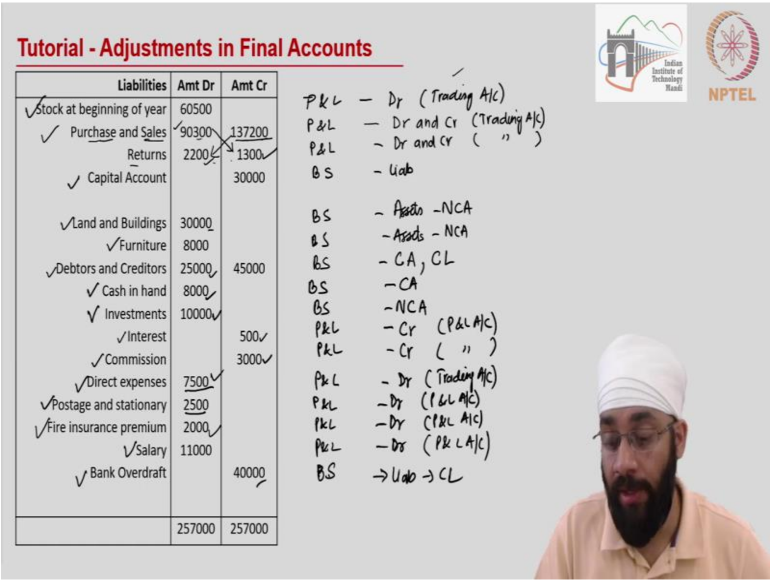
Financial Accounting
Dr. Puran Singh
School of Humanities and Social Sciences
Indian Institute of Technology, Mandi

Lecture – 63
5.12 Tutorial - Adjustments in Final Accounts

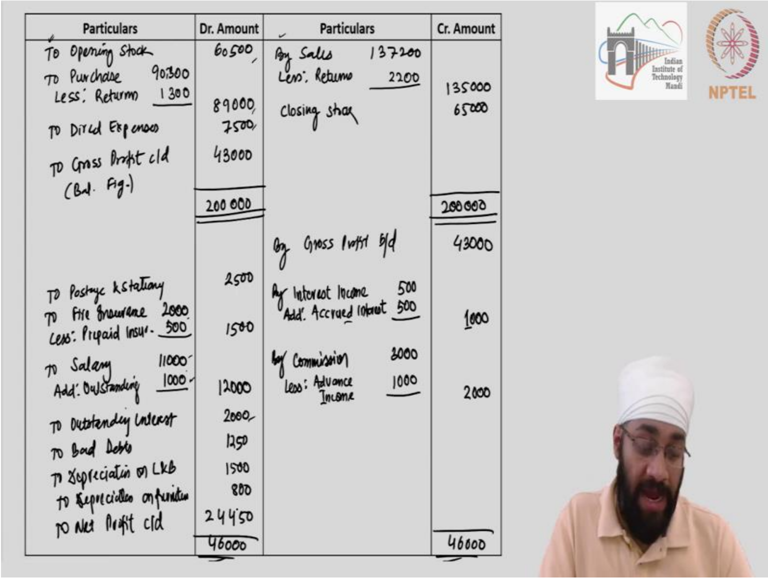
Hi, welcome to this tutorial. In this video we are going to take the trial balance and adjustments and prepare the final accounts. We will make the adjustment in the final accounts. We will use the learnings, the information, that we had in the last two videos as well.

