Study Unit 5: End of Year Adjustments

Learning Objectives

By the time, you have finished this chapter, you able to

1. Understand the accounting cycle
2. Be able to understand the types and nature of the adjustments required in order to prepare financial statements
3. Understand the need for such adjustments
4. Be able to prepare schedules of end-of-year adjustments.

Introduction

Regardless of the type of business or the accounting system used, it is not possible to keep all accounts up to date at all times. At the end of each financial (accounting) year, certain accounts must be updated by adjusting entries, to reflect the status of the organization and financial statements can then be prepared. In the accounting cycle below, this chapter forms the fifth stage.

The accounting cycle

After examining documents, journals, ledgers and the trial balance, we establish a sequence known as the accounting, cycle. The accounting cycle refers to the sequence in which data is recorded and processed until the financial statements are extracted.

The accounting cycle has the following stages:

i) Occurrence and documentation. When a transaction has occurred, the relevant documents are prepared. These include invoices, receipts; goods received notes, payment vouchers, delivery notes, local purchase order etc.

ii) Journalizing of the transactions. Information from documents is recorded in the journals. Journals are also referred to as the books of original entry.

Examples of journals are the general journal, sales daybook, purchases daybook etc.

i) Posting the transactions from the journals to the Ledgers. Then we record the business transactions in the respective ledger accounts. Post the information from the journals to the ledgers. Ledgers include; general ledgers and subsidiary ledgers. Ledgers are books in which transactions concerning a particular account are summarized. Balance off the [edger accounts are at the end of the accounting period.

iv) Preparation of the trial balance. Extract from the ledger balances, the trial balance. The trial balance is a list of debit and credit balances extracted from the ledgers. If the double entry rule is not complied with, the totals of the debit and credit columns will be not equal; what can be done with this is a subject of chapter 10.

v) Adjustments of accounts. Adjustment of some accounts is needed before the preparation of the financial statements. The major adjustments include provision for bad debts, provision for depreciation, incomes and expenses. You make these adjustments in the work sheet see chapter 7. After incorporating the adjustments in the trial balance, the financial, statements are prepared.

vi) Preparing the financial statements. Financial statements are the outputs of recording organization transactions. The financial statements include the Income statement (Trading profit and loss account), Balance sheet, and Cash-flow statement, Statement of changes in equity and Notes\to the financial, statements. Nominal accounts shown in the trial balance are taken to the income statement. Net profit is added to the capital figure brought forward and any drawings are deducted to find the adjusted capital figure. These adjustments take place in the balance sheet. The remaining balances in the trial balance are taken to the balance sheet.

Accruals and Prepayments:

When the income statement is being prepared for a specific period, we must bring into account:

a) All expenses relating to that period whether we have actually paid them or not.
b) All items of income and gains whether we have actually received them or not.

For this purpose, some adjustments are needed at the end of the accounting period relating to:

i) Accrued expenses - These are expenses, which are outstanding and have not yet been paid. In order to ensure that the full expenses of the period have been included in the income statement, the accountant must ensure that the expense accounts include not only those items that have been paid for during, the period but any outstanding amounts due for expenses.

ii) Prepayments- These are expenses, which have already been paid but relate to the following accounting period or the normal operating cycle. As well as ensuring that all of the expenses incurred in the period appear in the income statement, the accountant must also ensure that no items of expense that relate to future periods, 'but have already been paid for, are shown as expenses of the current period.

iii) Accrued income - This is income relating to the current accounting period or operating cycle but has not yet been received. So far all examples have concerned expenses of the business as these are the most common areas for accruals and prepayments (see below) to occur. However, some organizations also have some sources of miscellaneous income, which may also be prepaid or accrued (see iv below).

iv) Income in advance - This is income, which has already been received but relates to the following accounting period or operating cycle.

Note: The accounting problem is how to treat these issues. A student is at liberty to use any of the ways/methods whichever is easier. The method should normally give identical results.

- **Accrued expenses;**

Dr. Income statement or respective expense account

Cr. Accrued expense account

Example:

Salaries and wages paid during the year amounted to UGX 6,200,000=. Accrued wages as at 31/12 amounted to UGX. 250,000=. Show the entries as are necessary to bring this sum into account.

