ADJUSTMENTS IN PREPARATION OF FINANCIAL STATEMENT

Understanding Adjustments in Financial Statements

Meaning and Need for Adjustments in Financial Statements

- **Meaning:**
  - **Financial Statements:** These are the statements prepared to determine the financial performance (i.e. profit/loss or surplus/deficit) for a particular period as well as the financial position (assets and liabilities) of an enterprise on a particular date. Therefore, all the revenues earned and expenses incurred are accounted on the basis of Accrual Concept which recognizes all revenues when earned, whether received or not and all the expenses at the time when they are incurred irrespective of the fact whether paid or not.

  - **Adjustments:** There are a number of transactions relating to incomes or expenses which are for some reasons not recorded or require some adjustments in the books of account. Therefore, such incomes or expenses are to be considered and brought into the books at the time of finalizing or closing the books of account to ensure a proper and reliable set of financial statement are available. Such items and their treatment is termed as ***Adjustments***. The entries passed for incorporating such adjustments are known as ***Adjustment Entries***.

- **Need for Adjustments:** Adjustments are done to:
  - record the unrecorded transactions.
  - provide for anticipated losses.
  - rectify the located errors.
  - present fair and unbiased presentation of assets and liabilities.

Understanding Treatment of Adjustments

Important Point to be Noted while passing adjustment entries for all the below mentioned adjustments:

- If the amounts are related to an intra-state transaction, they will be subject to levy of both CGST and SGST.
- If the amounts are related to an inter-state transaction, they will be subject to levy of IGST.

1. **Closing Stock or Inventory:**
   - It is the stock of unsold goods at the end of the accounting period that is carried forward to the next accounting period as Opening Stock.
   - It is valued at cost or Net Realisable Value (market value), whichever is lower.
   - It is normally not included in the Trial Balance but is given as an additional information after trial balance.
     - If given in the ***Trial Balance***, it is just shown on the ***asset side of the Balance Sheet***.

- If given after the Trial Balance ***(as an adjustment)***, it is shown in the Balance Sheet on the asset side and also on the credit side of the Trading Account by passing the following adjustment entry as follows:

  Closing Stock A/c ...Dr.
  To Trading A/c
  (Being the closing stock recorded)

- Concept of Adjusted Purchases
  - Meaning: If Adjusted Purchases are given, it means that Opening Stock and Closing Stock have been adjusted in purchases. Formula for the same is as follows:

    $$\text{Adjusted Purchases} = \text{Net Purchases} + \text{Opening Stock} - \text{Closing Stock}$$

  - Treatment: Such amount of Adjusted Purchases is shown on the debit side of the Trading Account while Closing Stock is shown on the assets side of the Balance Sheet under Current Assets. It is to be noted that when adjusted purchases are debited to the Trading Account, Opening and Closing Stock will not be shown in the Trading Account as they are already considered at the time of computing the amount of Adjusted Purchases.

2. **Outstanding Expenses:**
   - An expense that has been incurred but has not been paid during the current accounting year, that may be in form of expenses of wages, rent, interest, etc.
   - It is normally not included in the Trial Balance but is given as an additional information after trial balance.
     - If ***shown in the Trial Balance***, it means adjustments are already done with respect to the expense and therefore, it is shown only in the Balance Sheet as a liability.
     - If ***given after the Trial Balance (as an adjustment)***, it is to be accounted as an expense for the current accounting year and therefore, debited to the Trading and Profit and Loss Account by way of adding it to the existing amount of the respective expense. Also, since such an expense is payable by the entity, it is shown as a liability in the Balance Sheet by passing following adjustment entry:

       Expenses A/c ...Dr.
       Input CGST A/c ...Dr.
       Input SGST A/c ...Dr. *or*
       Input IGST A/c ...Dr.
       To Outstanding Expenses A/c
       (Being unpaid expenses now recorded in the books)