(Refer Slide Time: 00:34)

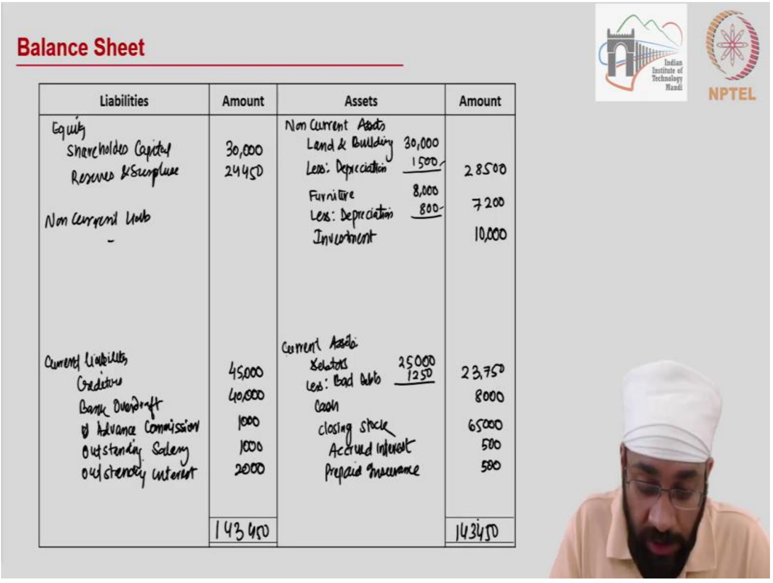


On the slide, I have the same trial balance as you have seen earlier. All I am going to do is to decide where each of these items will go.

(Refer Slide Time: 00:49)

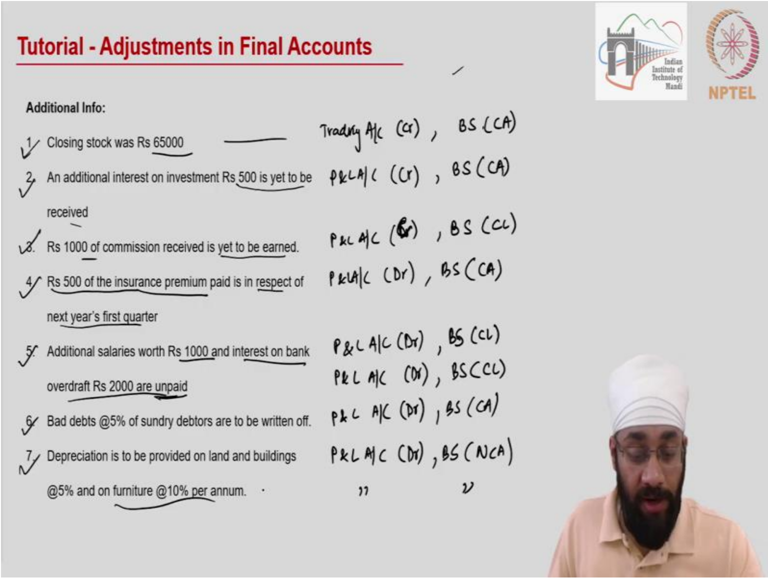


(Refer Slide Time: 00:51)



Then post them to their respective places. I have the format for profit and loss account and the balance sheet with me. I am going to pick each of the items and place it in one of the two places. As we already know, that items, accounts, in the trial balance, have already been adjusted, the double entry effects have taken place. Therefore, these balances are going to go to only one place; that is step 1.

(Refer Slide Time: 01:15)



Step 2 is parallel adjusting for the additional information. Again, we have already discussed why these transactions will affect profit and loss account and balance sheet and how. We have already done that. All we are going to do is combine everything: the trial balance and the additional information and we are going to write the balance sheet and the profit and loss account.

Let us get started. Stock at the beginning of the year. This is the opening stock and the opening stock will go to the income statement. As we are using the account format, it is the profit and loss account here. So, in the profit and loss account, on the debit side, this is going to be shown in the trading account, the first half of the profit and loss account. Why don't I just go ahead and write it there. So, I am going to write the opening stock. And, one new thing that I have started doing in this profit and loss account is to write *To* here. Now, previously you did not write *To* and *By* in the profit and loss account, but in some textbooks you will see that *to* and *by* are being used. The reason stays the same. This is an account; any account follows the ledger format. You have *to* and *by* used in the ledger. That is why they use it. Even if you do not use it, it does not matter. The idea for you is to understand how the data in the income statement is going to be arrived at, and this is the process. Do not worry too much about the prefixes to these. So, the opening stock is 60,500, written here. I am done with posting the first item in the relevant place. The second item is purchase and sales, we have both the balances given in one row.

