

- Introduction to Final Accounts with Adjustment
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## Introduction to Final Accounts with Adjustment

For the preparation of financial statements, it is necessary that all the adjustments arising out on the accrual basis of accounting are made at the end of the accounting period. Another important consideration in the preparation of final accounts with adjustments is the distinction between capital and revenue items. Entries which are recorded to give effect to these adjustments are known as **adjusting entries**.

### Key Definitions / Features

- **Adjusting Entries:** Journal entries made at the end of the accounting period to update the accounts before preparing final accounts.
- **Accrual Basis:** Accounting method where revenues and expenses are recorded when they are earned or incurred, not when cash is received or paid.

### Illustrative Example

If salary for December is unpaid at the end of the year, an adjusting entry is made to record the outstanding salary expense.

### Practice Set

- **Level 1:** Define adjusting entries and explain their importance.
- **Level 2:** Explain the difference between capital and revenue items with examples.

- **Level 3:** Prepare adjusting journal entries for accrued expenses and prepaid expenses.

## Answer Key

Adjusting entries are necessary to ensure that the financial statements reflect the true financial position and performance of the business by recognizing incomes and expenses in the correct accounting period.

## Quick Reference

- Adjusting entries update accounts before final accounts preparation.
- They follow the accrual basis of accounting.

## Glossary

- **Adjusting Entries:** Entries made to update accounts at period end.
- **Accrual Basis:** Recording transactions when they occur.

## Outstanding Expenses

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At the end of the accounting period, sometimes a business enterprise is left with some unpaid expenses due to one reason or another. Such expenses are termed as **outstanding expenses** and should be added to the relevant expense in the Trading Account or Profit & Loss Account and shown at the liabilities side in the Balance Sheet.

## Key Definitions / Features

- **Outstanding Expenses:** Expenses incurred but not yet paid at the end of the accounting period.
- Shown as a current liability in the Balance Sheet.

## Illustrative Example

Outstanding salary of ₹5,000 at year-end is added to salary expense and shown as a liability.

## Practice Set

- **Level 1:** Define outstanding expenses with an example.
- **Level 2:** Prepare journal entry for outstanding rent of ₹2,000.
- **Level 3:** Explain the effect of outstanding expenses on Profit & Loss Account and Balance Sheet.

## Answer Key

Journal Entry:

Particulars	Debit (₹)	Credit (₹)
Rent Expense A/c	2,000	
To Outstanding Rent A/c		2,000

Outstanding expenses increase expenses and liabilities.

## Quick Reference

- Unpaid expenses at period end.
- Added to expenses and shown as liability.

## Glossary

- **Outstanding Expenses:** Expenses incurred but unpaid.

## Prepaid Expenses

At the end of the accounting year, it is found that the benefits of some expenses have not been fully received; a portion of total benefits would be received in the next accounting year. That portion of the expense, the benefit of which will be received during the next accounting period is known as **prepaid expenses** and should be deducted from the relevant expense in the Trading Account or Profit & Loss Account and shown on the assets side of the Balance Sheet.

## Key Definitions / Features

- **Prepaid Expenses:** Expenses paid in advance for benefits to be received in future periods.
- Shown as a current asset in the Balance Sheet.

## Illustrative Example

Insurance premium paid ₹12,000 for 12 months on 1st October; at year-end only 3 months benefit is received, so 9 months premium is prepaid.

## Practice Set

- **Level 1:** Define prepaid expenses with an example.
- **Level 2:** Calculate prepaid insurance if ₹12,000 is paid for 12 months starting October 1 and year ends December 31.
- **Level 3:** Prepare journal entry for prepaid expenses.

## Answer Key

Calculation:

3 months benefit received (Oct-Dec), so prepaid for 9 months = ₹12,000 × 9/12 =

₹9,000

Journal Entry:

Particulars	Debit (₹)	Credit (₹)
Prepaid Insurance A/c	9,000	
To Insurance Expense A/c		9,000

Prepaid expenses reduce expenses and increase assets.

## Quick Reference

- Expenses paid but not yet incurred.
- Shown as asset in Balance Sheet.

## Glossary

- **Prepaid Expenses:** Payments made for future benefits.

## Advance or Unearned Income

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Certain incomes received by a business enterprise but the whole amount of it does not belong to the current period. Such portion of income which belongs to the next accounting period is income received in advance and is known as **unearned income**. This is to be deducted from the relevant income in the Trading Account or Profit & Loss Account and shown at the liabilities side of the Balance Sheet.

