TOMA
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Adjusting and Closing Entries

Why and when are Adjustments Made?

Adjustments are generally made at the end of an accounting period to consider some items with a view to assess the correct operational result i.e., profit or loss and to project a true and fair view of the state of affairs of an enterprise. Point-wise objectives of adjustment entries are as follows:

1. Periodicity: Adjusting entries are needed whenever transactions affect the revenue or expense of more than one accounting period.

For example: insurance premium paid for 3 years recorded as 'Prepaid insurance' .At the end of the year 1, one years insurance premium expired and shown as 'Insurance expense' one third of the amount and the rest two third shown as 'Prepaid insurance'.

2. Proper matching of cost and revenue: The accrual basis of accounting recognizes revenue when sales are made or services are rendered even though cash is not yet received. Expenses are recognized as incurred regardless of whether or not cash is paid.

3. To consider dues and/or outstanding expenses: If an item of expenditure does not represent full period's amount or in other words a portion of the expense remains to be paid for the period elapsed then it does require to add up the amount yet to be paid. Journal entry required for outstanding expenses is:

Relevant Expense A/C Dr.

To, Outstanding Expense A/C

4. Deferral and accrual accounting: A deferral is a postponement of the recognition of an expense already paid or of revenue already received.

For example: Rent income received 24,000 Tk. for two years in January 1.At the end of the first year it would not be feasible to record Tk.24,000 as income for that year. It should record Tk. 12,000 as income for that year and Tk.12,000 as advance income received (liability) for that year.

Journal:

January 1. Cash a/c Dr. 24,000

To, Rent income 24 000

Dec .31

Rent income Dr.12, 000

To, Unearned Rent (liability) Cr.12, 000

5. Accurate operational result and reasonable valuation of assets: Accounting works as an information system and its primary objective is to provide accurate and valid information to its uses. Adjustment entries make accounting figures correct and thus helps users of accounting information to rationalize their decisions making.

Examples:

1. In the Trial Balance there is a Consumable Supply Expenses (Dr balance) of Tk. 3,000. In the adjustment it is said that there is a Stock of Consumable Supplies at the end of the period Tk.1, 800. To adjust the thing the following journal entry is needed:

Dec.31. Stock of Consumable Supplies Dr. 1,800

To Consumable Supply Expenses 1, 800

We assume that at the time of procuring supply, we recorded the supply as 'supply Expenses'. But when Supplies are treated or recorded as an 'Asset' the entry would be different. For example, in the T/B Supplies Stock has a Dr. Balance of Tk. 10,000. And actual physical count at the end of the year shows Tk. 3,000 of Supplies on Hand. To adjust or consider the case, the following journal entry is needed:

Dec 31. Supplies Expense Dr.7, 000

To, Supplies Stock/Supplies Inventory/Supplies on Hand 7,000

2. Depreciation to be charged on Equipment @ 10% on Tk. 40,000. To adjust the item, following journal entry is needed:

Dec 31. Depreciation Expenses Dr. 4,000

To, Accumulated Depreciation –Equipment 4,000

OR, A Company purchased a Motor Car at a cost of Tk.1,00,000 which ca be used for an estimated life of 10 years with a salvage value of Tk. 20,000.

Calculation of Annual Depreciation: Cost of Motor Car =Tk.1, 00, 000

(-) Salvage value =Tk. 20,000

Depreciable Value=Tk. 80.000

Therefore, annual Depreciation of the Car would be Tk. 8000 i.e., (Tk.80, 000/10 years). To consider the annual depreciation of the Motor Car, the following journal entry is needed:

Deprecation Expenses Dr. 8,000

To, Accumulated depreciation-Motor Car 8,000

3. Prepaid Insurance in the T/B Tk 3,000(for three years.); adjusting it at the end of the first year the following journal entry is needed:

At the end of year 1: Insurance Expense Dr. 1,000

To, Prepaid Insurance 1,000

But if the item was recorded as an expense item, the adjustment entry would be as follows:

At the end of year 1: Prepaid Insurance Dr. 2,000

To, Insurance Expense 2,000

4. Accounts Receivable of a company shows a balance of Tk. 12,000 in the T/B. it is also estimated that 5% of Accounts Receivable is uncollectible.