So, there is 90,300 and 137,200. Which one is for purchase and which one is for sales? Well, if you've been paying attention, purchase always has a debit balance. So, this is the amount of purchase and sale being an income always has the opposite: the credit balance. So, this is the amount of sales. Again, this is going to go to a P & L account and will go to both debit and credit side in the trading account. Therefore, I am going to write here To purchase 90,300 and I am going to write By sales 137,200. I have written these amounts, not in the amount column, because I know there are returns as well and we need to make an adjustment. So, this is done. Then you have returns. Again, you have amounts in both the columns debit and credit. Returns refer to purchase returns or sales returns. We also know that the returns have an opposite balance of their parent account. By parent account I mean purchase returns' parent account is purchase account and sales returns' parent account is sales account. Thus, as sales have credit balance, sales returns have debit balance. Also, as purchase has debit balance, purchase returns will have a credit balance. Therefore, these are the amounts of purchase return and sales returns. Again they will go to debit and credit of the trading account. Let me make that adjustment. This is the purchase returns: 1300 which will be adjusted here and the sales returns is 2200to be adjusted here. Let me write some details here, less the returns; less the returns. There you go. You have 89,000 as the purchase and you have 135,000 as the sales.

Let us go forward, you have capital. Capital goes to the balance sheet and we write it on the liability side 30,000. The first heading is equity. Under equity we have shareholders capital, the amount was 30000 and done. Next up, you have land & building 30,000 and land and building goes to the balance sheet on the assets side under the noncurrent assets. So, balance sheet, under noncurrent assets, land & building, the amount was 30000. We know that there is depreciation. So, I am writing the amount inside the column. And, I will say less depreciation, there is an adjustment I will just leave it at that. Whenever we reach the depreciation, we will make the adjustment.

Next up, you have furniture. And, furniture has the same treatment. You go to the assets side and you have noncurrent assets of 8000. I will go to the balance sheet again, and I will write furniture amounting to 8000. We have to provide for depreciation. So, we will write less depreciation here. And, whenever we reach the adjustment we will pick up the amount from there.

Next up, you have debtors and creditors again. Both the things go to the balance sheet, debtors go to current assets and creditors go to current liabilities. Amount for debtors is 25,000. In the balance sheet, let me create somewhere here, current assets and debtors 25,000. I also know that I have to provide for bad debts at the rate of 5 percent, but I will do that when I reach the transaction. Right now, I have posted debtors. I also have to post the creditors. Let me write current liabilities here, and write creditors, the amount is 45,000 and done.

Next is cash in hand 8,000. Cash in hand goes to the balance sheet under the current assets. Let me write cash 8000, no adjustment required for the cash account. Then, you have an investment 10,000 that goes to the balance sheet under the noncurrent assets and there is no depreciation on investment at all.

Next up, you have interest. This is credit, so this is an income. Thus, Profit and loss account is involved. You will write it on the credit side in the profit and loss account, not the trading account. This is other income, this is non-operating income, interest 500. So, somewhere here I am going to write the interest income 500. I am again writing it inside because I know there is an adjustment which needs to be made to this.