3. **Prepaid Expenses:**
   - It is the amount of expense which is paid in advance and the benefit of which will be available in the next year. It is therefore, termed as unexpired expense or expenses paid in advance.
   - It is normally not included in the Trial Balance but is given as an additional information after trial balance.
     - If shown in ***the Trial Balance***, it means adjustments are already done with respect to the expense and therefore, it is shown only in the Balance Sheet as a Current Asset.
     - If given ***after the Trial Balance (as an adjustment)***, it is necessary to adjust the unexpired part of expense by way of reducing it from the amount of respective expense recorded in the Trading and Profit and Loss Account for the current accounting year. It is also shown as

an Asset in the Balance Sheet in order to get a clear picture of the financial position of the business by passing following adjustment entry:

Prepaid Expenses A/c   Dr.
    To Expenses A/c
(Being prepaid expenses recorded in the books)

It is important to note that, when the amount is transferred from Expense Account to Prepaid Expense Account, the amount of GST paid on such prepaid amount is not transferred.

4. **Outstanding Income:**
    - It is the amount of income which is earned during the accounting period but not received till the end of the accounting period. It is therefore, also termed as accrued income or income earned but not yet received.
    - It is normally not included in the Trial Balance but is given as an additional information after trial balance.
        - If shown ***in the Trial Balance***, it means adjustments are already done with respect to the income and therefore, it is shown only in the Balance Sheet as a Current Asset.
        - If given ***after the Trial Balance (as an adjustment)***, it is to be accounted as an income for the current accounting year and therefore, credited to the Profit and Loss Account by way of adding it to the existing amount of the respective income. Also, since such an income is receivable by the entity, it is shown as a Current Asset in the Balance Sheet by passing following adjustment entry:

Accrued Income A/c   …Dr.
    To Concerned Income A/c
    To Output CGST A/c
    To Output SGST A/c or
    To Output IGST A/c
(Being the accrued income accounted in the books)
**GST is not levied on Accrued Interest income*

5. **Advance Income:**
    - It is an income that has not been earned but is received in advance. It is the amount that relates partially or fully to the next year but has been received during current year. It is also known as unearned income or Income received in advance.
    - It is normally not included in the Trial Balance but is given as an additional information after trial balance.
        - If shown ***in the Trial Balance***, it means adjustments are already done with respect to the income and therefore, it is shown only in the Balance Sheet as a Current Liability.
        - If given ***after the Trial Balance (as an adjustment)***, it is to be shown on the credit side of the Profit and Loss Account by way of deduction from the amount of respective income. Also, since it is a liability it is shown in the Balance Sheet on the liabilities side by passing following adjustment entry:

Income A/c ...Dr.
To Income Received in Advance A/c
To Output CGST A/c
To Output SGST A/c or
To Output IGST A/c
(Being advance income accounted in the books)

6. **Depreciation:**
   - It is a fall in the book value of a depreciable fixed asset because of its wear and tear, passage/efflux of time, obsolescence or accident. It is charged on all fixed assets except Land because of its infinite economic life. It is taken as an expense and therefore, charged to the Profit and Loss Account. There are 2 methods of Recording Depreciation as follows:
     - **By charging or crediting depreciation to the Assets Account**: In this method, depreciation is deducted from the asset value and charged (debited) to the Profit and Loss Account. Therefore, the Asset is shown at its Written Down Value (i.e., cost *less* depreciation provided till date) in the Balance Sheet. Under this method, following Journal Entries are to be passed:

a. For purchase of Asset:
Asset A/c …Dr.
Input CGST A/c …Dr.
Input SGST A/c …Dr.
To Cash/Bank A/c
(Being Asset purchased and GST paid recorded in the books of account)

b. For charging Depreciation:
Depreciation A/c …Dr.
To Asset A/c
(Being the depreciation on asset charged to Asset Account)

c. For transferring Depreciation:
Profit and Loss A/c …Dr.
To Depreciation A/c
(Being the depreciation charged on asset transferred to Profit and Loss Account)