## Key Definitions / Features

- **Unearned Income:** Income received before it is earned.
- Shown as a current liability in the Balance Sheet.

## Illustrative Example

Rent received ₹10,000 in advance for next year is unearned income.

## Practice Set

- **Level 1:** Define unearned income with an example.
- **Level 2:** Prepare journal entry for rent received in advance ₹5,000.
- **Level 3:** Explain the effect of unearned income on Profit & Loss Account and Balance Sheet.

## Answer Key

Journal Entry:

Particulars	Debit (₹)	Credit (₹)
Cash A/c	5,000	
To Unearned Rent Income A/c		5,000

Unearned income is deducted from income and shown as liability.

## Quick Reference

- Income received but not earned.
- Shown as liability in Balance Sheet.

## Glossary

- **Unearned Income:** Income received in advance.

## Accrued Income

Accrued income refers to the income that has fallen due till the end of the accounting year, but has not yet been received. It is added to the relevant income in the Trading Account or Profit & Loss Account and shown on the assets side of the Balance Sheet.

## Key Definitions / Features

- **Accrued Income:** Income earned but not yet received.
- Shown as a current asset in the Balance Sheet.

## Illustrative Example

Interest on investment ₹1,000 earned but not received at year-end.

## Practice Set

- **Level 1:** Define accrued income with an example.
- **Level 2:** Prepare journal entry for accrued interest ₹1,000.
- **Level 3:** Explain the effect of accrued income on Profit & Loss Account and Balance Sheet.

## Answer Key

Journal Entry:

Particulars	Debit (₹)	Credit (₹)
Accrued Interest A/c	1,000	
To Interest Income A/c		1,000

Accrued income increases income and assets.

## Quick Reference

- Income earned but not received.
- Shown as asset in Balance Sheet.

## Glossary

- **Accrued Income:** Income earned but not received.

## Depreciation

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Depreciation is the decline in the value of an asset, on account of wear and tear or passage of time. It actually amounts to writing-off a portion of the cost of an asset which has been used in the business for the purpose of earning profits. In the Balance Sheet, the asset is shown at cost minus the amount of depreciation.

## Key Definitions / Features

- **Depreciation:** Systematic allocation of the cost of a tangible asset over its useful life.
- Shown as deduction from asset value in Balance Sheet.

## Illustrative Example

Asset costing ₹50,000 with useful life of 5 years; annual depreciation = ₹10,000.

## Practice Set

- **Level 1:** Define depreciation and explain its purpose.
- **Level 2:** Calculate depreciation using straight-line method for an asset costing ₹60,000 with 6 years life.
- **Level 3:** Prepare journal entry for depreciation ₹10,000.

## Answer Key

Calculation:

Annual Depreciation = ₹60,000 ÷ 6 = ₹10,000

Journal Entry:

Particulars	Debit (₹)	Credit (₹)
Depreciation Expense A/c	10,000	
To Accumulated Depreciation A/c		10,000

Depreciation reduces profit and asset value.

## Quick Reference

- Allocation of asset cost over useful life.
- Shown as expense and deduction from asset.

## Glossary

- **Depreciation:** Wear and tear expense of fixed assets.

## Provisions for Bad and Doubtful Debts

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It is a normal feature of business operations that some debts prove irrecoverable. This means that the amount to be realised from these becomes bad. An estimate is made for the amount that may not be recovered and this amount is set aside from the profits to absorb such losses. The amount set aside is known as provision.

### Key Definitions / Features

- **Bad Debts:** Debts that are irrecoverable and written off.
- **Provision for Bad Debts:** Estimated amount set aside to cover potential bad debts.

### Illustrative Example

Debtors ₹1,00,000; provision @5% = ₹5,000.

### Practice Set

- **Level 1:** Define bad debts and provision for bad debts.
- **Level 2:** Calculate provision for bad debts at 5% on debtors ₹80,000.
- **Level 3:** Prepare journal entry for provision for bad debts ₹4,000.

### Answer Key

Calculation:

Provision = 5% of ₹80,000 = ₹4,000

Journal Entry:

Particulars	Debit (₹)	Credit (₹)
Bad Debts Expense A/c	4,000	
To Provision for Bad Debts A/c		4,000

Provision reduces profit and is shown as a deduction from debtors in Balance Sheet.

## Quick Reference

- Estimate of irrecoverable debts.
- Shown as deduction from debtors.

## Glossary

- **Provision:** Amount set aside for probable losses.
- **Bad Debts:** Debts that cannot be recovered.

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