Next is commission 3,000, credit balance. This is an income, on the credit side in the P & L account, commission. I know there is an adjustment which needs to be made. Then, you have direct expenses of 7,500. The item, the account balance, clearly says direct expenses. So, this goes to the profit and loss account on the debit side in the first section in the trading account, because we show all the direct expenses. Direct expenses refer to the manufacturing, the factory related expenses. These expenses contribute directly to the cost of the goods. So, 7,500 is going to be shown here *To direct expenses 7,500* and I better use *By* here for consistency. Then, you have postage and stationery, debit side. Clearly an expense, and you show this in the profit and loss account on the debit side. Again, one could argue that postage and stationery could be used in factory. If you know that you show it in the direct expenses. But in this case, we have been clearly given the direct expenses. So, I am going to write this on the debit side: *To postage and stationary 2,500*. Next, is fire insurance premium 2,000 debit balance. This is an expense on the debit side and we are going to show this in the P & L account 2,000 fire insurance premium. Fire insurance premium 2000 and I know there is an adjustment. Therefore, I am not writing the amount in the final column. Then, you have a salary of 11,000. Clearly, it will go to the debit side as an expense, and in the second half *To salary 11000*. Again, I know there is an adjustment. So, I am not writing the amount in the final column. Then, you have a bank overdraft of 40,000. This goes to the balance sheet on the liability side under the current liabilities. Bank overdraft is a short-term liability from the bank. So, bank overdraft the amount is 40000, there you go.

Thus, we are done with the first step in the process of preparing the final accounts. We have posted the account balances from the trial balance and every balance has gone into one of the two places either profit and loss account or the balance sheet. The first part which we had already done and practiced before as well, has been completed. The only difference is that we know that there are some transactions where adjustment is required. Therefore, we have written some amounts not in the final amount column. So, that is something new. And, the other new thing that we did was we are using *To* and *By* in the profit and loss account just to familiarize you with this because when you look at the textbooks or some other resources you may see use of these words. The justification for this is that there is a debit side, credit side as this is an account. So, you better use to and by. It does not matter if you do not do this; the understanding you should certainly have. The next thing to do is to adjust for the additional information. Again we have gone through the additional information and we have identified the impact. So, I am not going to explain, why I am doing certain treatment to these accounts? Why am I adjusting it at different places? But I am just going to post these transactions in the respective places.

Let us start with closing stock; closing stock as we discussed needs to be adjusted in the trading account. So, this will go to the trading account, on the credit side and this will go to the balance sheet under the current assets. 65,000 to be shown here, I will write closing stock 65,000. Now, by showing closing stock on the credit side, we are reducing the total on the other side. That is the idea and the convention dictates we show it here. Closing stock will also be shown under current assets. So, closing stock 65,000 and we are done with adjusting the first adjustment first transaction.

The second is an additional interest on investment 500 yet to be received, this was income earned, but not received. Accrued income, we are going to show this on the credit side of the profit and loss account. And, we are going to show this in the balance sheet under the current assets. So, 500 to be received is going to be added here. We are going to add to it and we will call it accrued interest. Interest, which has been earned, which has become due, but we have not received it. Therefore, the total interest income in this financial year is 1000. The trial balance would have only given you 500, this figure, but there is an additional 500. Now, since you have to receive this amount in the next one year this becomes a current asset for you as well. So, we will show another current asset and we will call it accrued interest. Accrued interest, or interest earned but not received, 500 as a current asset.

Next you have, commission received- yet to be earned. This is advance income. We discussed that in the profit and loss account you will deduct this from the commission to be earned on the credit side. And, in the balance sheet you are going to show this under the current liabilities because this is unearned income. 1000 commission- we have to deduct this advance income. Advance income means that you have to still perform your services to earn this income. If you have not earned this 1000 you cannot show this 1000 as your income as per the matching principle and hence, deducting this from the commission. You have received this 1000 but you have not earned it. You have to provide services for this. It is a current liability for you. Let me write, advance income or advance commission, 1000. There you go. The next item is 500 insurance premium paid is in respect of the next year's first quarter. So, we have a prepaid insurance, prepaid expense, in the profit and loss account and we are going to show this on the debit side and let us go there. Fire insurance premium that we have paid 2000, out of this 500 is for the next year: it is not this year's expense. This year's expenses are only 1500. So, we are deducting the prepaid insurance. Whatever is prepaid, paid in advance, you have a claim over it, you will convert it into a service. This becomes your current asset. So, you are going to write prepaid insurance equal to 500, this becomes a current asset. We will show this in the balance sheet under current assets.

