Financial Accounting
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Lecture – 61
5.11 Transactions to be adjusted in Final Accounts (Part 1)

In this video, we are going to look at the transactions which need to be adjusted in the Final Accounts.

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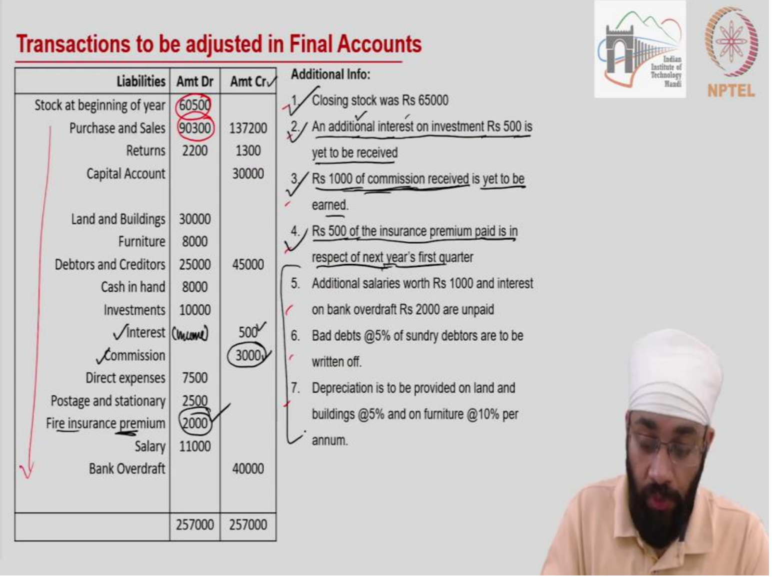

On the screen, you see a trial balance. There are a range of account balances which are given. And there are 7 additional pieces of information. These are the transactions which need to be adjusted in the final accounts. We are now going to look at each of these transactions and discuss what is going to be the impact of these transactions on the final accounts, and how do we adjust for these transactions without writing the journal entry, ledger posting, and trial balance.

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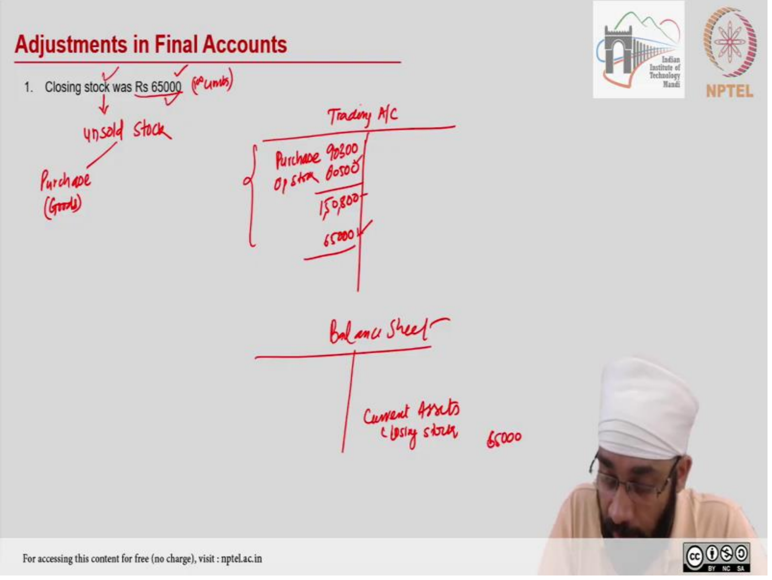

We going to look at the first transaction; first additional piece of information. Closing stock has been identified to be 65,000, some x number of units must be there, let us say they are 100 units: an assumption. There is a process which takes place to count the closing stock and it is called the stock audit. The information from the stock audit comes out to be much later after the trial balance has been prepared. We know that the closing stock is the unsold stock. And if this is the unsold stock, this must have been first of all purchased. In the purchase account, you have all the goods that are purchased; and some of these goods are sold while others are unsold. In the trading account of the trading and profit and loss account, and I write only the trading account because I am talking about the first section in the profit and loss account, we have to show the purchase. What is the amount of stock that was purchased during the year? Now, if this closing stock has been identified later, then in the trial balance purchase of stock should be shown. Let me go back to the trial balance. In the trial balance these are the purchases 90300, this is the purchase amount during the year. However, out of these purchases, 65,000 is unsold: you cannot show 90,300 as the purchases in the trading account. And also, you have opening stock as well 60,500. Actually, this opening stock plus purchases (90300+60500) comes out to 150,800: it is the value of the total stock available during the year to be sold. Out of this, 65000 has not been sold, and you cannot show this 65000 as your expense. So, you have to deduct it out of the total amount purchased, but this has not been done in the trial balance already. Therefore, we will need to make an adjustment. That is what is meant by adjustments to final accounts. So, this 65000 has to be taken out of the total purchases, so that the correct amount of purchase is shown. That is the first adjustment. The other impact of the closing stock, this unsold stock, is going to be that this stock is available to be sold in the next year and you expect to convert the stock into cash in the next one year, so it is giving you temporary capacity to generate revenue. Thus, this is a current asset for you as well. So, in the balance sheet under the current assets, you have to show unsold stock, or closing stock which is more popular. Closing stock has to be shown: the amount being 65000. That is the adjustment you need to do. In the trading account, the way it is shown and we have discussed this earlier as well; we do not sum this up.

