12 ADJUSTMENTS IN PROFIT AND LOSS ACCOUNTS

Objectives

At the end of this chapter, students should be able to:

- Distinguish between bad debts and provision for bad debts;
- Make the entries for bad debts and provision for bad debts into ledger and final accounts;
- Distinguish between prepayments (payment in advance) and accruals (payment in arrears);
- Make entries for prepayment (payment in advance) and accruals (payment in arrears) in the final accounts;
- Identify provisions for discount allowed;
- Make entries into the ledger and final accounts for provision for discount allowed;
- Identify provisions for depreciation;
- Make entries into the ledger and final accounts for provision for depreciation.

12.1 Introduction

The trial balance drawn up at the end of the year takes into account all the book-keeping entries made by the book-keeper during the year. In practice, further entries are usually needed to be made and these give rise to the need for adjustments. This chapter deals with the various adjustments in the final accounts like bad debts, provision for bad debts doubtful debts, prepayments and accruals, provision for discount allowable, etc. These adjustments constitute what is called Adjustments in the final accounts and they always appear as a footnote after the trial balance might have been prepared.

12.2 Bad Debts and Provision for Doubtful Debts

Transactions on credit between the business organisation and the customer give rise to debts. In this case, a debt is said to be bad when it becomes irrecoverable and doubtful when there is uncertainty about it being paid in full by the debtor. In either case, adjustments have to be made in the annual accounts. If no adjustment is made for debts that have proved bad, the amount of debtors in the books would be overstated. To avoid this, the amount due from debtors is reduced by crediting debtors and debiting bad debts accounts. Then, the balance in the bad debts account is subsequently transferred to the profit and loss account.

Example 12.1

In the books of a firm, outstanding debtors as at April 31st, 2009 stood at N360,000. A provision for bad and doubtful debts is to be made at 10% on the outstanding total show the entries to reflect the decision in the books of account.

Solution

April 30 2009	Profit and Loss A/c Dr Provision for bad debts Being 10% provision for bad and doubtful debts created on sundry Debtors	360,000	 360,000

General Ledger

Dr Provision for Bad and Doubtful Debts Cr

	2009 April 30	Profit and Loss A/c	360,000

Profit and Loss Account for the year ended April 30, 2009

		N	N
Provision for bad and doubtful debts 360,000			

Balance Sheet as at 30th April, 2009

		N	N
	Current Assets	360,000	
	Less provision	36,000	324,000

12.2.1 Provision for Doubtful Debts

A provision may be defined as any amount written off or retained for the purpose of meeting any known liability or fall in the value of an asset. In this case, provision for doubtful debts is an estimated expense for bad debts, which can not be calculated with substantial accuracy. It is charged to the profit and loss as an expense and deducted from the debtors in the balance sheet, ie, Total debtors - bad debts = Net debtors. A written off bad debt removes the account from debtors ledger.

Example 12.2

A business started trading on 1st January, 2004. During the three years ended 31st December, 2004, 2005 and 2006, the following debts were written off as bad:

May 2004	15,000
October 2005	12,000
June 2006	17,000

On 31st December 2004, the total debtors was N50,000. The provision was N6,000.

On 31st December 2005, the total debtors was N21, 000. It was decided that provision should be N10,000.

On 31st December 2006, the total debtors remaining was given as N35,000; provision was estimated to be N2,500.

You are required to prepare the necessary accounts using method 1.

Solution

Bad Debts Account

2004		₦	2004		₦
Dec 31	Sundries	15,000	Dec 31	Profit and Loss	15,000
2005			2005		
Dec 31	Sundries	12,000	Dec 31	Profit and Loss	12,000
2006			2006		
Dec 31	Sundries	17,000	Dec 31	Profit and Loss	17,000

Provision for Doubtful Debts Account

2004		₦	2004		₦
Dec 31	Balance c/d	6,000	Dec 31	Profit and Loss	6,000
2005			2005		
Dec 31	Balance c/d	10,000	Jan 1	Balance c/d	6,000
			Dec 31	Profit and Loss	4,000
		10,000			10,000
2006			2006		
Dec 31	Balance c/d	2,500	Jan 1		10,000
	P& L	7,500			
		10,000			10,000