*Calculation of estimated uncollectible accounts= (12,000*5%) = Tk. 600*

To adjust the Accounts Receivable account and consider the thing the following journal entry is needed:

Bad Debt Expenses /Uncollectible Accounts Dr. 600

To, Allowance for Doubtful Accounts 600

5. A Company invests an amount in Fixed Deposit Account. Interest is received twice a year on May 1 and November 1 in the amount of Tk.1,200 on each date. Pass entry at the closing date of December 31, 2002.

Adjusting entry:

Dec. 31, 2003 Interest Receivable Dr. 400

To, Interest Income 400

[(1200*2/6) = Tk 400]

6. A company let out a property at a monthly rental of Tk. 300 on 10th December, 2000. Pass the entry on the calendar year closing date.

Adjusting entry:

Dec 31,2000: Rent Receivable Dr. 200

To, Rent Income 200

7. Wages paid for four weeks of December at Tk. 2,000 per week but the wages for the last three working days accrues at the year-end closing date.

Adjusting entry:

Dec 31. Wages expense Dr. 1,000

To, Wages Payable 1,000

Note: to record one half of a weeks wages

8. Rent received in advance for three years Tk. 3,000 on January 1 and the entry was:

January 1: Cash A/C Dr. 3,000

Unearned Rent Cr. 3,000

(To record the rent received in advance)

At the end of the first year the adjusting entry would be:

Dec 31. Unearned Rent Dr. 1,000

To, Rent Income 1,000

(To record portion of advance earned in current year)

Problem 1:

Selected accounts of City Real Estate are shown below as of December 31, 2003, of the current year before any adjustment:

Particulars	Dr	Cr.
Prepaid Insurance	2,700	
Supplies on Hand	750	
Office Equipment	8,400	
Unearned Rental Fees		3,000
Salaries Expenses	2,100	
Rental Fees Earned		12,000

Based on the following information, pass the necessary adjusting entries on December 31:

(a) Prepaid insurance represents premiums for 3 years paid on January 1

(b) Supplies of Tk. 450 were on hand at December 31

(c) Office Equipment is expected to last 10 years.

(d) The firm collected 6 months rent in advance on January 1 from a tenant Tk 500 per month

(e) Accrued salaries not recorded as of December 31 are Tk. 360

CLOSING ENTRY

Closing entries are made after adjustment of different accounts and are required to close all the temporary accounts (nominal accounts) at the end of a particular accounting period or at the end of a fiscal year. The following closing entries are needed to close the nominal accounts:

1. To close the Revenue:

Sales a/c	Dr
Interest income a/c	Dr
Dividend income a/c	Dr
Gain on sale of asset a/c	Dr
To, Income Summary/ Profit and Loss Account	

2. To close the Expenses:

Income Summary/ Profit and Loss Account Dr

To, Purchase a/c

To, Wages a/c

To, Salaries a/c

To, Depreciation a/c

To, Interest expense a/c

3. ***To record the profit:***

Income Summary/ Profit and Loss Account Dr

To, Capital A/C or Retained Earnings

4. ***To record the loss:***

Capital A/C or Retained Earnings Dr

To, Income Summary/ Profit and Loss Account

5. ***To transfer the dividends declared:***

Retained Earnings Dr

To, Dividends Paid A/C

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Financial Reporting and Financial Statements

Businesses communicate accounting information to the external users through a process known as financial reporting. Financial reporting is a process through which companies communicate financial information to the public. Financial statements are the basic means of communicating the information to those who use it. The elements of financial statements provide ".information about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events, and circumstances that change resources and claims to those resources", including ".information about an enterprise's performance provided by measures of earnings and its components". The four general-purpose financial statements are the following:

- Income Statement
- Statement of Changes in Equity
- Balance Sheet
- Statement of Cash Flows

- An **Income Statement** presents revenues and expenses and resulting net income or loss for a period of time. An income statement is also called Statement of Operations, Earnings Statement, or Profit and Loss Statement (P/L).
- A **Statement of Changes in Equity** shows all changes in owner's equity for a period of time. This statement is also called Owners' Equity Statement.
- A **Balance Sheet** presents assets, liabilities and owner's equity at a specific date. A balance sheet is also called Statement of Financial Position.
- A **Cash Flow Statement** summarizes information about cash outflows (payments) and inflows (receipts). This statement may also include certain information not related to actual cash flows.

Objectives of Financial Reporting

The objectives of financial reporting are summarized in the following excerpts:

1. Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
2. Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans.
3. Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change

resources and claims to those resources.

4. Financial reporting should provide information about an enterprise's financial performance during a period. The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components.
5. Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.
6. Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
7. Financial reporting should provide information that is useful to managers and directors in making decisions in the interests of owners.

