniture and on the liabilities side of the balance sheet as creditor for furniture.
2. For example, if it is given in adjustments that goods destroyed by fire Rs 6,000 and nothing is recovered from insurance company, it appears on the credit side of trading account and again on the debit side of profit and loss account.

Example 7

Trial Balance

	Dr. (Rs.)	Cr. (Rs.)
Rent	500	

Adjustments: Outstanding rent Rs.300

Solution

Profit and Loss Account

	Rs.	Rs.	
To Rent	500		
Add: Outstanding	300	800	

Balance Sheet

Current liabilities:		
Outstanding rent	300	

The rent charged to Profit and Loss Account is Rs.500 + Rs.300 = Rs.800

Note: Again the outstanding rent of Rs.300 has to be shown as current liability in the balance sheet.

(b) ***Prepaid or unexpired expenses (Paid in advance)*** In case any of the expense is prepaid, it must be deducted from the concerned head in trading or profit and loss account. Again it will be shown in balance sheet as an asset.

Example 8

Trial Balance

	Rs.	
Wages	6,000	

Adjustments: Wages prepaid Rs. 250

Solution

Trading Account

	Rs.	Rs.	
To Wages	6,000		
Less: prepaid	250	5,750	

Balance Sheet

	Current assets:	*Rs.*
	Wages prepaid	250

The wages charged to trading account is Rs. 6000 – Rs. 250 = Rs. 5,750

Note: Again the prepaid wages of Rs.250 has to be shown as current asset in the balance sheet.

(c) *Provision for depreciation (Charge depreciation)* Depreciation refers to the reduction in value of the asset. It results because of

- Wear and tear of the asset
- Passage of time
- Technological developments and obsolescence

Generally, all fixed assets are subject to depreciation.

The formula to calculate depreciation under a popular method, called straight-line method, is given as follows:

$$\text{Depreciation} = \frac{\text{Cost of the asset} - \text{Scrap}}{\text{Number of life years}}$$

Example 9 A building is bought for Rs.2,50,000. It is expected to be actively useful for say 10 years after which it can be sold for Rs.50,000. Calculate depreciation per year.

$$\text{Depreciation} = \frac{250{,}000 - 50{,}000}{10} = \text{Rs. } 20{,}000$$

The depreciation on building per year is Rs. 20,000.

Generally depreciation is charged as a percentage on the value of fixed asset per annum. If depreciation is given as an adjustment, it is to charged to profit and loss account and again it should be deducted from the concerned asset in the Balance Sheet.

In the above example, charge Rs. 20,000 to profit and loss account debit side. This adjustment is shown in profit and loss account as follows:

Profit and Loss Account

	Rs.	
To Depreciation on Buildings	20,000	

Show Rs.2,30,000 (= 250,000 – 20,000) as the value of buildings in the balance sheet under fixed assets. This will appear in balance sheet as shown below:

Balance Sheet

		Rs.	*Rs.*
	Fixed Assets:		
	Buildings	2,50,000	
	Less: depreciation	20,000	
			2,30,000

(d) *Writing off bad debts and provision for bad and doubtful debts* A bad debt is debt which is irrecoverable and hence it will be written off as a loss. At the time of preparation of balance sheet, some debts might have become bad and they will be written off as bad debts and there is certainty regarding that loss. But, some other debts are likely to become bad and it is not known how much of the debt is certainly going to become bad. As a matter of conservatism policy, the businessmen, estimate the debts which are likely to become bad and make a provision for bad debts.

At times, there may be need for additional bad debts to be provided. Here add the additional provision to the given bad debts in the trial balance. Also, deduct the new bad debts only from sundry debtors of balance sheet current assets heading. The following are the examples with regard to bad debts and provision for bad debts (or reserve for bad debts). These examples focus on the treatment of these items in final accounts.

Example 10

Trial Balance

	Rs.	*Rs.*
Sundry debtors	50,000	

Adjustments: (a) Write off bad debts Rs. 5,000. (b)Create 5 % reserve for bad and doubtful debts.