- **By creating Provision for Depreciation/Accumulated Depreciation Account**: In this method, depreciation is credited to the Provision for Depreciation Account or Accumulated Depreciation account every year. Depreciation is accumulated in a separate account instead of adjusting into the asset account at the end of each accounting period. In the balance sheet, the asset will continue to appear at the original cost every year. Thus, the balance sheet shows the original cost of the asset and the total amount of depreciation charged on asset. Under this method, following Journal Entries are to be passed:

a. For purchase of Asset:
Asset A/c …Dr.
Input CGST A/c …Dr.
Input SGST A/c …Dr.
To Cash/Bank A/c
(Being Asset purchased and GST paid recorded in the books of account)

b. For charging Depreciation:
Depreciation A/c …Dr.
To Provision for Depreciation A/c
(Being the depreciation on Asset recorded in the Provision for Depreciation Account)

d. For transferring Depreciation:
Profit and Loss A/c …Dr.
To Depreciation A/c
(Being the depreciation on asset transferred to Profit and Loss Account)

- It is normally not included in the Trial Balance but is given as an additional information after trial balance.
  - If shown ***in the Trial Balance***, it means that the depreciation entry is already passed and the asset will appear in the balance sheet at its reduced value since the depreciation amount is credited to it and necessary debit is charged to the Profit and Loss Account.
  - If given ***after the Trial Balance (as an adjustment)***,
    I. If Provision for Depreciation Account is not maintained: Here, the depreciation amount is calculated as per the rate and method specified in the question and is then debited to the Profit and Loss Account. Since, the amount of depreciation is deducted from the value of the asset, the Asset appears in the Balance Sheet at its Written Down Value (i.e., Book Value *less* Depreciation).

    II. If Provision for Depreciation Account is maintained: Here, the depreciation amount is calculated as per the rate and method specified in the question. Such amount is debited to the Profit and Loss Account and added to the balance of Provision for Depreciation Account. The total of accumulated depreciation in Provision for Depreciation Account is then deducted from the original cost of the asset in the Balance Sheet.

7. **Bad Debts:**

- It is the amount receivable by the business which becomes irrecoverable and is therefore, treated as a loss by the business. In the books of accounts, it is debited to the Profit and Loss Account and reduced from the balance of respective Debtor's Account in the Balance Sheet.
- It is normally not included in the Trial Balance but is given as an additional information after trial balance.
  - If shown ***in the Trial Balance***, it means that the amount of Sundry Debtors appearing in the Trial Balance is after deducting the bad debts and is therefore, only recorded on the debit side of the Profit and Loss Account as a loss.
  - If given ***after the Trial Balance (as an adjustment)***, such bad debts are known as further bad debts and it means that the balance of the Sundry Debtors in the Trial Balance is prior to the amount of bad debts. Therefore, such an adjustment amount is debited to the Profit and Loss Account by way of additions to the bad debts already written off and shown on the assets side of the Balance Sheet as a deduction from Sundry Debtors. Following adjustment is required to be passed:

    Bad Debts A/c …Dr.
    To Debtor's A/c
    (Being the bad debts recorded)

- It is very important to understand the treatment of Bad Debts Recovered while studying this concept:
  - Meaning: It is that amount which was earlier written off as bad debts and is now recovered either fully or partially. In such case, the amount recovered is not credited to the Debtor's Personal Account, but is credited to the Bad Debts Recovered Account as the amount recovered was earlier written off as loss. Such recovered amount is a gain and is therefore, credited to the Profit and Loss Account.
  - Following adjustment entry is to be passed:

    Cash or Bank A/c …Dr.
    To Bad Debts Recovered A/c
    (Being the bad debts recovered)

    Bad Debts Recovered A/c …Dr.
    To Profit and Loss A/c
    (Being the bad debts recovered transferred to Profit and Loss Account)

8. **Provision for Doubtful Debts:**
   - It is the provision created by the firm for the amount of likely bad debts at the end of the accounting year. This is done in order to comply with the Convention of Conservatism or Prudence Concept which requires that the amount of expected losses are provided while expected incomes are not to be recorded.
   - Entry to be passed for creating provision is as follows:

