Financial Statements Analysis and Reporting
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Lecture - 12
Financial Statements with Adjustments Part-I

Welcome all. In our previous discussion, in our previous lecture we learnt that how to prepare the balance sheet and what is the purpose of balance sheet and how to prepare it some of the items from this statement, these balances were taken to the liabilities and capital side and the some of the items were taken to the asset side, most of the items of the liabilities and capital and assets, I have explained it to you and you can refer to the books and you can understand that if there is any doubt and we will now learn how to prepare little more means complex types of the balance sheets.

Not complex, I would use the term as, but having a more information, covering more information, because till now whatever the profit and loss account we discussed and I explained to you and the statements we prepared and the balance sheet we prepared here that was a very simple kind of the balance sheet and now, we will move towards the balance sheet and profit and loss account having more information's.

Now, how to treat with that more information and that extra information? Here, I was talking to you in my last part of discussion also that here one item is the, here which we are talking as say, closing stock which is given outside this statement and once any item which is given outside this statement, any number of items given outside this statement, we have to give the double treatment to these items means in case of the closing stock in our previous discussion, I have given a double treatment to it one I showed for the first time in the trading account in the credit side closing stock and the second treatment I gave it in the balance sheet.

Why we made that double treatment to this extra item the item outside the trial balance was that, look the items which are given here, the balance is given here, double entry accounting system for these balances has already been completed. We have seen that the first take the transaction to the journal from journal to ledger and ledger to the trial balance and this is the trial balance.

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Problem 2: Financial statements

The following balances are extracted from the books of Kautilya & Co. on 31st Dec., 2011. You are required to prepare the Trading and Profit & Loss Account and Balance Sheet as on that date:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Stock in 1st Jan., 2011	500	Return outwards	250
B/R	2250	Trade Expenses	100
Purchases	19,500	Office Fixtures	500
Wages	1400	Cash in Hand	250
Insurance	550	Cash at Bank	2375
Sundry Debtors	15000	Rent & Taxes	550
Carriage Inwards	400	Carriage outward	725
Commission (Dr.)	400	Sales	25,000
Interest on Capital	350	Bills Payable	1500
Stationery	225	Creditors	9825
Return Inwards	650	Capital	8950
Commission (Cr.)	200		

Closing stock was valued at Rs 12,500.

So, whatever the balances we are found out here either this side or this side double entry treatment has already been done to these balances, but the balances which are outside the trial balance they are extra items, they are not treated as per the double entry accounting system. So, it means we have to while preparing the financial statements profit and loss account and balance sheet, we have to complete the double entry system for these transactions directly in the profit and loss account and the balance sheet that is why we give the double. We make the, or we give the double treatment to these items in the profit and loss account and balance sheet profit and means closing stock we keep on selling we keep on selling till the last day of the year.

So, closing stock you will find always outside the trial balance because you do not stop trial balance takes time to prepare, because see for example, some firms accounting period is from January to December and 31st December is the date of the balance sheet, profit and loss account and the balance sheet. So, by 31st December, if the balance sheet has we have to prepare it means we have to prepare the trial balance some times before the date of the balance sheet, because we have to tally the trial balance also, we have to check for the balances, if some imbalance occurs we have to remove that error also. So, we have to say for example, we have completed the job the work of preparing the trial balance say till the end of November.

Now, but the firms sales are continuing, firms are transactions are continuing. We would not say that we will stop the business in November and then we will complete the job in December all kind of statements and then for the month of December we will not do any business and we will start doing the business from January onwards no business continues. So, it means those transactions which were happening till 13th November, we have already factored them into this statement and the balances have already been created a calculated, but those transactions which are happening after 13th November means from1st December to 31st December those items are left out here, because trial balance is ready. So, those items are taken here as extra and we have to make the double treatment means without taking it to journal, without taking it to ledger, without taking it to trial balance, we have to take these items directly to profit and loss account and balance sheet and we have to adjust it there, that is why here the double entry system is complete, but for these transactions this information double entry system is not complete. So, we will have to give it the double treatment.

Now, there are different items to whom the double treatment has to be given and if number of items are there, then we must be knowing there what are these items which may be available here as extra information and how to treat them in the profit and loss account and balance sheet or how to give the double effect for that. So, here you have number of items and the first one is the closing stock and others are there. So far as I am talking about the double effect of these additional transactions.