Next up you have: additional salaries worth 1,000 are unpaid. Let me take this one by one. Salaries which are unpaid are going to be shown in the profit and loss account on the debit side. Right now, the salary is 11,000 and we have to add to it the outstanding salary, unpaid salary, which has become due, 1,000. The actual expense of this financial year is 12,000. The trial balance will only give you 11000, they did not consider the 1000 which has not been paid.

So, 12,000 is the actual expense. The 1,000 which has not been paid will be paid within next one year, it becomes a current liability. So, you will write it under current liabilities in the balance sheet as outstanding salary 1,000. The other part of this transaction, interest on bank overdraft is also due. We will show this in the profit and loss account on the debit side and in the balance sheet under the current liabilities, same as we did for the outstanding salaries. Here we are going to show *To interest*, I should say outstanding interest rather. So, let me just correct it *To outstanding interest*. Now, interest on overdraft, you could write the detail as well, the amount is 2,000. And, this outstanding interest also goes to balance sheet under the current liabilities. One point is that you do not have an existing expense like salary, where you had the 11,000 already paid and you added to it 1,000. In this case there is no existing amount: you just show 2,000 which has not been paid. All the salaries if they were not paid, you will show directly in the amount column, so likewise. It does not matter whether you have already spent it or not: if something is outstanding; that means, this amount is to be considered as the expense of this year. So, we show it as an expense 2,000, and this has not been paid. Thus, it becomes the current liability and hence, shown in the balance sheet as well.

Then, you have bad debts at the rate of 5 percent of sundry debtors: this is a loss. We will go to profit and loss account on the debit side and will show this as a loss. I write here *To bad debts,* and this is 5 percent of 25,000, which was the debtors' amount. So, the amount is going to be 1,250 and here 1,250 to be deducted. So, you have a net amount of 23,750 as the balance in the debtors. This goes to the balance sheet under the current assets. to be deducted from the balance of the debtors.

The last adjustment is depreciation; depreciation is regarded as an expense. So, we will show this in the profit and loss account on the debit side. I will write *To depreciation*. Now, depreciation is to be charged on two accounts: land & building at the rate of 5 percent and furniture at 10 percent. Let me go to the balance sheet here. Land & building at 5 percent comes out to be 1,500. Here the balance is going to be 28,500 and for furniture we have 10 percent depreciation, so 800 the balance is 7200. So, these 1500 and 800 will be shown as expense:1500 and 800 depreciation on land and building and to depreciation on furniture. Again, in the income final income statement that you club all the depreciation expenses and show the final number. In the notes you can provide details of this, but this is an internal account we are looking at how these numbers are arrived at. We are writing everything in detail and later on you could club it and make a nice presentable statement. The impact is on the balance sheet under noncurrent assets as well and same goes for the depreciation of furniture as well. Now we have done the second step which is making adjustments for the additional information. All we need to do now is to figure out the amounts of gross profit, net profit, and then total the balance sheet.

Let me just figure out the totals. I have done those already: the total comes out to be 200,000 on this side. Again, the convention of closing the accounts is being followed: you have gross profit here, *To gross profit* and this is carried down. This, of course, is a balancing figure as well. So, 60500, 89000, 7500, you are left with a gross profit of 43,000. Now, you bring this forward *By gross profit* brought down 43,000 on the credit side, this gives you a total of 46,000, and this leads to a net profit. So, *To net profit* carried down, this is a balancing figure, of course, of 24,450. This is the balancing figure and this is going to be added to the reserve and surpluses in the balance sheet. We go to reserves and surplus and you have 24450 here. In the balance sheet there were no noncurrent liabilities surprisingly, but we will just keep it for the sake of format. You sum these up and you have a total of 143,450: this is the total of balance sheet on both sides.

So, there you go. In this video we looked at the adjustments to be made. We had a discussion on how these adjustments are to be made and where all will be impacted. Now, you know the whole process of preparing the final accounts plus doing the additional adjustments according to the developed system.