Method 1

Income statement (extract)		**Balance sheet (extract)**	
Salaries and wages:		Current liabilities:	
Paid:	6,200,000	Accrued salaries and wages:	250,000
Add: accrued	<u>250,000</u>		

6,450,000

Accrued wages and salaries are shown as a credit balance in the balance sheet.

Method 2

Salaries, and wages account

Bal. B/f	6,200,000	Dec.31 income statement	6,450,000
Bat. C/f (accrued).	250,000		
	6,450,000		6,450,000

- **Prepayments or prepaid expenses:**

Dr. Prepayments account.

Cr. Income statement or respective expense account

Prepayments appear as current assets in the balance sheet.

Insurance paid during the year amounted to UGX. 380,000 of which UGX. 120,000 was prepaid as at 31/12. Show the entries as are necessary to bring this sum into account.

Example.

Method 1

Income statement (extract)

Insurance:

Paid:	380,000
Less: Prepaid	120,000
	260,000

Balance sheet (extract)

Current assets:

Prepaid insurance: 120,000

Method 2

Insurance account

Cash/Bank	380,000	Income statement	260,000
		Prepaid (bal c/f)	120,000

380,000	380,000

- **Accrued income:**

Dr. Accrued income account

Cr. Income statement or respective income/gain account

Example:

Rent received during the year amounted to UGX.650, 000. Accrued or owed rent as at 31/12 amounted to UGX.70, 000. Show the entries as are necessary to bring this sum into account.

Method 1

Income statement (extract)

Rent receivable:

Received:	650,000
Add: Accrued	70,000
	720,000

Balance sheet (extract)

Current assets:

accrued rent/rental income: 70,000

Method 2

Accrued rent account

Income statement	720,000	Cash/Bank	650,000
		Accrued (bal c/f)	70,000
	720,000		720,000

- **Income in advance**

Dr. Income statement.

Cr. Income in advance or respective income/gain account

Income received in advance appears as a current liability in the balance sheet

Example:

Rent received during the year amounted to UGX. 800,000 of which UGX. 80,000 was received in advance as at 31/12. Show the entries as are necessary to bring this sum into account.

Method 1

Income statement (extract)

Rent receivable:

Cash/Bank:	800, 000
Less: Rent in advance	80,000
	720,000

Balance sheet (extract)

Current liabilities:

Rent in advance: 80,000

Rent receivable account

Income statement	720,000	Cash/Bank	800,000
(bal C/f) Income in advance	80,000		
	800,000		800,000

Nominal accounts with Debit and Credit Balances:

Accrued expenses of the previous accounting period will appear as credit balances brought forward. Similarly, expenses prepaid in the previous period will show debit balances brought forward in the respective account. Accrued income of the last period will have a debit balance and income in advance will have a credit balance in the respective accounts. These accounts may also have balances carried forward at the end of the years. In these circumstances, all items must be taken in the respective accounts and the balancing figure will show the amount to be transferred to the income statement.

Example:

Rent and rates paid in the year amounted to 2,550,000. The following information was also provided.

2002	**Accrued rent**	**prepaid rent**
Jan 1	200000	90,000
Dec 31	300,000	70,000

Sow the amount charged to the income statement.

Rent and rates account.

Jan 1 bal B/f	200,000	1-Jan	200,000
Dec. 31 income statement		31-Dec Income statement 2,670.000	
(12/15*1,500,000) + (12*80,000)))	2,160,000		
Dec 31	300,000	31-Dec	70,000
	2,940,000	2,940,000	
Jan 1 2003 Bal. B/f	70,000		

Example 2

A trader sublets part of his business premises to two tenants - P Burton and A White. At 3lst Dec 2002, P Burton owed 200,000, two months' rent and A. white had paid a month's rent of UGX.80, 000 in advance for the month of Jan.2003.