These transactions are basically called as adjustments. So, we have to make the adjustments, this information is called as adjustments. We have to treat these adjustments in the books of accounts, in the profit and loss account and balance sheet and then finally, we have to treat them. So, numbers of items are there. These items are pre identified, which normally happen to be there in any organization and any firm and these items are pre identified. So, one item is say for example, this is the closing stock.

Closing stock we have already learnt that how to give the double treatment and how to adjust this figure in the financial statements. So, one effect of the closing stock will be in the credit side of the profit and loss account and second effect of this closing stock will be on the asset side of the balance sheet. So, double effect is complete. There are numbers of other items, which I would like to discuss with you and you should be knowing it in advance, what could be different items having a double treatment or which will be available for the adjustments.

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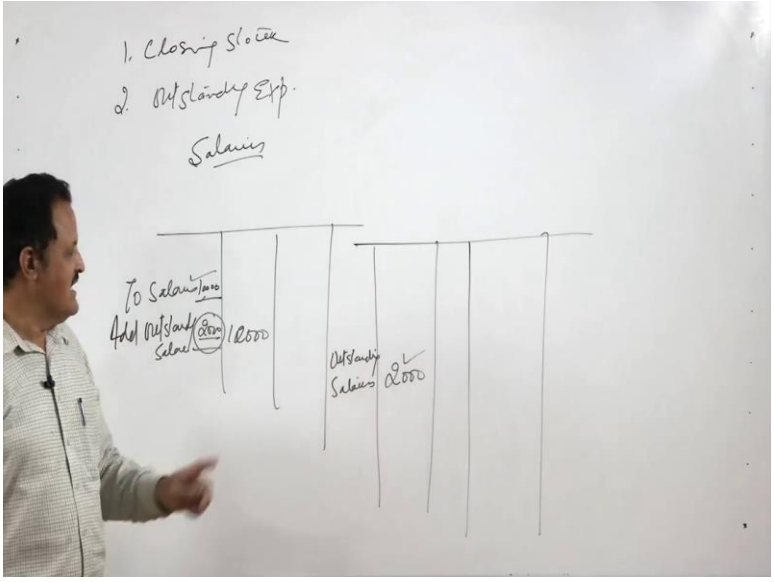

So, first one is the closing stock. We have done and the second one is now we talk about the first one is the closing stock, we have learnt that how to doubly treat it as per the double entry accounting system.

Then second is the outstanding expense. Outstanding expenses are basically, as I shared with you in my previous lecture also, those expenses which have already been incurred by the firm, the benefit of which has been enjoyed by the firm and the payment has not yet been made. So, these expenses for example, we take here outstanding expenses as the salaries of the employees meaning you take these salaries of the employees and these are outstanding, you may find that the information of salaries is also here and the information of the salaries is also.

Here, what does it mean that till now 13th November whatever the salaries have been paid by this firm to their employees they have been adjusted as per the double entry accounting system and we have already calculated the balance, but these salaries some of the salaries are also there which are means people have worked for the firm, but they have not been paid, may be it can be up to 13th November, total salaries are not paid or may be up to 31st December, total salaries the firm has not paid employees have worked, but part of the salaries are to be paid.

So, what we have to do is, we have to find out the total amount of the salaries. How much is paid already? How much is due to be paid? That is the total salaries expense for the current accounting period. Now, in this case we will have to give the double effect to this additional information of the outstanding expenses. So, as I told you must have salaries here also and here also. So, you will take these salaries and where would you take these salaries to, first effect of these salaries will be in the profit and loss account, this is your profit and loss account, you are writing here to salaries and for example, the figure given here is say 10,000 rupees put it in the inner column here, 10,000 rupees salaries and here it is written the salaries worth rupees 2,000 are outstanding that additional information is given. So, you would write here we have which means the information is here we have to give the double treatment. So, first effect here you have to outstanding salaries, you will have to add in the salaries head, to outstanding salaries and this amount is 2,000 rupees.

So, total of the salaries balance item will become, in the, that will come in the profit and loss account will become 12,000 rupees total. This is now the total this much are already paid which are there in the trial balance this much are due to be paid which are the additional investment in the information in the adjustments. So, the total salaries expenditure is 12,000 rupees and second effect of this 2,000, because this is already done this we have to do the double treatment. So, for that second effect of this will come in the balance sheet and in the balance sheet, you will put it in the liabilities side that is outstanding salaries as I told you outstanding expenses.