Elements of Financial Statements of Business Enterprises

Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. The items in financial statements represent in words and number certain enterprise resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims. The Statement of Financial Accounting Concept defines 10 interrelated elements that are directly related to measuring performance and status of an enterprise.

1. **Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. **Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
3. **Equity** is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.
4. **Investments by owners** are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.
5. **Distributions to owners** are decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.
6. **Revenues** are inflows or other enhancements of assets of an entity or settlements of its

liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

7. **Expenses** are outflows or other using up of assets or incurrence of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
8. **Gains** are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
9. **Losses** are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

Closing the Books

For the purpose of closing the accounts at the end of a particular period, accounts are classified into two types e.g., Permanent and Temporary Accounts.

Permanent Accounts are balance sheet accounts (i.e., assets, liabilities, and equity). They are not closed each period. Their balances are carried forward into the next period. Permanent accounts are also called *Real Accounts*. In contrast, revenue, expense, and distribution accounts are Temporary Account. At the end of a period, amounts in **Temporary Accounts** are transferred to Income Statement. Thereby, Temporary Accounts must have zero balances at the end of one accounting period (after closing the books) and at the beginning of the following period. Temporary accounts are also called *Nominal Accounts*.

Temporary Accounts are closed at the end of each period. The process of transferring the balances from the temporary accounts to the Permanent Account and Retained Earnings is referred to as closing the accounts or *closing the books*.

Preparation of Financial Statements

The four General-Purpose Financial Statements are:

- Income Statement
- Statement of Changes in Equity
- Balance Sheet
- Statement of Cash Flows

Exercise: From the following Trial balance prepare Income Statement and Balance Sheet at the end of 2005.

Trial Balance of a Company

as at 31 December, 2005

Accounts	L.F.	Debit (Tk)	Credit (Tk)
Opening Stock Dr		41,000	
Purchases Dr		1,10,000	
Drawings Dr		18,000	
Sales Returns Cr		6,000	
Wages Dr		5,400	
Salaries Dr		9,000	
Traveling Dr		950	
Rent, Rates and Taxes Dr		2,400	
Purchase Returns Cr			1,500
Interest Paid Dr		1,200	
Discount Allowed Dr		800	
Insurance Charges Dr		600	
Bad Debts Dr		600	
Sales Cr			1,80,000
Sundry Debtors Dr		14,000	
Fixed Assets Dr		35,000	
Creditors Cr			62,500
Cash Dr		8,200	
General Expenses Dr		1,200	
Advertisements Dr		900	
Capital ~~Dr~~ Cr			8,750
Investments Dr		3,500	
Bank Overdraft Cr			5,000
Commission Received Cr			1,000
Total		**2,58,750**	**2,58,750**

Note: Closing Stocks are not included in the Trial Balance

From the following Trial Balance of Jibon Ltd. of December 2005, prepare a Profit & Loss Account for the year and a Balance Sheet:

	(Taka)	(Taka)
Capital Cr		60,000
Drawings Dr	10,000	
Plan and Machinery Dr	80,000	
Purchases and Sales Dr	60,000	1,75,000
Returns	1,000	750
Stock (1-1-05) Dr	30,000	
Discount	350	800
Bank charges Dr	75	
Sundry Debtors and Creditors	45,000	25,925
Salaries Dr	6,800	
Manufacturing wages Dr	10,000	
Carriage inwards	750	
Carriage ~~inwards~~ outward — Dr	1,200	
Provision for bad debt. Cr		525
Rent and taxes Dr	8,000	
Advertisement Dr	2,000	
6% Mortgage Loan (1-7-05) Cr		5,000
Commission Dr		400
Cash in hand Dr	900	
Cash at Bank Dr	12,325	
	2,68,400	2,68,400

Adjustments:

1. Stock in trade on 31st December 2005 was Tk. 35,000. Included in stock were goods valued at Tk. 1,000 destroyed by fire, the insurance company has admitted claim to the extent of Tk. 800.
2. Sales omitted from being recorded Tk. 1,000.
3. Goods worth Tk. 510 was taken by the proprietor for his personal use.
4. Depreciate plant and machinery @ 10%.
5. Advertisement expense is to be written off in two years.
6. Salary Tk. 300 is outstanding and Rend prepaid is Tk. 200.
7. One-fourth of the commission has been received in advance.
8. Write off Tk. 500 as bad debts and make a provision for bad debt 5% on remaining debtors.