During the 'year 2003, the trader received UGX.1, 500,000 for 15 months from P Burton and UGX. 800,000 for 10 months from A White. Show the rent receivable account in the trader's ledger for the year 2003. No personal accounts are opened for the sub-tenants.

Rent Receivable Account

Jan 1 bal B/f	90,000	1-Jan	200,000
Cash/Bank	2,550,000	31-Dec Income statement	2,670.000
Dec 31	300,000	31-Dec	70,000
	2,940,000		2,940,000
Jan 1 2003 Bal. B/f	70,000		

Reserves:

These are those amounts, which are set aside out of profits to retain assets in the business. The motive may be to strengthen the financial position of the business. The Amounts transferred to reserves are treated as under.

Dr. Income statement

Cr Reserves

More specifically, however, these amounts are shown as appropriations within equity as shown in the statement of changes in equity.

Provisions: -

Are those amounts which are set aside of profits for a specific purpose. For example, provision for bad debts, Provisions for discounts allowed or received and provisions for depreciation. These provisions are made in view of some expected events. Any expected future loss relating to the current accounting period must be charged to the income statement of the current year. Similarly, any expected gain in future relating to the current year must be credited to the income statement of the current year. This treatment is essential for computing correct net profit. Care must be taken however to follow the requirements of IAS 37: Provisions, contingent asset and contingent liabilities.

Bad debts and provision for doubtful debts:

Bad debts: Debts due from debtors are shown as an asst. When a debt becomes irrecoverable, it must be written off as bad debt; otherwise, the balance sheet will not show a true and fair view of receivables/debtors. Actually if a debt is considered uncollectible then it would be prudent to remove it totally from the accounts and to charge the amount as an expense to the income statement. The original sate remains in the books as this did actually take place. The debt is however removed as it is now considered that the debt will never be paid and an expense is charged to the income statement. This bad debt is regarded as a loss to the business. We treat this as under:

At the end of the year:

Dr. Bad debts written off account

Cr. The Receivables/debtors account,

These entries effectively close the Bad debts written off account, create a charge to the income statement and the Receivables/debtors restated to a recoverable figure (net).

Example:

As at 31/12, UGX.200, 000 owing from P Bush was written off as bad debt. Show the necessary entries in the ledger accounts.

P Bush

Jan 31 Bal b/f	200,000	31-Dec	
		B/debts W/0	200,000
	200,000		200,000

Bad debts written off account

Dec 31 P Bush	200,000	31-Dec	
		Income Statement	200,000
	200,000		200,000

Bad debts recovered: Bad debts written off in the previous accounting periods may be recovered at tater stage in some cases. In other words, there is a possible situation where debt is written off as

ad in one accounting period, perhaps because the debtor has been declared bankrupt, and the money, or part of the money, due is then unexpectedly received in a subsequent accounting period.

These recovered bad debts are regarded as gain and are treated as under:

Step I Reinstate the debtor:

Dr. Receivables/debtors

Cr. Bad debts recovered

Step 2 Record the receipt of cash or cheque:

Dr. Bank

Cr. Receivable/debtors

Note that this is the usual entry for cash received from a customer.

This double entry may be simplified to:

Dr. Cash account

Cr. Bad debts recovered account -

As the debit entry and credit to the receivables account cancels out each other. However, it may be useful to pass the transaction through the customer's account so that the fact that the debt was eventually paid, or partly paid, is recorded there.

Step 3

Dr. Bad debts recovered account

Cr. income statement

This last entry effectively closes the Bad debts recovered account and recognizes income in the income statement. Note: In examinations, it is possible to circumvent the above steps by simply:

Dr. Bank/cash

Cr. Income statement

As these will be the only accounts whose balances will be affected.

Provision for bad and doubtful debts: It is a matter of common experience that some part of debts outstanding at the last date of the accounting period becomes irrecoverable later. In other words, a doubtful debt is one about which there is some cause for concern but which is not yet definitely irrecoverable. Therefore, although it is prudent immediately to recognize the possible expense of not collecting the debt in the income statement, it would also be wise to keep the original debt in the accounts in case the debtor does in fact pay up. This is achieved as below.