Solution

Adjustment a: (1) Bad debts of Rs.5,000 should be shown on the debit side of profit and loss account. (2) Provide 5 % on debtors towards reserve for bad and doubtful debts (RBD) after deducting Rs.5,000 from the debtors.

Now, the debtors after deducting bad debts is Rs. 45,000 (= 50,000 – 5000)

Adjustment b: Provide 5% for RBD on Rs. 45,000; so the provision for bad and doubtful debts is Rs. 2,750.

This will appear in profit and loss account as given below:

Profit and Loss Account

To bad debts		5,000	
Add: To 5% provision for bad and doubtful debts	2,750		
		7,750	

These adjustments will appear in balance sheet as shown below:

Balance Sheet

	Current Assets:	*Rs.*	*Rs.*
	Sundry debtors	50,000	
	Less: bad debts	5,000	
		45,000	
	Less: 5% provision for bad and doubtful debts	2,750	
			42,250

The net debtors is shown in balance sheet after deducting (a) bad debts in the adjustments and (b) reserve for bad and doubtful debts in the adjustments.

Example 11

Trial Balance

	Rs.	Rs.
Sundry debtors	40,000	
Bad debts	500	
Provision for bad and doubtful debts		1000

Adjustments: (a) Write off further bad debts Rs.1000.

(b) Increase provision for bad and doubtful debts to Rs.1,200

Solution

Profit and Loss Account

To bad debts	500		
Add: further bad debts (adjustments)	1000		
To new provision (from adjustments)	1200		
	2,700		
Less: old provision (from trial balance)	1,000		
		1,700	

These adjustments will appear in balance sheet as shown below:

Balance Sheet

		Rs.	Rs.
	Current Assets:		
	Sundry debtors	40,000	
	Less: further bad debts (adj)	1,000	
		39,000	
	Less: new provision for bad and doubtful debts (PBDD -adj)	1,200	
			37,800

The procedure of dealing with provision for bad and doubtful debts can be simplified shown as follows:

(e) *Provision for bad and doubtful debts*

Profit and Loss Account

Bad debts from trial balance	XX	
Add: further bad debts (from adjustment)	XX	
New provision for bad and doubtful	XX	
debts (adjustments)	XX	
Less: old provision for bad and doubtful	XX	
debts (trial balance)		XX

Balance Sheet

Sundry debtors	XX	
Less: further bad debts (adjustment)	XX	
	XX	
Less: new provision for bad and doubtful debts (adj)	XX	XX

(f) *Provision for discount on debtors* The treatment for provision for discount on debtors is similar to that of provision for bad and doubtful debts. The provision for discount on debtors should be calculated only on good debts as discount is allowed on prompt payment. Hence, after deducting further bad debts given in the adjustments and provision for bad debts (new) from the debtors, calculate provision for discount on debtors at the given percentage. Provision for discount on debtors will appear on the debit side of profit and loss account and again in balance sheet as a deduction from sundry debtors.

(g) *Provision for discount on creditors* Provision for discount on creditors will be calculated on sundry creditors at the given percentage. It appears on the credit side of profit and loss account and again in the balance sheet as a deduction from sundry creditors.

(h) *Appreciation in assets such as investments* In exceptional cases, certain assets such as investments may appreciate in value. As a matter of conservatism principle, appreciation is not advisable to be shown in the final accounts. However, when appreciation of investments is given as adjustment, it appears on the credit side of profit and loss account and again in balance sheet as an addition to investments.

(i) *Accrued income or income receivable* This appears on the credit side of profit and loss account and again in balance sheet on the assets side.

(j) *Income received in advance or unearned income* This appears as a deduction from the concerned income in profit and loss account and again in balance sheet as a liability.

(k) *Interest on capital* It appears in the debit side of profit and loss account and again in balance sheet as addition to capital.

(l) *Interest on drawings* It appears on the credit side of profit and loss account and it will be deducted from capital account along with the drawings.