So, this 2,000 rupees, because this is a liability also till the time we do not pay it, we will keep on showing it in the balance sheet as the liabilities, they are the short term liabilities, current liabilities, but they will be they will be in the balance sheet. So, first effect is adding in the head of salaries in the profit and loss account and second effect will be showing it in the balance sheet as the liability. So, this way you are completing the double effect on the all outstanding expenses may be it is salaries, it is wages, it is a rent, or it could be anything. If any expense, the benefit of which has been enjoyed by the firm, but the payment has not yet been made it is called as outstanding expense and that outstanding expense has to be added in the major head of that expense in the profit and loss account and then it has to be shown as the liability in the balance sheet.

That way we are going to complete the double entry or the double effect for or double treatment for that transaction.

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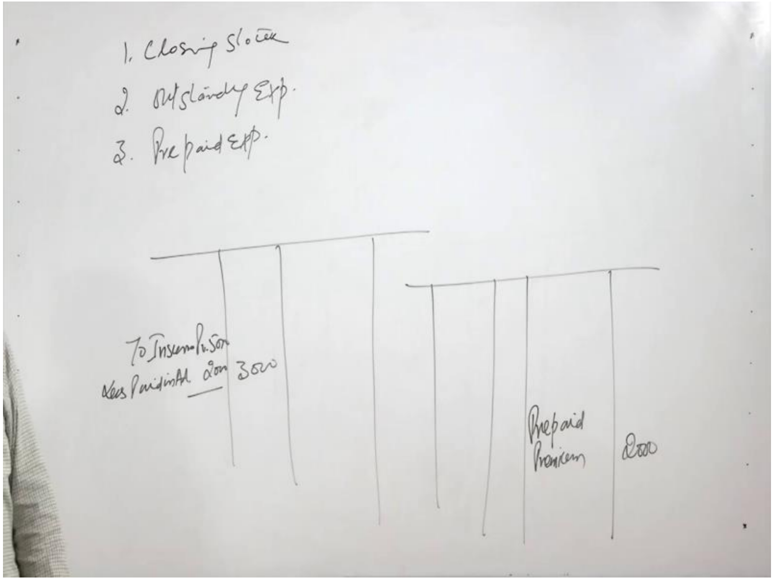

Now, 3rd could be prepaid expenses prepaid expenses. It is a reverse of the 2nd outstanding expenses and prepaid expenses. So, prepaid expenses are the reverse of the second one that is the outstanding expenses. Outstanding expenses means the benefit of which has been enjoyed, but the payment has not been made and reverse of this is that, we have paid in advance, but the benefit has yet not been enjoyed. Firm has, as I told you in my last lecture also that say; advance payments.

Any payment which has been made by the firm as we discussed that I gave you the example that some material is very scarce and supply is to ensure the supply of that material to the firm makes the advance payment to the suppliers. So, those prepaid expenses are to be given the double treatment, because that will also be given as additional information. So, how they have to be treated doubly, I mean given the double treatment in the profit and loss account and balance sheet, we will have to talk about that and we will have to take it here. So, for example, you talk it here is as that is the say; insurance premium, item means insurance premium and total expenditure of the insurance premium, here for example, it is shown here is it is 550, but we assume that the total information given to you there is, 5,000 rupees insurance premium.

And here it is written that insurance premium worth rupees say or the insurance premium is paid up to the June next year. It is written like this, it means our accounting period is ending in December of that particular year and the insurance premium is paid till that June means for the 6 months of the next year also.

It means when you talk about it say; June means we have paid the premium for this year and we have paid the premium for the next year also and that for example, that amount works out as 2,000 rupees. So, you will say total insurance premium which is shown as an expense is 5,000 rupees, but 2,000 out of that which is paid till June is extra, because any premium paid till June next year and we are preparing the profit and loss account till December. So, we cannot account for these expenses which are for the next year in this year that will be wrong. So, what you have to do is, you have to subtract that. So, what we will do; we will prepare again the first effect of this prepaid expense of insurance premium will be in the profit and loss account. So, in the profit and loss account you will have both the things. You will write here to insurance premium and you will show 5,000 rupees here in the inner column. You say they are less paid in advance or prepaid; less prepaid which is 2,000 rupees.