The anticipated loss must be also taken into account for the computation of correct amount of net profit. For this purpose, a provision for bad and doubtful is created and it is charged to the income statement. This provision is credited to the provision for bad debts account and is shown as a deduction from Total receivables/debtors in the balance sheet. The provision for Bad debts may be computed in the following two ways.

i. Anticipated bad debts may be added up to a total figure for the provision for bad debts.
ii. A specific percentage of total receivables/debtors may be computed to get the provision figure. This percentage depends upon debts not recovered in the previous periods and it will be different for different firms.

The provision for bad debts is adjusted at the end of every year according to the total amount owing from debtors. The creation of a provision for bad debts does not affect the personal accounts of the debtors, since these debts have not yet become irrecoverable. The following entries are made in this case:

Provision for bad debts:

(i) On creation;

Dr. Bad and doubtful debts expense

Cr Provision for bad debts account

(ii) To Increase:

Dr. Income statement (with increase)

Cr. Provision for bad debts acc9unt

(iii) To decrease:

Dr. Provision for bad debts account

Cr. Income statement (with the decrease) V

Provision for discount allowed:

(i) On creation;

Dr. Income statement

Cr. Provision for discount allowed account.

(ii) To Increase:

Dr. Income statement (with increase)

Cr. Provision for discount allowed account

(iii) To decrease:

Dr. Provision for discount allowed account

Cr. Income statement (with the decrease)

Provision for Discount received:

(j) On creation;

Dr. Provision for discount received account

Cr. Income statement

(ii) To Increase:

Dr. Provision for discount received account)

Cr. Income statement (with the increase)

(iii) To decrease:

Dr. Income statement (with decrease)

Cr. Provision for discount received account.

The balance on the provision for discount received account is shown as a in the balance sheet.

Depreciation:

Tangible non-current assets except land depreciate Depreciation is defined as the allocation of t of the depreciable amount of a tangible non-current asset to the years in which benefit is expected from the use of that asset ('Depreciable amount' means book value less residual value) IAS Property, plant and equipment; requires the depreciation method used to reflect the pattern in which the asset's economic benefits are consumed by the enterprise (Depreciation accounting will be dealt with later in chapter 11)

At the end of the year, depreciation must be provided on Tangible non-current assets. Here;

Dr. Depreciation expense account

Cr. Accumulated/provision for/aggregate depreciation account

At the end of the operating cycle/financial-year,

Dr. Income statement (with -the depreciation expense).

Cr. The asset account (with the aggregate depreciation) Note: This entry is necessary as far as it is-necessary to comply with the requirements of IAS 16: Property, Plant and Equipment: to show-the net book value of the asset in question.

Corporation tax:

If draft accounts of the business suggest that net profit is earned, a provision must be made for corporation tax to be paid Taxation is real A provision for corporation tax therefore becomes an ability in the balance sheet because it satisfies the definition of a liability, a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources -om the enterprise (IAS 37). -

Thus the accounting entry required is:

Dr. Income statement (with the provision for corporation tax)

Cr. Corporation tax payable

Proposed Dividends:

Dividends area reward to Shareholders. If profits are made, some of it must be appropriated to The shareholders as dividends. Where dividends have been proposed after the balance sheet date, then only disclosure as a note to financial statements is required. This is only necessary to comply with I

IAS 10: Events after the balance sheet. However, where the dividends are proposed before the balance sheet date, then an obligation exists at the balance sheet date and a provision that becomes a liability as per IAS 37 is required.

Thus;

Dr. Retained earnings.

Cr. Dividends payable (Balance sheet item)

Closing inventory:

It is anything but a simple procedure to arrive at the valuation placed on closing inventory, because;

- Initially the existence of inventory, and the quantities thereof, have to be ascertained by means of an inventory count; and
- Following from this, a valuation has to be placed on the inventory, which, as will be seen, may differ according to which accounting policy a company adopts.

At any point in time most manufacturing accounts and retailing businesses will hold several categories of inventory including:

- Goods purchased for resale
- Consumable stores (such as oil) a
- Raw materials and components (used in production process)
- Partly-finished goods (usually called work in progress)
- Finished goods (which have been manufactured by the enterprise)

The closing inventory figure is somewhat affected by the matching and prudence principles.