Profit and Loss Account

2004	₦	2006	₦
Bad debts	15,000	Reduction in provision fo	
Provision for bad debts	6,000	bad debts	7,500
2005			
Bad debts	12,000		
Provision for bad debts	4,000		

Balance Sheet

	2004	₦	₦
	Debtors	50,000	
	Less provision for bad debts	6,000	44,000
	2005		
	Debtors	21,000	
	Less provision for bad debts	10,000	11,000
	2006		
	Debtors	35,000	
	Less provision for bad debts	2,500	32,500

In this method, the adjustments for provision are made on the debit side of the bad debts account. No separate account for provision for doubtful debts and it is carried down as a credit balance in the bad debts account.

The accounts involved are:

i. Bad debts account

ii. Profit and Loss account

iii. Balance sheet

(Using the above question, the entries would be as follows :)

Bad Debts Account

	₦		₦
2004		2004	
Dec 31 Sundries	15,000	Dec 31 Profit & Loss	21,000
Dec 31 Prov. for doubtful debts	6,000		
	21,000		21,000
2005		2005	
Dec 31 Sundries	12,000	Jan 1 Prov. For doubtful debts	6,000
Dec 31 Prov. for doubtful debts	4,000	Dec 31 Profit & Loss	10,000
	16,000		16,000
2006		2006	
Dec 31 Sundries	17,000	Jan 1 Prov. doubtful debts b/d	4,000
Dec 31 prov. for doubtful debts	2,500	Dec 31 Profit and Loss	15,500
	19,500		19,500

Profit and Loss Account

		₦	
2004	Bad debts	21,000	
2005	Bad debts	10,000	
2006	Bad debts	15,500	

12.3 Posting of Entries into Ledgers and Final Accounts

This is one of the methods of recording the provision for doubtful debts. In this method, the provision for doubtful debts account is prepared. The amount to be provided is debited to the profit and loss account and credited to the provision for doubtful debts account. The balance on the bad debts is also debited to the profit and loss account. These accounts must be prepared:

i. Bad debts account

ii. Provision for doubtful debts accounts

iii. Profit and loss account

iv. Balance sheet

Bad Debts Account

	₦		₦
Year		Year	
Dec 31 Sundries	x	Dec 31 Profit and Loss	x
Year		Year	
Dec 31 Sundries	x	Dec 31 Profit and Loss	x

Provision for doubtful debts account

Year	₦	Year		₦
Dec 31 Balance c/d	x	Dec 31	Profit and Loss	x
Year		Year		
Dec 31 Balance c/d	x	Jan 1	Balance b/d	x
	X	Dec 31	Profit and Loss	x
Year		Year		

2009		2009		
Dec 31 Balance c/d	x	Jan 1	Balance c/d	x
		Dec 31	Profit and Loss	x

Profit and Loss Account for the year ended 31st Dec, 2009

Year	₦	Year	₦
Bad debts	x		
Provision for bad debts	x	Reduction on provision for	
Year			
Bad debts	x	Bad debts	x
Provision for bad debts	x		
Year			
Bad debts	x		
Provision for bad debts	x		

Balance sheet (extract) as at 31st December, 2009

Year	₦	₦
2009		
Current Asset		
Debtors	x	
Less provision for doubtful debts	x	x

12.4 Distinction between Accruals and Prepayments

Accruals: These are otherwise referred to as payments in arrears, amount accrued, amount due but unpaid, expenses owing or amount outstanding and it may affect such expenses as rents, rates, wages, salaries, insurance premium, general expenses, etc. For example, if office rent for a year beginning 1st of Jan is N120, and by Dec. 31st ;only N100 has been paid, rent accrued at the end of that trading period is N20.00.

Accruals or payment in arrears are expenses of the business for the trading period and are debited to the profit and loss account for the year while in the balance sheet, they are shown as liabilities after the sundry creditors.

The procedure involved in treating an accrual is shown below:

i. Debit expenses account with the amount of expense already paid (N100.00) and credit cash.

ii. Debit appropriate expenses account with the accruals (N20) as balance carried down and transfer the amount of accruals (together with the amount of expenses already paid) to the Profit and Loss Account.

iii. Credit the expense account with the accruals (N20) as balance brought down and show this amount as liability in the Balance Sheet.