So, finally, the figure of 3,000 will come here and this 3,000 rupees figure is valid only as a premium for the current year till the 31st December of this year. So, we should count for this only, not 5,000 rupees, because that way we are exaggerating our expenses and your profit will be under say valued. So, we cannot do that. So, we have to subtract, those expenses which are not due, but we have made these expenses, we have paid these expenses, where they have to be subtracted for calculating the total expenses, for the current year and 2nd effect of this will be in the balance sheet. So, when you are preparing a balance sheet. So, as I told you earlier also that the balance sheet is the means, whatever is the prepaid expense are here that is considered as asset. So, this extra premium paid worth rupees 2,000, you can call it as a prepaid premium worth rupees 2,000 will be also shown as an asset in the balance sheet.

So, if it is outstanding expense that is a liability and if it is a prepaid expense, then which has not become due, yet that will be shown as asset in the asset side of the balance sheet. So, double treatment of the prepaid expenses, one will be subtracted from the major head in the profit and loss account, because it is not yet due and second thing is that which is not yet due will be shown as an asset by the firm, because the benefit of that will be enjoyed by the firm sometime in future. So, these are the prepaid expenses and the treatment of these prepaid expenses in the financial statements directly, because they are adjustments, they are the transactions after the date of your trial balance. So, we will have to treat them directly in two ways, performing or completing the double entry accounting system.

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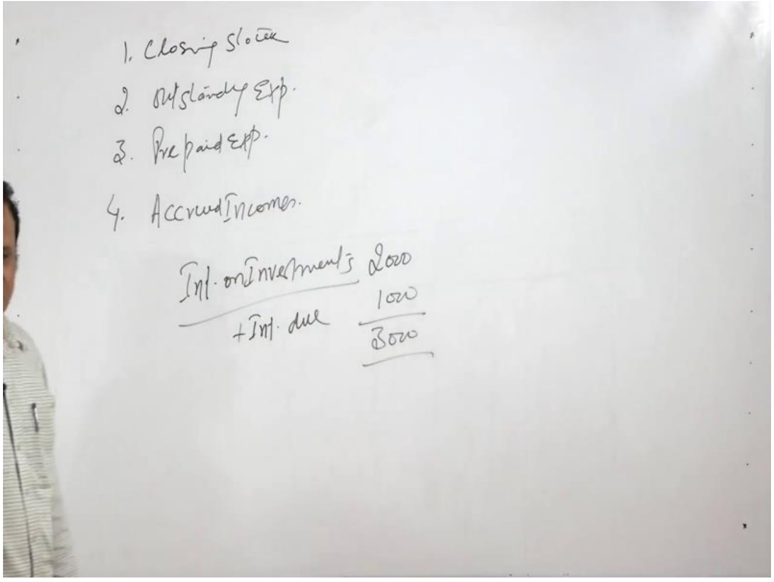

After that, we have the next thing is the accrued incomes. Next adjustment is for accrued incomes. Accrued incomes are like, though incomes which are, we have to take it to the accrued incomes means incomes which have become due to be received by the firm, but they have not been received. Here, it is a prepaid expense means expenses which have been paid, but they were not due. Similarly, here accrued expense incomes are used the term accrued incomes are those incomes which have become due to be received by the firm, but they have not been received in the real terms. So, they are called as accrued incomes.

So, accrued incomes will be that is say whatever the total means, you will have two heads one information will be available here and one information will be available here. So, for example, accrued income we talk about here is the, we take the example of interest on investments. So, it means say for example, we are given a figure here that in the upper part, we are given the figure of say; interest on investment is 2,000 rupees and lower part says; here that interest on investments worth rupees 1,000 is due, but not yet received it means that is also due, but that is not received. So, that has become due, but not been received. So, first will be, so, total interest will be plus interest due and that is 1,000 here. So, that will become the total interest income of that year will be 3,000 rupees.

Now, how to treat it in the, how to give the double treatment to this head, particularly that is the accrued incomes or for us the accrued interest.

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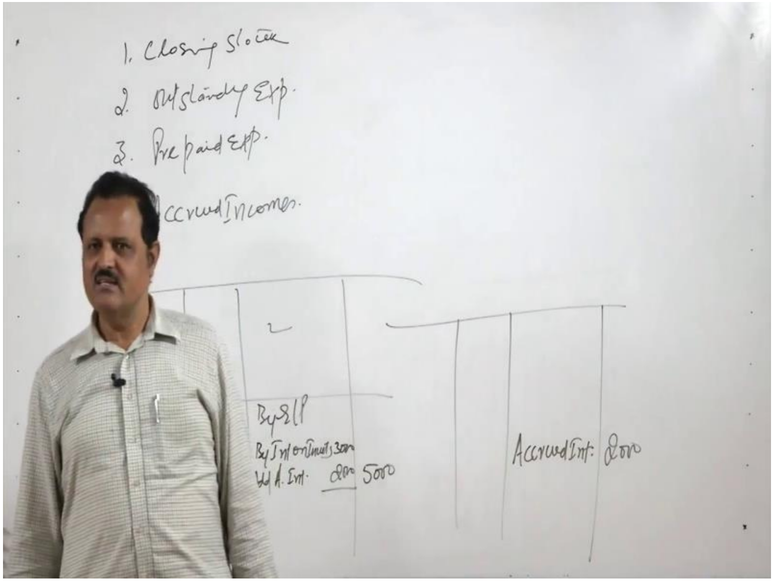

