4. Adjustments for Financial Statements

This chapter discusses the following themes

4.1 Nature of income and expenditure

4.2 Adjustments of income and expenditure for the accounting period

4.3 Adjusting balances of debtors for correct information

4.4 Updating value of non current assets

Let us do Adjustments related to Financial Statement

Kosala is a sole proprietor. In his business he does not maintain proper accounts. However he records all income, expenses and other transactions in a book. He calculates profit by deducting cash expenses from cash income. Once he got an opportunity to speak with one of his relatives who has a sound knowledge in accounting. After the discussion Kosala realised that following factors have to be considered when calculating profits.

- All income and expenses are not considered in calculating profits.
- Only income and expenses that is relevant to the given accounting period is regarded in calculating profit.
- The debt which cannot be recovered from customers has to be written off.
- Expenses incurred on fixed assets have to be written off annually.

You may have realized that there are many factors which have to be considered in calculating profits for a business organisation.

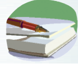
As mentioned above there are entries that are necessary for accurate calculation of profits and the financial position. Let us see how they are entered in the financial statements.

Introduction

In an organization it is necessary to do accurate calculation of business activities for a given period of time. It allows the relevant parties to get accurate results for their decision making. It requires adjusting relevant income and expenses, accrued income and accrued expenses, prepayments and receipts in advance, doubtful debts and depreciation of fixed assets. This chapter discusses ways to identify these adjustments and to record them in the Journal and relevant Ledger accounts.

Your attention is drawn on the following basic terms in this chapter.

- Capital Expenditure
- Revenue Expenditure
- Revenue
- Accrued Income
- Accrued Expenses
- Pre Payments
- Receipt in Advance
- Bad Debts
- Depreciation of Fixed Assets
- Straight line Depreciation Method

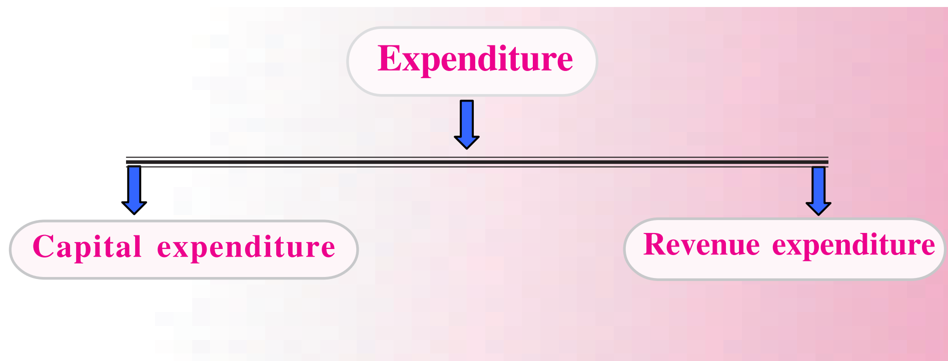


4.1 Nature of Income and Expenditure

There are many parties who are interested in financial activities of a business organization. Systematic recording of financial transactions are useful for these parties. They are mainly interested in two aspects of an organization. The first is the financial results of the organization for a given time period. The second is the financial position of the organization.

To identify above, it is important to get an understanding of the nature of income and expenditure of the organization.

Any business organization has to incur day- to-day expenses in their business activities. These expenses are done to achieve a gain to the business. The gain from these expenses may accrue on the same accounting period or in many future accounting periods. Based on its nature the expenses can be categorized into two main groups.



Capital Expenditure

An expense that results long term future benefits is a capital expenditure. A long term refers to a time period more than one year. Normally these expenses result benefits for many future years.

Example : ⊙ A purchase of a motor vehicle to a textile retail store.

The above motor vehicle can be used in the store for its business activities. These expenses result non-current assets to the organization. Observe the following figure.

Figure 4. I: Fixed Assets of a Textile Retail Store

Revenue Expenditure

If benefits of an expense accrue for a short term they are referred to as revenue expenditure. Short term refers to a time period less than one year. The day-to-day expenses of an organization are revenue expenses. There are many revenue expenses in an organization.

Following are examples of revenue expenditure.

- Insurance premium, electricity, telephone charges, rates
- Transport, advertising, sales commissions
- Loan interest, Bank charges.

Revenue

Revenue is the income earned by a business organization through selling goods or services.