From the following Trial Balance of Jibon Ltd. of December 2005, prepare a Profit & Loss Account for the year and a Balance Sheet:

	(Taka)	(Taka)
Capital		60,000
Drawings	10,000	
Plan and Machinery	80,000	
Purchases and Sales	60,000	1,75,000
Returns	1,000	750
Stock (1-1-05)	30,000	
Discount	350	800
Bank charges	75	
Sundry Debtors and Creditors	45,000	25,925
Salaries	6,800	
Manufacturing wages	10,000	
Carriage inwards	750	
Carriage inwards	1,200	
Provision for bad debt.		525
Rent and taxes	8,000	
Advertisement	2,000	
6% Mortgage Loan (1-7-05)		5,000
Commission		400
Cash in hand	900	
Cash at Bank	12,325	
	2,68,400	**2,68,400**

Adjustments:

1. Stock in trade on 31st December 2005 was Tk. 35,000. Included in stock were goods valued at Tk. 1,000 destroyed by fire, the insurance company has admitted claim to the extent of Tk. 800.
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7. One-fourth of the commission has been received in advance.
8. Write off Tk. 500 as bad debts and make a provision for bad debt 5% on remaining debtors.

CASH BOOK

Cash book is book where all cash receipts and payments (including bank deposits and withdrawals) are recorded first, in chronological order, for posting to general ledger. Cash Book serves dual role of a ledger as well as journal. Cash book is the account which keeps track of all the cash transactions of the business. It is a part of Ledger. Because of the enormously large amount of cash transactions in a typical business, this Cash Account is maintained as a separate book known as **CASH BOOK**. Cash book is also a **book of original entry**. Cash book consists of Cash Account and Bank Account. Cash book is regularly reconciled with the bank statements as an internal auditing measure.

- Cash Account is an **Asset Account or Real Account** and thus,
  - Any increase in Cash or Bank Account is debited to the account and:
  - Any decrease in Cash or Bank account is credited to the account.
  - Cash Book **always shows a debit balance.**

Types of Cash Book

- Single Column Cash Book
- Double Column Cash Book
- Triple Column Cash Book
- Petty Cash Book

Contra Entries

These entries are made to record:

1. **When money is withdrawn from the bank for office use:** It is recorded in cash column on its debit side by writing 'Bank account' in the column of particulars and in bank column of the same cash book but on its credit side by writing 'Cash account' in the column of particulars.

2. **When money is taken from Office cash and deposited into bank:** When cash is deposited into bank, it is recorded in the bank column of the cash book on its debit side by writing 'Cash account' in the column of particulars and in the cash column of the same cash book but on its credit side by writing 'Bank account' in the column of particulars.

Two entries are made in the Cash Book on the same page at the same time. The double entry for each transaction is complete. There will be no more postings of these entries to the ledger and these contra entries are indicated by a sign "c" in the folio column.

Cash Discount

A cash discount is a deduction from the amount due. It is given to encourage prompt payment of debts. Cash discount which is given by the trader to its customers is known as Discount allowed. Cash discount is allowed to the customers to encourage prompt payment of their debts. Discount allowed is recorded in the discount column on the debit side of the triple column Cash Book and posted individually to the credit side of the debtors accounts to which they relate.

Cash discount received by the trader from its supplier is known as Discount received. The trader ends up paying less by the amount of discount received. Discount received is recorded in the discount column on the credit side of the triple column Cash Book and posted individually to the debit side of the creditors accounts to which they relate.

Exercise on Cash Book

1. From the following transactions of Mr. Rahman prepare a single Column Cash Book for the month of January, 2008:

Jan 1	Opening balance of cash	Tk. 6,000
2	Cash brought as capital	10,000
4	Cash purchase of goods	4,000
6	cash Sales	8,000
7	Deposit into Bank	5,000
8	Paid karim by cheque	1,000
9	Received from Kamal	5,500
10	Paid electric bills	600
12	Purchased a still almirah	2,000
14	Received from Mr. A Aziz	1,800
15	Paid for advertisement	900
18	Paid telephone bill	250
20	Paid house rent	2,480
25	Withdrawn from bank	2,900
29	Paid salaries for the month	4,000