We will have first effect in the profit and loss account. Here, of that particular year you will show it in the credit side, because it is the indirect income, not the direct income. So, after this the trading account is ready here, you will take here the by gross profit and then you will say by interest accrued means interest has become due, but we have not yet received. So, this is the accrued interest and that will be shown on the credit side of this and that accrued part of the interest will be how much. So, say we say here as the total not accrued. We will have to take the both the interest items, one is that is the by gross profit, then it is by interest on investments. For example, you are given already in the upper part in the trial balance you are given 3,000 rupees, put it in the inner column then you will say; add accrued interest accrued interest and that is say 2,000 rupees.

So, it means total income of the on account of interest will be shown as interest in the outer column that is 5,000 rupees. So, one effect of that would income accrued interest is, you are adding that 2,000 rupees balance in the major head of interest which is given here and additional that is accrued part that is 2,000 rupees we are adding. So, total interest income for this year is out of from the interest head, interest on investments head is 5,000 rupees, not 3,000 rupees 3,000 rupees, we have received 2,000 rupees we will be receiving, but we have earned it.

So, this is the 1st effect 2nd effect of this interest will be in the balance sheet. So, in the balance sheet you are going to have the balance sheet like this and accrued incomes which are earned, but not yet received these incomes are shown as assets accrued interest accrued interest is say 2,000 rupees, it will be shown here as income as asset in the balance sheet. Accrued interest will be shown as an asset in the balance sheet, this is the 2nd treatment to this particular item that is the accrued incomes and 1 effect is in the profit and loss account adding into the existing head of incomes and then 2nd effect is that part which is not yet received has been earned, but not yet received will be shown as asset in the balance sheet, this is the treatment of the accrued incomes.

Now, we will take some other items, which are to be treated means additionally outside the profit and loss account, trading and profit and loss account. So, it means which are given additionally outside the trial balance and we will have to treat them in the profit and loss account and the balance sheet.

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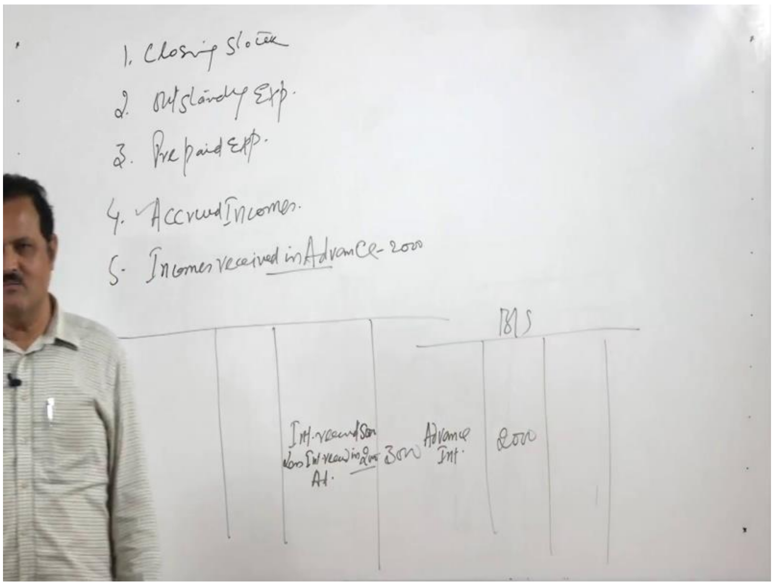

So, next item is the income received in advance and the double effect to this income received in advance. Now, you see reverse of this one. Here, the income was earned, but not yet received, that is the accrued income here the income is received by the firm, but that is not due to the firm. So, how to treat it? It will have the same reverse treatment what we gave the treatment to this item, you will give the reverse treatment to this item and it will also have the double effect and double effect for example, again we take the interest amount, total interest received for example, is given as 5,000 rupees and it is the total balance of the interest given here is 5,000 rupees, interest income, credit balance 5,000 rupees as interest income.