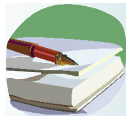
Activity 01

Upamali bought a building for Rs.500,000 on 01/01/20XX for her clothes retail store. She bought textiles and made clothes for her store. She bought 4 sewing machines at a cost of Rs. 100,000. Two employees were hired to the store and their salaries for the year 20XX were 200,000. She spent Rs. 300,000 to buy material and thread to make clothes. When carrying out business activities she spent Rs. 10,500 as electricity charges and Rs. 6,500 as insurance premium. She earned revenue of Rs. 950,000 for the year by selling the clothes made in her store.

Based on the above information calculate the,

i. Capital expenditure
ii. Revenue expenditure

Let us observe how income and expenditure are adjusted when preparing financial statements for an accounting period.



4.2 Adjusting Income and Expenditure Relevant for an Accounting Period

All the transactions relevant for a given accounting period have to be recorded in financial accounts. However some transactions which are relevant to an accounting period may not be entered in accounts at the end of the accounting period. The entries made to include those items to accounts are known as adjustment entries. These adjustment entries are done through the General Journal. Some of the adjustment entries are as follows.

- Accrued expenses and accrued income
- Prepayments and receipts in advance
- Bad debts
- Depreciation of non-current assets

Accounting information is presented according to accepted accounting principles. Further there are accounting concepts that provide a basis for accounting. Accrual concept is one of the main concepts of accounting.

Accrual Basis

According to accrual concept income and expenditure that are relevant to an accounting period but not received and paid yet must be considered in calculating financial results of a business organization.

They must be recorded in financial statements. Prepayments and receipts in advance must also be considered similarly.

Accrued Expenses

An expense which is relevant for an accounting period but not paid yet is termed as accrued expense.

Example : ⊙ Sandamali rented a building on 01/01/20xx for Rs. 125,000 to retail textile. The annual rent of the building is Rs.150,000. When preparing final accounts as at 31/12/20xx she had paid only Rs.125,000.

The journal entries and ledger accounts for recording accrued building rent is as follows.

General Journal

Date	Voucher No.	Description		L. F.	Debit Rs.	Credit Rs.
31.12.xx		Building rent	Dr		25,000	
		Accrued building rent				25,000
		(Recording of accrued building rent)				

Debit | Building Rent Account | Credit

Date	Description	L. N.	Amount Rs.	Date	Description	L. N.	Amount Rs.
01.01.xx	Cash		125,000				
3112.xx	Accrued building rent A/c		25,000				

Debit | Accrued Building Rent Account | Credit

Date	Description	L. N.	Amount Rs.	Date	Description	L. N.	Amount Rs.
				31.12.xx	Building rent A/c		25,000

According to the above example, building rent of Rs. 25,000 not paid yet is debited to the building rent account. It is debited because it is an expense relevant to the accounting period and it increases expenses for the period.

As accrued building rent is not paid yet it is a liability, therefore it is credited to the accrued rent account.

Accrued Income

Income which is relevant to an accounting period but not received yet is called accrued income.

Example : ⊙ Sandamali has deposited Rs. 240,000 in a 16% monthly interest fixed deposit on 01/01/20xx. Monthly interest for the month of December was not received yet when the final accounts were prepared for 31/12/20xx.

The journal entries and ledger accounts for recording accrued income is as follows.

General Journal

Date	Vouc. No.	Description	L. N.	Debit Rs.	Credit Rs.
31.12.XX		Accrued interest income A/C Dr Interest income A/C (Recording of accrued interest income)		3,200	3,200

Debit — Interest Income Account — Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
				01.12.XX	Cash		35,200
				31.12.XX	Accrued interest income		3,200

Debit — Accrued Interest Income Account — Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
31.12.XX	Interest Income		3,200				

According to the above example interest income of Rs. 3,200 which is not received yet is credited to the interest income account. It is credited because it belongs to the accounting period and it is an increase of income.

The accrued interest is considered as an asset because it is not received yet and it is an increase of an asset.

Prepayments

Business organizations may make payments which are more than the amount to be paid for the accounting period. Therefore if payments are made which are not relevant for this accounting period but for the future period they are known as prepayments.