     Profit and Loss A/c …Dr.
     To Provision for Doubtful Debts A/c
     (Being the provision made for doubtful debts)
   - The amount of Provisions debited to the Profit and Loss Account reduces the current year's profit with the amount of provision and the same is carried forward to the next year. In the next year, on the occurrence of bad debts these are written off with the amount of available provisions. While writing off, the amount of Bad Debts is debited to Provision for Doubtful Debts Account, the amount of bad debts here are not debited to the Profit and Loss Account since it was already debited in the earlier years.
   - It is to be noted that such provision amount is deducted from the amount of book debts in the Balance Sheet but the two accounts are maintained separately and therefore, balance of Sundry Debtor's or Customer's Account is not affected by making the Provision for Doubtful Debts.
   - Following are the important points to be noted:
     - The amount of such provision given on the credit side of the Trial Balance is known as an old provision for accounting purposes.
     - The additional amount of provision made for the current year is known as new provision.
     - The amount of bad debts given outside the Trial Balance are known as further bad debts. Such further bad debts are first deducted from the debtors for calculating Provision for Doubtful Debts. This is because the Provision for Doubtful Debts is created only on doubtful debts and not on Bad Debts.
     - The amounts of bad debts and new provision for doubtful debts are deducted from the Sundry Debtors on the asset side of the Balance Sheet.

9. **Provision for Discount on Debtors:**

- It is the provision created by the firm for the amount of likely discount to be allowed out of the total amount receivable from the debtors. It is similar to the concept of Provision for Doubtful Debts. However, here discount is not allowed on debts that become bad and therefore, while calculating the amount of provision for discount on debtors, rate of discount is applied on the amount of debtors computed after reducing the amounts of bad debts and the provision for doubtful debts. When both i.e., Provision for Doubtful Debts and Provision for Discount on Debtors are to be calculated, Provision for Doubtful Debts is calculated first and then Provision for Discount on Debtors is calculated after subtracting Provision for Doubtful Debts.
- Accounting Entries:

i. **Discount Allowed to Debtors**:

Discount Allowed A/c
To Debtors A/c
(Being the discount allowed to debtors)

ii. **Transferring the amount of Discount Allowed to Profit and Loss Account**:

Profit and Loss A/c …Dr.
To Discount Allowed A/c
(Being the discount transferred to Profit and Loss Account)

iii. **In case Provisions for Discount on Debtors exists**:

Transfer discount allowed to the Provision for Discount on Debtors Account instead of the Profit and Loss Account

a. Discount Allowed A/c …Dr.
To Debtors A/c
(Being the discount allowed to debtors)

b. Provision for Discount on Debtors A/c …Dr.
To Discount Allowed A/c
(Being the discount transferred to Provision for Discount on Debtors Account)

iv. **Creating Provision for Discount on Debtors**:

Profit and Loss A/c …Dr.
To Provision for Discount on Debtors A/c
(Being the balance of Provision for Discount on Debtors Account charged to Profit and Loss Account)

10. **Manager's Commission**:

- This is the amount of commission entitled to the Manager of the firm and is calculated as a fixed percentage of profit. No GST is levied on such commission.
- Generally, there are two practices followed for providing manager's commission:
  - Manager's Commission on net profit before charging his commission where following steps are to be followed:
    i. Step 1: Calculate the total of debit side and the total of credit side
    ii. Step 2: Calculate Net profit by deducting total of debit side from the total of credit side.
    iii. Step 3: Calculate Manager's Commission by the formula:

iv. Entry passed is as follows:
Profit and Loss A/c …Dr.
To Manager's Commission Payable or Outstanding Commission A/c
(Being the outstanding commission of manager transferred)
v. If given ***in the Trial Balance as an expense***, then it will be shown only on the debit side of the Profit and Loss A/c.
vi. If given ***inside the Trial Balance as 'Manager's Commission Payable'***, then it will be shown on the Liabilities side of the Balance Sheet as a current liability.