The matching principle justifies the carrying forward of purchases not sold by the end of the accounting period, to leave the remaining purchases to be matched with sales. This appears a to mean that we would simply carry forward the inventory at its cost to the business. However, the prudence concept requires that losses be accounted for as soon as they are anticipated. In the context of the value of closing inventory, this means that if inventory were expected to

sell below cost after the balance sheet date (for example, because they are damaged or obsolete), account must be taken of the loss in order to prepare the balance sheet.

The amount at which the inventory should be stated in the balance sheet is the lower of cost and net realizable value. IAS 2: Inventories (Dec.2003) describes the accounting treatment for inventories. In particular, net realizable value is the estimated selling price in the ordinary course of business less the estimated costs to completion and the estimated costs necessary to make the sale. Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. The cost of inventories other than those for which specific cost are appropriate, is assigned using the First in first out (FIFO) or weighted average cost formula.

Example:

The following information relates to dosing inventory of Y Ltd.

Item	Cost	Net Realizable Value	Bal. Sheet Figure
	(UGX)	(UGX.)	(UGX.)
Cooking oil.	230	231	230
Bags of rice	1512	1413	1413
Bags of cement	4564	6102	4564
Sugar	1200	2210	1200
			7407

In the above example, inventory has been carried at the lower of cost and net realizable value giving e; a closing inventory figure of UGX.7407. Thus, the double entry would be; DR. Inventory UGX 7,407; CR. Trading Account UGX 7,407.

Summary of Year-end adjustments

The accounting period adopted by an enterprise is known as the fiscal year. The period most commonly adopted is the calendar year, although other periods corresponding to the enterprise's natural business year/operating cycle may be used, particularly for incorporated companies.

Matching concept: Revenues and expenses may be reported on the income statement by (1) the cash basis or (2) the accrual basis of accounting. When cash is received, and expenses are reported in the period in which cash is paid. Most enterprises however, use the accrual basis of accounting. Under the accrual method, revenues are reported in the period in which they are earned, and expenses are reported in the period in which they are incurred in the process of generating revenues. The accrual basis of accounting requires the use of an adjusting process at the end of the accounting period to match properly the revenues and expenses within the period.

Nature of the adjusting process: At the end of the accounting period, some of the account balances are not necessarily correct. For example, the balances of prepaid expense accounts are normally overstated because the day today consumption or expiration of these assets has not been recorded. Likewise, some revenue or expense items related to the period may not be recorded, since these items are customarily recorded only when cash has been received or paid. The entries required at the end of the accounting period to bring the accounts up to date and to ensure the proper matching of revenues and expenses under the accrual method are called Year- end adjustments or simply adjusting entries. Adjusting entries are required for Plant assets (Tangible non-current assets), prepaid expenses, unearned revenues, accrued assets, and accrued liabilities; to mention a few.

Plant assets: The decrease in the usefulness of plant assets is called depreciation. The adjusting entry to record depreciation must recognize the expense as well as the decrease in plant assets.

The adjusting entry debits a depreciation expense account and credits the related aggregate depreciation account. The latter account is called a contra account because it is offset against the related plant asset account. The difference between the balance of the asset account and the balance of the related accumulated depreciation account is referred to as the book value of the asset.

Prepaid expenses: are those costs of goods and services that have been purchased but not used. The portion of the asset that has been used during the period has become an expense; the remainder will not become an expense until sometime in the future. At the time the expense is prepaid, it may be debited to either asset account or an expense account. Either alternative may be elected, since the effect on the financial statements, after adjusting entries, is the same.

Unearned revenues: Items of revenue that are received in advance represent a liability that may be termed as unearned revenue. The portion of the liability that is discharged during the period, through the delivery of goods and services, has been earned; the remainder will be earned in the future. When revenue is received in advance, it may be credited to either a liability account or a revenue account. Either alternative may be used, since the effect on the financial statements, after adjusting entries, is the same.