Example : ⊙ Sandamali's Business has to pay an insurance premium of Rs.5,600 for the year 20xx. However on 01/01/20xx she has paid Rs.6,000 as the insurance premium.The journal entries and ledger accounts for recording prepayment of insurance premium is as follows.

General Journal

Date	Vouc. No.	Description	L. N.	Debit Rs.	Credit Rs.
31.12.XX		Prepayment of insurance premium Dr Insurance Premium A/C (Recording of prepaid insurance premium)		400	400

Debit — Insurance Premium Account — Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
01.01.XX	Cash		6,000	31.12.XX	Prepaid insurance premium A/C		400

Debit — Prepaid Insurance Premium Account — Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
31.12.XX	Insurance premium A/C		400				

According to the above example because of the prepayment the insurance premium paid is more than what is required to the time period. Therefore the extra amount paid has to be removed from the expense account. As it is a reduction of insurance premium it has to be credited to the insurance premium account. To show the relevant double entry a temporary prepaid insurance premium account is opened and it is debited with the prepayment. It is recognised as an asset.

Receipts in Advance

An amount of income received for an organization can be relevant for the future accounting period. Therefore income which is received for future accounting period is known as receipts in advance.

Example : ⊙ Sandamali's Business has started advertising services. They have received Rs. 750,000 for customer's advertisements on 01.03.20xx. Rs. 50,000 of this income is for the next year.

The journal entries and ledger accounts for recording advertisement income received in advance is as follows.

General Journal

Date	Vouc. No.	Description	Le folio	Debit Rs.	Credit Rs.
31.12.xx		Advertisement income account Dr. Advertisement income in advance A/C (Recording of Advertisement income received for next year)		50,000	50,000

Debit Advertisement Income Account Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
31.12.xx	Advertisement income in advance		50,000	01.03.xx	Cash		750,000

Debit Advertisement Income in Advance A/C Credit

Date	Description.	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
				31.12.xx	Advertisement Income A/C		50,000

According to the above example, as there is advertisement income received in advance, the Advertisement income account is credited with an extra amount that is not relevant to the accounting period. Therefore the extra amount received has to be removed from the income account. It is debited to the Advertisement income account. To show the relevant credit entry a new account is opened as the Advertisement income in advance account. It is a liability for the business.

Activity 02

Akila carries out a printing business. Following are some information relevant for the accounting period ending 31/12/20xx of her organization.

i. Electricity expenses to be paid as at 31/12/20xx are Rs. 2,500

ii. Part of her building is rented out from 01/01/20xx for a monthly rent of Rs. 2,600. When preparing final accounts the total rent received as at 31/12/20xx was Rs.25,000.

iii. The insurance premium for 20xx was Rs. 2,800, but she has paid Rs.3,000.

iv. She has received Rs. 350,000 as income from printing books for year 20xx. Rs.4,500 of this is for the next year.

Write down the journal entry for the above adjustments and show how they are accounted in the ledger account.

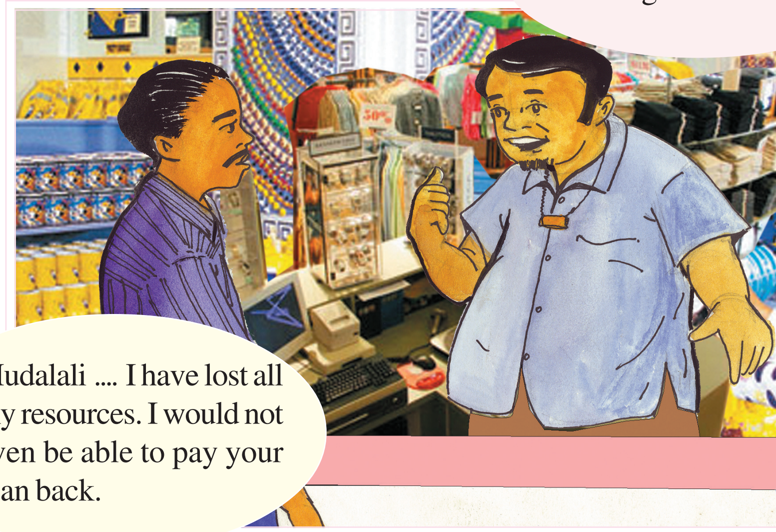
4.3 Adjusting Balances of Debtors for Correct Information

An organization may sell on cash or credit. When sales are made on credit it creates debtors. Debtors are assets to the company. When large amount of sales are done on credit it creates a large amount of debtors. Therefore the organization has to keep track of theses debtors and the sums due are received on time and how much has not been received are some of the concerns relating to the debtors.