2. From the following cash and bank transactions of Mr. M Mannan prepare a Cash Book for the month of June, 2009:

June 1	Opening balance of cash Opening balance of bank	Tk. 6,000 1,00,000
2	Cash withdrawn from bank	15,000
3	Cash purchase	16,000
5	Paid to Mr. X by cheque	25,000
7	Cash sales	20,000
10	Bonus to employees	12,000
9	Creditors paid by cheque	15,500
10	Paid electric bills	1,600
12	Purchased a still Almirah by cheque	2,000
14	Cheque received from Mr. A Aziz	1,800
15	Paid for advertisement	900
18	Paid telephone bill by cheque	250
20	Paid cash for house rent	2,480
25	Cheque deposited to bank	2,900
29	Paid salaries for the month by cheque	4,000

Capital Expenditure versus Revenue Expenditure

Capital expenditure is an amount spent to acquire or improve a long-term asset such as equipment or buildings. Usually the cost is recorded in an account classified as Property, Plant and Equipment. The cost (except for the cost of land) will then be charged to depreciation expense over the useful life of the asset.

Capital expenditure occurs when a business gets a long term advantage due to that expenditure. It is usually incurred for accusation of an asset. These expenditures do not occur in the regular day to day transactions of the business.

Common examples

- Purchase of furniture, office building etc.
- Purchase of additional furniture or machinery
- Expenditure incurred in connection with the purchase of a fixed asset. For example, carriage paid of machinery purchased.
- Purchase of patent right, copy rights etc.

Revenue Expenditure

Expenditure which is not for increasing the value of fixed assets, but for running the business on a day to day basis, is known as revenue expenditure.

Revenue expenditure is an amount that is expensed immediately—thereby being matched with revenues of the current accounting period. Routine repairs are revenue expenditures because they are charged directly to an account such as Repairs and Maintenance Expense. Even significant repairs that do not extend the life of the asset or do not improve the asset (the repairs merely return the asset back to its previous condition) are revenue expenditures.

Difference between Capital and Revenue expenditure.

Buying a car is capital expenditure because its benefit to the business will be spread over a long time. Fuel cost for running this car is revenue expenditure and it will be used up in few days and does not add to the value of the fixed asset.

It's important to understand the basic difference between Capital and Revenue expenditure. Appended below, in tabulated form, the characteristic and some salient points to understand the difference:

CAPITAL EXPENDITURE
Outlay resulting in the increase or acquisition of an asset or INCREASE in the earning capacity of a business
REVENUE EXPENDITURE
Outlay as is necessary for the MAINTENANCE of earning capacity including the upkeep of the fixed assets in a fully efficient state.
SALIENT POINTS TO NOTE
1. Accounting fraud occur because management choose to classify should be revenue expenditure as capital expenditure. The revenue expenditure should be taken up into the Income Statement but instead now being suspended or deferred into the Balance Sheet. In the process, lesser expenses are being charge into the Income Statement, hence profit are overstated to impress the investors or outsiders

2.	Strong GAAP and Accounting standards have classified what should be assets, what should be deferred in the balance sheet so that there should be a clearer demarcation between Capital and Revenue expenditure
3.	We need to note that certain expenses are recognized as being of a capital nature, although no tangible property may have been acquired as a result. Examples are Research and Development Expenditure, Pre-Incorporation and Preliminary Expenses, Interest on Borrowings for Building, Legal Expenses to Acquire Property, additional Renovations to Properties and Others
4.	The classification of what is capital expenditure cf a company might not applies to another company that is not in the same industry. Say in a property based company, most land and buildings are revenue expenditure as they are purchase with the intent for re-sale.
5.	As we learned from the above, when the purpose of expenditure is to Maintain the business it is revenue and if it is to Improve the business it is capital. However, at times in a company, the classification of pure capital or revenue expenditure in a company is not so straightforward especially when there is a mixture of both capital and revenue expenditure in nature.

Capital Receipts and Revenue Receipts

Capital receipts consist of

- additional payments made to the business either by owner or shareholder of the business; or
- from sale of fixed assets of the business.

On the other hand, all receipts in the normal running or through day to day transactions of the business are categorized as Revenue receipt. Sales receipts of the business are revenue receipts.

Difference between Capital Receipts and Capital Revenues:

Capital Receipts	Revenue Receipts
(a) Receipts derived from activities which are not part of the normal trading activities of the business	(a) Receipts related to NORMAL ACTIVITIES of the business
(b) Appears as capital or liabilities in the Balance Sheet	(b) Credited as revenue to Trading and Profit & Loss Account
© Examples: receipts of cash brought in by partners, shareholders, debenture holders and bank loans	© Examples: receipts from sales of goods and services, rent, commission and interest on bank deposits received by the business.