Accrued Assets (accrued revenues): All assets belonging to the business at the end of an accounting period and all revenues earned during the period should be recorded in the ledger. But during a fiscal year it is common to record some types of revenue only as cash received; consequently, at the end of the period there will be items of revenue that have not been recorded by an adjusting entry which debits an asset account and credits a revenue account.

B Accrued Liabilities (accrued expenses): Some expenses accrue from day o day but are usually recorded only when paid. The amounts of such accrued but unpaid items at the end of the accounting period are both an expense and a liability. It is for this reason that. accruals are called accrued liabilities or accrued expenses. At the end of the accounting period, the amount of the accrued liability must be recorded by an adjusting entry that debits an expense account and credits a liability account.

The effect of omitting adjusting entries: Since each adjusting entry affect both an income statement account and a balance sheet account; the failure to record them will result in an incorrect income statement, statement of changes in equity, and balance sheet.

NOTE: Students are reminded that one of the uses of a journal is to record adjusting entries.

Conclusion

The foregoing chapter has introduced us to the most common adjustments we are likely to encounter in practice. In the next section, we prepare financial statements - Income statement, statement of changes in equity and Balance sheet. The use of the general journal is likely to be a common feature.

Tutor marked questions -study unit 5

Multiple Choice questions

Depreciation is;

a) The amount spent to buy a non-current asset
b) The scrap value of any asset
c) The part of cost of any asset consumed during its period of use by the firm
d) The amount spent in replacing the assets
e) None -

At the balance sheet date the balance on the provision for depreciation account is;

a) Transferred to the depreciation account
b) Simply deducted from the asset in the balance sheet
c) Transferred to the asset account

d) Transferred to the income statement
e) None

A credit balance brought down on a rent account means;

a) we owe that rent at that date
b) we have paid that rent in advance at that date
c) we have paid too much rent
d) we have paid too little in rent
e) None

If a provision for depreciation account is in use, then the entries for the year would be

a) Dr. Asset account, Cr. Income statement
b) Cr. Provision for depreciation account, Dr. Income statement
c) Cr Income statement Dr Aggregate depreciation accounts
d) Cr. Asset account, Dr. Aggregate depreciation account —
e) None

5) When the final accounts are prepared, the Bad debts acco'unt is dosed by a transfer to the

a) Balance sheet
b) Trading account
c) Aggregate bad debts account
d) Income statement
e) None

Rent received in cash during the year amounted to UGX 213, 000 Accrued or owed rent as at 31/12 amounted to UGX 70, 000 What amount of this income should be recognized in the income statement?

a) 213,000 b) 70 000 c) 273, 000 d) 143,000 e) Zero

7) The creation of a provision for bad debts does not affect the personal accounts of the debtors because;

a) These debts have not yet become irrecoverable
b) These debts are never recovered
c) These debts are taken to the balance sheet
d) These debts are not paid.

7) The following is true about Closing inventory except;

a) The closing inventory figure is somewhat affected by the matching and prudence principles.
b) The matching principle justifies the carrying forward of purchases not sold by the end of the accounting period, to leave the remaining purchases to be matched with sales.
c) The prudence concept requires that losses be accounted for as soon as they are anticipated.
d) In the context of the value of closing inventory, c) above means that if inventory were expected to sell below cost after the balance sheet date (for example, because they are damaged or obsolete), account must be taken of the loss in order to prepare the balance sheet.
e) None

8) A provision for corporation tax becomes a liability in the balance sheet,

a) Because it has to be paid
b) Because Government is greedy
c) Because that is the only logical way of doing business
d) Because it satisfies the definition of a liability
e) Because we simply can't pay

9) The balances of prepaid expense accounts are normally overstated because; -

a) The day today consumption or expiration of these assets has not been recorded.
b) They have to be -
c) Accountants like it
d) It is easier to do
e) None

10) Prepaid expenses are those costs of goods and services that have been purchased but not used.

The portion of the asset that has been used during the period become,

a) Equity interest
b) An expense
c) Liability and the remainder wilt not become an expense until some time in the future
d) Problematic for accountants because it is eaten up .
e) None