Even though the organization has a good control over handling debtors, some of the amount due from them may not be received. It is a loss to the organization. The loss is considered as an expense. Thus, the amount which is not collectable at all is called **bad debt.**

Reasons for Bad Debts

Bad debts may arise due to death of a debtor, bankruptcy of debtors, destruction caused by natural disasters.



Accounting for Bad Debts

Due to bad debts the assets called debtors decrease. Therefore bad debts are considered as a loss. The relevant journal entry is as follows.

Bad debts account	**Debit**	
Debtors account		**Credit**

As bad debts increase expenses is debited to bad debt account. Further as debtors reduce due to bad debts it is credited to the debtors account. The write off of bad debts should be made as an adjustment entry in the General journal.

Example : ◉ Gamindu is a debtor of Sandamali's business. The balance of his account as at 31.12.20xx is Rs. 7,500. As Gamidu's organisation went bankrupt the money due from him has to be written off as bad debts.

The journal entries and ledger accounts for recording bad debts are as follows.

General Journal

Date	Vou. No.	Description		L. F.	Debit Rs.	Credit Rs.
31.12.xx		Bad debts A/c	Dr		7,500	
		Gamindu A/C				7,500
		(Writing off money due from Gamindu as bad debts)				

Debit — Bad Debts Account — Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
31.12.xx	Gamindu		7,500				

Debit — Gamindu's Account — Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
31.12.xx	Balance c/d		7,500	31.12.xx	Bad debts A/C		7,500

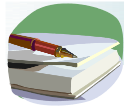
As bad debt is a loss it is debited to the bad debt account. As the asset debtors decrease due to bad debts it is credited to the debtor account.

Activity 03

Mr. Thilakawardena sells goods both on cash and credit. Going through his account he found that credit sales were Rs.36,000 and cash sales were Rs. 74,000.

Amal is a debtor whose bankruptcy was proven by the courts. He owes Rs. 8,500 to the business. It was decided to write it off as a bad debt.

i. Show the journal entries and ledger entries for the above situation.
ii. What would be the effect to the profit of the business?



4.4 Updating Value of Non Current Assets

Business organizations use many assets when carrying out business activities. The assets acquired for long term and which are not for sale are called non current (fixed assets). Examples of non current assets are as follows :

- Building
- Machinery and equipment
- Motor vehicles
- Furniture and fittings
- Office equipment.

The machinery and equipment in the above example may be used in the organisation for ten years. In accounting the expense done on above machinery and equipment is written off as expenses throughout its life of 10 years. In other words the asset which is accounted as a capital expenditure is written off as revenue expenditure throughout the life of the asset.

In accounting the amount which is written off as expenditure is termed as depreciation. Depreciation is required for assets which have a life more than one year. There can be many reasons for depreciation of an asset.

Reasons for Depreciation

Reduction in value of an asset or depreciation of an asset can be due to many reasons. The following two factors are important factors of depreciation.

i. Physical wear and tear

ii. Asset being outdated

Physical wear and tear

Examples for above are deterioration, wearing off, erosion and depletion due to usage.

Asset being outdated

It is the result of new and efficient assets being introduced to the market.

Example : ⊙ The removal of typewriters from offices due to introduction of computers.

Deciding the Amount to be Depreciated

The value that cannot be recovered when the asset is disposed from the organisation is the depreciable amount of the asset. Following factors are considered when deciding the annual amount to be depreciated from an asset.

- Cost
- Useful life time (lifespan)
- Salvage value

Cost – Purchase price and all other costs incurred to bring the asset to the condition of usage

Useful life time – The time period which the asset is productive to the organization or the units that can be produced by the asset

Salvage value – The amount to which the asset can be sold after its useful life

After considering the above factors the organization can decide the amount to be depreciated within the life of the asset.

Methods of Depreciation

There are many methods to depreciate assets. The Straight Line Method of depreciation is considered at this level.