Example

The above transaction will appear as follows:

Rent a/c

Dec 29	Cash	₦100	Dec 31	Profit & Loss A/c	₦120
Dec 31	Balance due c/d	20			₦120
		₦120	Jan 1	Balance (rent due) b/d	₦20

Activity 12.1

	a Accrual	b Total expenses for the year already paid	c Expense Account	d Profit and Loss Account
a	15	60	Telepone	
b.	60	300	Wages	
c.	50	250	Rent	
d.	80	240	Advertisement	
e.	70	800	Rates	
f.	90	400	Electricity	

Using the information above, complete column (d) with the appropriate amount.

Prepayments: It may happen that some services are paid for without enjoying them. These expenses paid for in advance are called prepayments. Prepayments, otherwise termed payments in advance, prepaid or deferred expenses, are often made for such items as insurance, rent, rates, etc.

Since a true financial position of a business at a certain period must be shown, it is only proper to set prepayments against the profits of the present period.

Example12.3

On 31st December, N240 was paid in advance as rates out of which N40 was a prepayment.

Solution

Dec 31	Cash	₦240	Dec 31	Profit & Loss A/c	₦ 200
			Dec 31	Balance c/d (rates)	₦ 40
		₦240			₦ 240
Jan 1	balance b/d	40			

Thus: the accounting procedure in recording prepaid item is as follows:

I Debit the expense account with the total expense paid (N240.00) and credit cash.

ii. Transfer portion of expense for the period to Profit and Loss Account; (N200)

iii. Credit expense account with prepayment as balance carried down: (N40)

Iv. Debit expense account with prepayment as balance brought down and show it as Assets in the balance sheet under prepayments.

Note:

Prepayments and accruals, as with any other item of adjustment, will appear as a footnote after the trial balance might have been prepared. Any such adjustments or items outside the trial balance must be treated twice in the final accounts; first in the trading, profit and loss account and finally in the balance sheet.

12.4 Provision for Discounts Allowed and Received

After making provision for bad and doubtful debts, the remaining balance in the debtors account is the sum that is expected to be received. However, the figure is overstated if cash discounts are allowed to customers for prompt payment

and so, a provision for cash discount needs to be made. Until discount is actually received from creditors, we should not record it in the books of account by creating a provision but discounts expected to be allowed on debtors must be provided for because it is an anticipated loss.

12.5 Summary

In this chapter, students have learnt that:

– Prepayments and accruals among others constitute what
are called adjustments in book-keeping and accounting.

– Prepayments and accruals like other adjustment items are treated twice in the book of accounts; first in the trading and profit and loss account and finally in the balance sheet.

– Prepayments is otherwise known as payments in advance or prepaid or overpayment or deferred expenses.

– Accruals is otherwise referred to as payments in arrears, accrued expenses, amount due but unpaid, expenses owing or amount outstanding.

– Provisions are set aside out of profit for a specific purpose.

– Bad debts are irrecoverable debts which occur when a customer is unable to pay his debt.

12.6 Revision Questions

1. A service which a firm has enjoyed, but which has not yet been paid for is_________.

A. prepaid expenses

B. accrued expenses

C. overhead expenses

D. preliminary expenses

2. Prepayment is treated in the balance sheet of a firm as a__________.

A. fixed asset

B. long term liability

C. current asset

D. current liability

3. When bad debt is recovered, it is_______________.

A. credited to cash account

B. credited to profit and loss account

C. debited to debtors account

D. shown in the balance sheet

4. The term 'bad debt' is used to describe___________.

A. a debt that is long over due

B. an overcharge on a debtors account

C. a debt owned by a former employee

D. a debt that cannot be recovered

5. Use the information below to answer this question.

	₦
Rent accrued 1st January, 2005	600
Rent paid in 2005	11,300
Rent prepaid 31st December, 2005	500
Rent expenses for the year 2005 is	

A. N11,400

B. N11,300

C. N11,200

D. N10,200

6. Explain the following terms:

(a) bad debts

(b) provision for discount allowed

(c) provision for doubtful debts

(d) prepayments

7. (a) State three distinguishing features between reserves and provisions.

(b) State two types of reserves with an example each.

8. Differentiate between adjustments and closing entries.