

LECTURE 8

ADJUSTMENTS TO THE FINANCIAL STATEMENTS

LEARNING OUTCOMES

Upon completion of the lecture, the students should be able to:

- Explain and show how bad debts are written off.
- Distinguish the differences between bad debts and provision of bad debts.
- Adjust the expense accounts for accruals and prepayments.
- Adjust the revenue accounts for the amount owing.
- Ascertain the amount of expenses and revenues to be shown in the Profit and Loss account.

Bad Debts

- **When some of the business's customers did not pay for the goods sold to them on credit, the debts are considered bad debts.**
- **These bad debts must be charged to the Profit and Loss Account as an expense when calculating the profit or loss for that period. In addition, the bad debts must be removed from the Asset Account.**
- **This is done by crediting the Debtor's account to cancel the asset and increasing the Expense account of bad debts by debiting it there.**

Reasons for Bad Debts

Among the reasons concerning bad debts are:

- **The debtors may be refusing to pay one of a number of invoices.**
- **The debtors may be refusing to pay part of the invoices.**
- **The debtors may owe payment on a number of invoices and has indicated that only a proportion of the total amount due will ever be paid because the debtor's business has failed.**
- **The debtor's business has failed and nothing is ever likely to be received.**



Provisions for Doubtful Debts

- **In drawing up the financial statements, few objectives have to be achieved:**
 - **To charge as an expense in the Profit and Loss Account for that year an amount representing debts that will never be paid.**
 - **To show in the Balance Sheet a debtors figure as close as possible to the true value of debtors as at the Balance sheet date.**
- **Hence, so as not to overstate the debtors balance and the profit for the period, provision for doubtful debts is needed.**

Estimating the Provision

In order to arrive at a figure for doubtful debts, the business must consider that some debtors will never pay any of the amount owed, while others will pay part of the amount owing only, leaving the remainder permanently unpaid. The estimated figure can be made:

- **By looking at each debt, and deciding to what extent it will be bad.**
- **By estimating, on the basis of experience, what percentage of the total amount due from the remaining debtors will ultimately prove to be bad debts.**

Accounting Entries

- **Bad Debts Account**

This expense account is used when a debt is believed to be irrecoverable and is written off.

- **Provision for Doubtful Debts Account**

This account is used only for estimates of the amount of the debtors remaining at the year end after the bad debts have been written off that are likely to end up as bad debts.

- For the first year the provision is made
 - Dr. Profit and Loss Account with the amount of the provision**
 - Cr. Provision for Doubtful Debts Account [the debtors amount in the Balance sheet will be deducted by the total provision]**
- Increasing the provision
 - Dr. Profit and Loss Account with the increase**
 - Cr. Provision for Doubtful Debts Account [the debtors amount in the Balance sheet will be deducted by the total provision]**

- Reducing the provision

Dr. Provision for Doubtful Debts Account [the debtors amount in the Balance sheet will be deducted by the total provision]

Cr. Profit and Loss Account with the decrease

- If there is a reduction in the provision, it is treated as a gain to the gross profit, and if there is an increase in the provision, it is treated as an expense to the gross profit.

Bad debts recovered

When a debt that has been written off is recovered:

- **Reinstate the debt by making the following entries:**

Dr. Debtor's Account

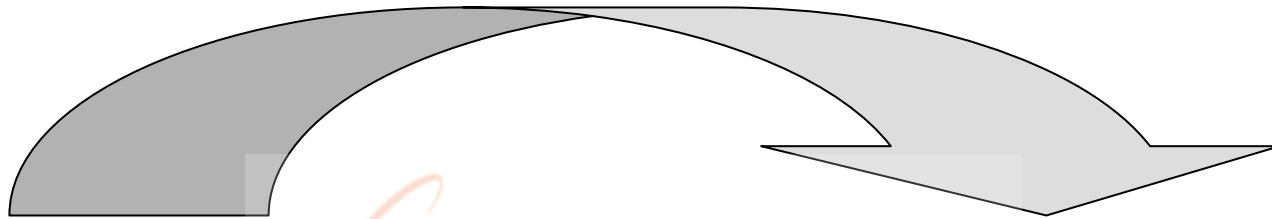
Cr. Bad Debts Recovered Account

- **When payment is received from the debtor in settlement of all or part of the debt:**

Dr. Cash or Bank Account

Cr. Debtor's Account

Accruals



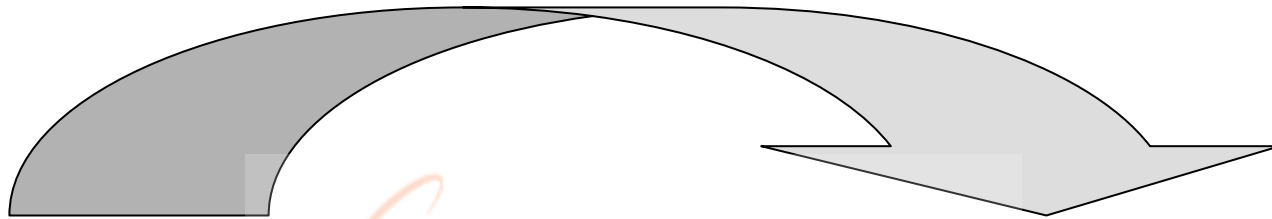
- **Current Period**

**The expense or
revenue incurred**

- **Future Period**

**Cash is paid or
received**

Prepayments



- **Current Period**

Cash is paid or received

- **Future Period**

The expense or revenue incurred

Typical Accounts

- **Accruals**

Accrued Rent, Credit sales etc.



- **Prepayments**

Prepaid expenses, Unearned revenue etc.