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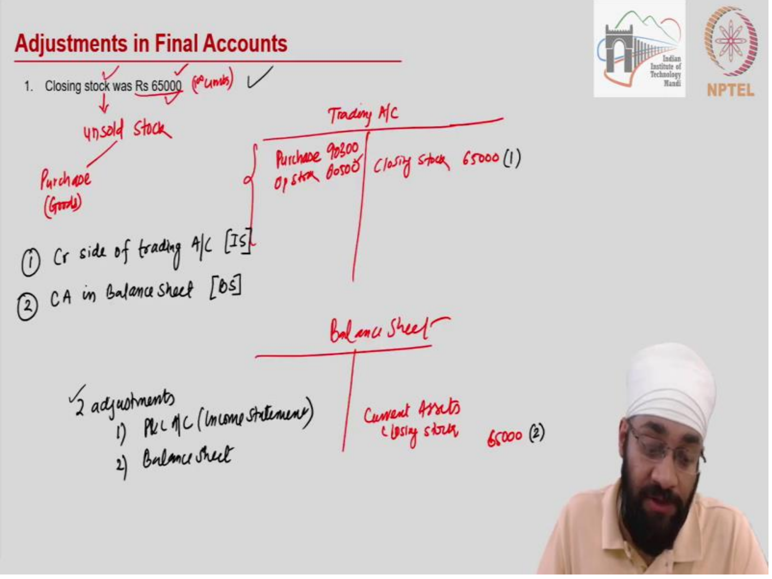

But in the trading account, we show it on the opposite side; closing stock 65000. This is as good as deducting it from the other side, but the conventions dictate that you write closing stock on the opposite side. So, you should note that there are two adjustments that we are doing number 1 and number 2. The first adjustment of a closing stock is to show it on the credit side of the trading account. This effect is happening in the income statement. The second adjustment is that you show under the current asset in the balance sheet and this is the impact in the balance sheet.

We learn from this that for this adjustment we did two adjustments; one adjustment in the profit and loss account, because profit loss account includes both the trading account and profit and loss account or we could say income statement. And the other impact is in the balance sheet, just remember these two and we will see if there is a trend as we move along with more transactions. I hope this made sense: a closing stock has to be adjusted in the purchases and also in the current assets.

Let us go to another transaction. So we have discussed this one transaction. Now, we are going to the second transaction which is an additional interest on investment: rupees 500 is yet to be received, it says additional which means there must be an interest item in the trial balance. And here it is 500, given on the credit side. This is an income, and now it says an additional interest on investment 500 is yet to be received.

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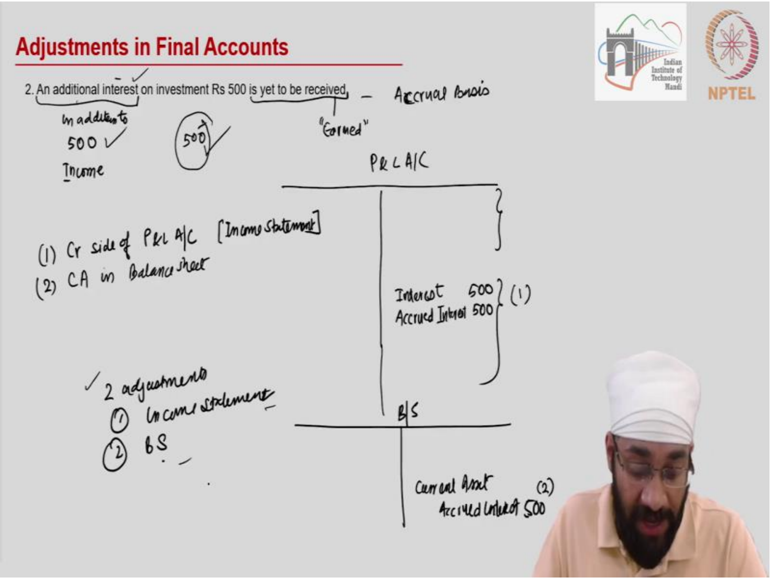