Straight Line Method

In this method the depreciable value of the asset is written off in equal amounts throughout its useful life. Depreciable value of the asset can be calculated by deducting the salvage value from the total cost of the asset. The depreciation amount per year can be calculated by dividing the depreciable value from the useful life of the asset. It can be calculated as follows.

$$\text{Depreciation per year} = \frac{\text{Total cost} - \text{Salvage value}}{\text{Useful life of asset}}$$

Depreciable value of an asset = Total cost-Salvage value

Therefore,

$$\text{Depreciation per year} = \frac{\text{Depreciable value of an asset}}{\text{Useful life of asset}}$$

Example : ⊙ An organization bought a machine for Rs. 300,000 on 01/01/20xx. The useful life of the asset is 8 years. The estimated salvage value is 60,000. If straight line method is used for depreciations what is the annual depreciation amount.

$$\text{Annual depreciation} = \frac{300{,}000-60{,}000}{8} = \frac{240{,}000}{8}$$
$$= \underline{\text{Rs. } 30{,}000}$$

In straight line method the annual depreciation is normally quoted as a percentage. This percentage shows how much to be depreciated as an expense from the asset for a year. The percentage can be calculated as follows.

$$\text{Depreciation percentage} = \frac{\text{Annual depreciation}}{\text{Cost}} \times 100$$

Therefore the percentage of depreciation for the above example is,

$$\text{Depreciation percentage} = \frac{30{,}000}{300{,}000} \times 100$$
$$= \underline{10\%}$$

Accounting for Depreciation

Each year the annual depreciation amount of an asset has to be written off from the cost of the asset as an expense. An expense account is created in relation to the asset being depreciated. It is termed as the depreciation account for the particular asset. The double entry for it is as follows.

The relevant depreciation account	**Debit**
Provision for depreciation account	**Credit**

The relevant depreciation amount for the period is an expense. Therefore it is debited to the depreciation account. It is logical to credit the relevant asset account to complete the double entry. However, when accounting, a separate Provision for Depreciation account is created and it is credited with the depreciation amount.

The journal and ledger entries for the depreciation of the machine in the above example are as follows.

General Journal

Date	Vou. No.	Description	L. F.	Debit Rs.	Credit Rs.
31.12.XX		Machine Depreciation Dr Provision for machine depreciation (Recording annual machine depreciation)		30,000	30,000

As above the Provision for depreciation account has to be credited each year until the end of the useful life of the asset.

Debit Machines Account Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
01.01.XX	Cash		300,000				

Debit Machine Depreciation Account Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
31.12.XX	Provision for machine depreciation A/C		30,000				

Debit Provision for Machine Depreciation Account Credit

Date	Description	L. F.	Amount Rs.	Date	Description	L. F.	Amount Rs.
				31.12.XX	Machine Depreciation A/C		30,000

Activity 04

To start manufacturing cement bricks Mohammed purchased a machine for Rs. 150,000. The useful life of it is 16 years. The estimated salvage value is Rs.30,000.

Mohammed expects answers to following problems.

i. Why is depreciation considered as an annual expense?

ii. What do asset cost, useful life and salvage value mean?

iii. What are the reasons for reduction in value of the machine?

If he is planning to use straight line depreciation method to depreciate the machine

a. Calculate the depreciation amount per year.

b. Find the annual percentage of depreciation of the machine

c. Prepare the journal and ledger entries to account for depreciation for the year 20xx.

Activity 05

Sadeeptha is carrying out a retail store. Following are some information of his business organization.

1. Non current assets as at 01/01/20xx

Land and building (cost)	Rs.250,000
Furniture and equipment (cost)	Rs. 80,000
Motor vehicles (cost)	Rs. 100,000

2. He has rented a building to carry out his business activities. The monthly rent is Rs.2,000. Rs. 16,000 has been paid as annual rent for the building.

3. He paid Rs. 24,000 as advertisement expenses on 1st June 20xx. Rs.12,000 from it for the next year.

4. Ajith owed Rs.5,000 to the organization. As he has died the amount is to be written off as bad debt.

5. Sadeeptha uses the vehicle of the business to transport the customer's purchases. The income received through this is Rs.24,000. Rs.4,000 of it is for the next year.

6. The land and building, furniture and equipment and motor vehicles are depreciated on straight line basis at 10%,5% and 20% respectively.

You are required to,

i. Prepare the general journal showing the adjustment entries as at 31/12/20xx.

ii. Prepare the relevant ledger accounts.