- Manager's commission on net profit after charging his commission where following steps are to be followed:
  i. Step 1: Calculate the total of debit side and the total of credit side.
  ii. Step 2: Calculate Net profit by deducting total of debit side from the total of credit side.
  iii. Step 3: Calculate Manager's Commission by the formula:

$$\text{Net Profit before Charging Commission} \times \frac{\text{Percentage of the Commission}}{100 + \text{Percentage of the Commission}}$$

11. Interest on Capital:

- Capital is the investment that has been made by the proprietor into his business and the interest charged on such amount of investment is termed as Interest on Capital. It is to be noted that interest is allowed on the balance in Capital Account in the beginning of the accounting year and if any fresh capital is introduced during the accounting year, interest is allowed from the date on which the capital was introduced till the end of the accounting period. Such interest charged is an expense for the business on one hand and gain to the proprietor on the other.
- It is normally not included in the Trial Balance but is given as an additional information after trial balance. Following adjustment entry is passed:
  a. If given ***in the Trial Balance***, it means that the entry for crediting the Capital Account is already passed and only the following entry is required to be passed:
  Profit and Loss A/c …Dr.
  To Interest on Capital

  b. If ***after trial balance***, following adjustment entries are required to be passed:
  Interest on Capital A/c …Dr.
  To Capital A/c
  Profit and Loss A/c …Dr.
  To Interest on Capital A/c

12. Goods Taken for Personal Use:

- These goods which are taken or withdrawn by the proprietor from the business for his personal consumption or personal purposes are termed as Drawings. Such drawings result in a decrease in stock or purchases and therefore, Purchases is credited and Drawings Account is debited. This is shown in the Trading Account as a deduction from Purchases and in the Balance Sheet as a deduction from Capital. While doing this, GST paid on such goods is also reversed as the credit of such Input GST will not be available to claim set off against output GST.

- Following adjustment entry is to be passed:

  Drawings A/c …Dr.
  To Purchases A/c
  To Input CGST A/c
  To Input SGST A/c or
  To Input IGST A/c
  (Being the adjustment of goods taken by owner for personal use)

13. Goods distributed for Staff Welfare:

- Sometimes, the goods are distributed to staff free of cost as staff welfare. Such amount of goods distributed for staff welfare is considered as an increase in indirect expenses and an equivalent decrease in the direct expenses. Accordingly, it is shown on the credit side of Trading Account or as a deduction from the purchases and on the debit side of the Profit and Loss Account as Staff Welfare Expense. While doing this, GST paid on such goods is also reversed as the credit of such Input GST will not be available to claim set off against output GST.
- Following adjustment entry is to be passed:

  Staff Welfare Expenses A/c …Dr.
  To Purchases A/c
  To Input CGST A/c
  To Input SGST A/c or
  To Input IGST A/c

14. Abnormal Losses:

- These are the losses that occur because of accidents like fire, natural calamities, etc. Such losses may be loss of Assets or loss of Goods.
  a. Loss of Assets: In this case, Profit and Loss Account is debited and Asset Account is credited.
  b. Loss of Goods: In this case, value of stock available will fall which will indirectly reduce the amount of gross and net profit. While doing this, GST paid on such goods is also reversed as the credit of such Input GST will not be available to claim set off against output GST.
- Following adjustment entries are to be passed:
  - If stock is not insured:

    Profit and Loss A/c …Dr. (total value of abnormal loss)
    To Trading A/c
    To Input CGST A/c
    To Input SGST A/c or
    To Input IGST A/c
  - If the goods are insured, then the claim admitted by the insurance Company is deducted and the claim not admitted is debited to Profit and Loss Account.

    I. Accidental Loss of Stock/ Loss of Stock by Fire A/c …Dr. (total value of abnormal loss)
    To Trading A/c
    To Input CGST A/c
    To Input SGST A/c or
    To Input IGST A/c

II. Insurance Claim or Company A/c …Dr. (amount of insurance claim)
Profit and Loss A/c …Dr. (amount of unrecovered loss)
To Accidental Loss of Stock/ Loss of Stock by Fire A/c (total value of loss)