Let me go to this slide and discuss what this means. An additional interest means it is in addition to the existing 500 that you have in the trial balance. So, this is an income during the year. Now in addition to this income, there is an additional 500 which is yet to be received, which means you have not received cash. However, accounting is done on an accrual basis which means whether or not you receive cash, if you have earned the income, you have to show it in the given financial year. Have you earned the income? Well clearly, it is the transaction mentioned that is yet to be received and if it is to be received, it must have been earned.

So, we assume that this has been earned already which means services have been delivered. This is interest on investment which means the money was deposited in some scheme and you have to receive that interest. So you have earned this interest on the investment, so this is an additional 500. Whatever has been earned has to be shown as the income. Instead of 500 in the profit and loss account, we are talking about the second section where you show the interest income, we have to show an additional income which is income earned, but not received also called accrued income. Here we will call it accrued interest 500. So, the income in this year is actually 1000; you have not received 500, but the total income should be shown as 1000. The first adjustment that you need to do is to show this in the credit side of the P & L account and this is the impact on the income statement. The second impact of this is going to be in the balance sheet. As this 500 is yet to be received, it is yet to be converted in cash, it is similar to the stock, just as stock has to be converted into cash. Any item which is to be converted into cash within the next one year is a current asset: it helps you add a temporary capacity to the business. So, the other impact will be in the balance sheet under current assets. Under current assets you will show an item called accrued interest, amount being only 500. Because the rest 500 has been received, you will not get any cash for that amount, because that is already done. This additional 500 goes to number one, the income statement and number two in the balance sheet; so, let me write here under the current assets in the balance sheet.

Again, what we observe is that just like we had in the previous case, you had two adjustments; one in the income statement and one in the balance sheet. A trend is emerging for both the transactions that you have: you had two places where you needed to adjust; and one of the places was in income statement, the other one was in the balance sheet, let us see what happens with the third transaction.

Here is the third transaction. It says Rs 1000 of commission received. Is there a commission received? Well, here the commission credit side means it has been received. The adjustment says that we have now come to know that rupees 1000 out of this 3000 commission received is yet to be earned. Now, this is the exact opposite of the previous adjustment that we did. Here you have received the money, but you have not earned it; this is unearned revenue.

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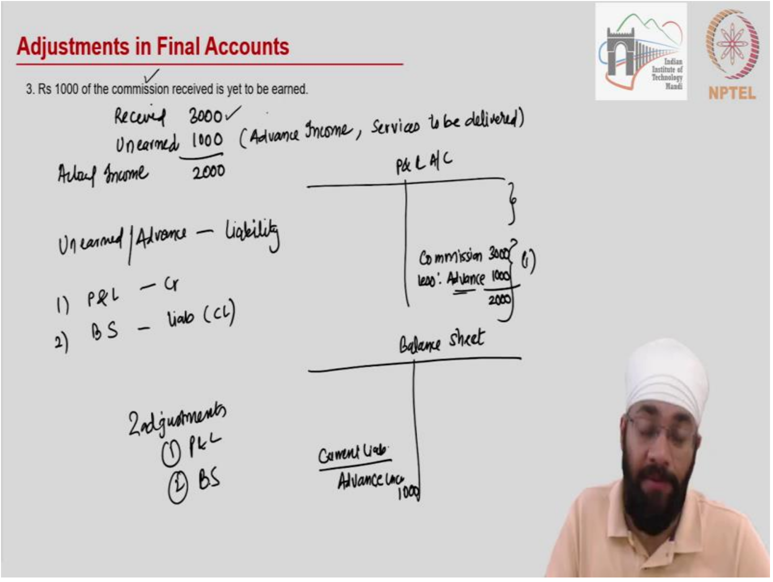

So, let me do a little bit more discussion here. You have received 3000; however, you have not earned or unearned 1000 of it. So, 2000 is the actual income according to the matching concept. The matching concept says incomes of this year to be matched to expenses of this year. We are talking about the income of 3000 which has been received, but you have rendered services worth only 2000 to this client and 1000 is yet to be earned. Unearned can also mean that this is an advance income which has been given to you and you have the services to be delivered, or goods to be delivered. And if you do not do that, then the other party has a claim on the business, they can recover this money from the business. If you have not done your part, you have not earned income and if you have not earned the income, you cannot show it in the books of accounts as your income. What should you show it as, is the question? The first impact is going to be in the profit and loss account where you have commission and I am talking about the second section. You have a commission 3000. What you should do is, you should deduct from this the advance commission, the unearned commission, which is 1000; and in effect only show 2000 as your actual income during this year. That is the first impact of this adjustment.

The second impact of this adjustment is going to be in the balance sheet. In the balance sheet, this advance income or unearned income represents a liability. A liability which you will have to meet in the next one year. You have to deliver goods or services against it. So, the impact is going to be that under the current liabilities you show advance income or unearned income, whichever name it does not matter. Advance income: you show an amount 1000. The two impacts: one of them is in the profit and loss account, the other one is in the balance sheet on the liability side, under current liabilities. Two adjustments, one being in the profit and loss account, the other being in the balance sheet. This is the same as what we had for the last two transactions.

Clearly a trend is emerging and we can believe this to be true that any adjustment goes to two places. There are two places where the adjustment needs to be made. And one of the places is in the profit and loss account, the other one is in the balance sheet. Well, let us look at a few more transactions; and then if we still see the trend, then we will come to this conclusion.

Next step, we have Rs 500 insurance premium paid which is in respect of the next year's first quarter. Let me look for insurance premium. Fire insurance premium is there. Any other premium? No. So, the fire insurance premium is 2000 and it says rupees 500 of this amount, so out of 2000 rupees 500 has been paid for the next year. If you have paid something for the next year, you have paid in advance. So, anything which has been paid for the next year should not be counted as the expense of this year, so we need to make an adjustment for this.

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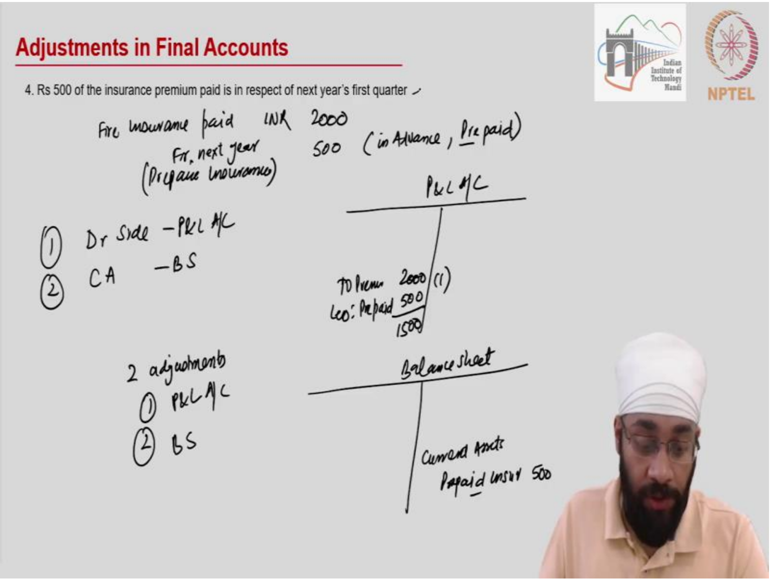

Let me go to the relevant slide here. So, the fire insurance that has been paid is 2000 and right now if the adjustment is not made, we will show this full to 2000 in the income statement in the profit and loss account. We will show *To insurance premium*, let me just write it in short and 2000. According to this the profit is going to be lower, because actually the amount of 500 this is for next year which is paid in advance. Paid in advance is also called prepaid: pre means before, in advance. So, prepaid insurance is not the expense of this year. So, what you have to do is to deduct from this 2000 the amount which is prepaid. Thus, 500 has to be deducted and only 1500 should be shown in the income statement. That is the first adjustment that needs to be done. The other adjustment is going to be in the balance sheet again. So, in the balance sheet under the current assets, we are going to show prepaid insurance and the amount is going to be 500. Why will I be showing this as a current asset? Because within the next one year you are going to receive the benefit against it and at that point of time you will not have to pay for it. So, it kind of saves cash for you; it does not bring in the cash, but it saves the cash which is almost equivalent to bringing in cash in accounting. So, the first impact is that we show it in the debit side of the profit and loss account. And the second impact is that we show it under the current assets in the balance sheet. In conclusion you have two adjustments: one in the profit and loss account, the other one in the balance sheet.

Again, the trend is converting itself into a fact into a thing which can be true for the rest of transactions as well. So, let me stop here. These are four transactions. I am going to continue this discussion for three more transactions in the next video.