Now, here you are given additional information that interest worth rupees 2,000 is not yet due and has been received in advance it is given here, it means that 2,000 rupees becomes the interest received in advance, that income was not due to us we have received in advance. It means what you have to do is out of these 5,000 rupees interest due for the current year is only 3,000 rupees. So, what I will do, less interest received in advance and that is 2,000 rupees.

So, that way you will calculate the total interest due for the current period and that will be 3,000 rupees. So, how do you treat it in the, you will give the double treatment to it. Double treatment will be one in the profit and loss account and 2nd in the balance sheet. In the profit and loss account, what treatment we gave to this item, that when we showed in the credit side that is the interest income, interest received. Earlier we showed 3,000 and then we made 2,000 plus. So, we get 5,000.

But now we will have to do the reverse. We will show here interest received is we will make the treatment here that is interest received is 5,000 rupees less interest received in advance is 2,000 rupees. So, actual amount will be shown here in the as the income of the current year will be 3,000. Interest income will be 3,000 not 5,000 rupees. So, one effect is that that income which has been received in advance not yet earned will be subtracted from the total income earned. So, we are giving the first effect here, in the profit and loss account and the second effect for this item will be in the balance sheet and in the balance sheet you will show that is the advance interest as liability and that will be 2,000 rupees. So, interest received in advance which is not due, which has not yet been earned it is shown in advance, it will be advance interest and that is the liability till the time it becomes due to be received we will keep on showing this item, this amount 2,000 rupees as liability and we will not treat it is as the income of the current year.

So, this is how to treat the advance, incomes received in advance which are not yet which were not due to be received, but have been received by the firm they are called as income received in advance.

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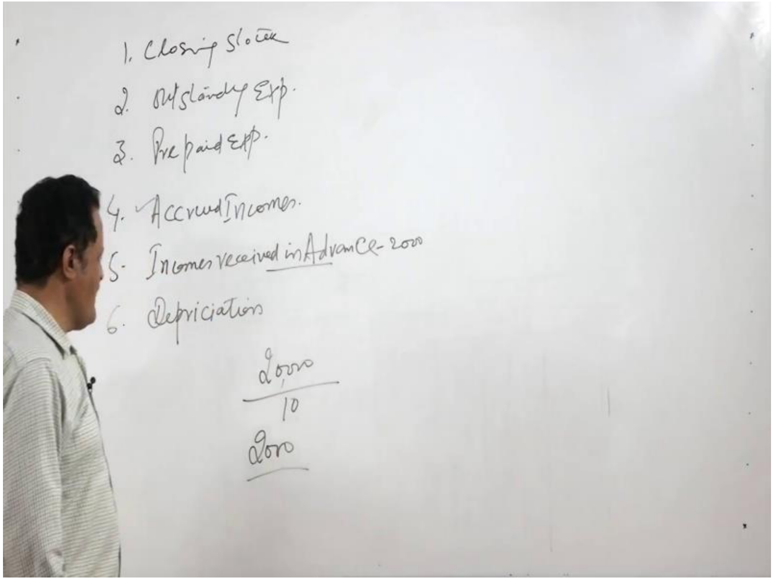

And then there is another item 6th item very interesting item that is called as depreciation. Now, for example, what is depreciation? You must have heard about the term depreciation. What is the depreciation? Depreciation is basically charge on fixed assets, long term assets. Any asset any property of the business which has a life of more than 1 year, we will have to apply the depreciation or the concept of depreciation on those kind of the assets say other than land, but land has no we do not never charge any depreciation on land. Land never depreciates land appreciates, but we never charge any depreciation on the land. So, it means depreciation is not to be charged on land, other than land every asset will depreciate. So, what will happen say for example, we have a building and building today, we purchase is for 20,000 rupees building we purchased for 20,000 rupees and it has a life of 10 years you will divide it by 10 and every year this buildings value is reducing by 2,000 rupees.

So, this 2,000 rupees, reduction in the value of the building, because of bear and tear or may be, because of use or may be, because of any other reason is called as a depreciation. Any reduction in the value of any asset, because of bear and tear, because of any obsolescence, because of any technological reasons, because of any other reasons, if the value decreases then that value is called as reduction in the value of any asset is simply the reduction in the value of any asset is called as the depreciation and that will be divided by the number of years every year equally you are reducing the value of the asset.

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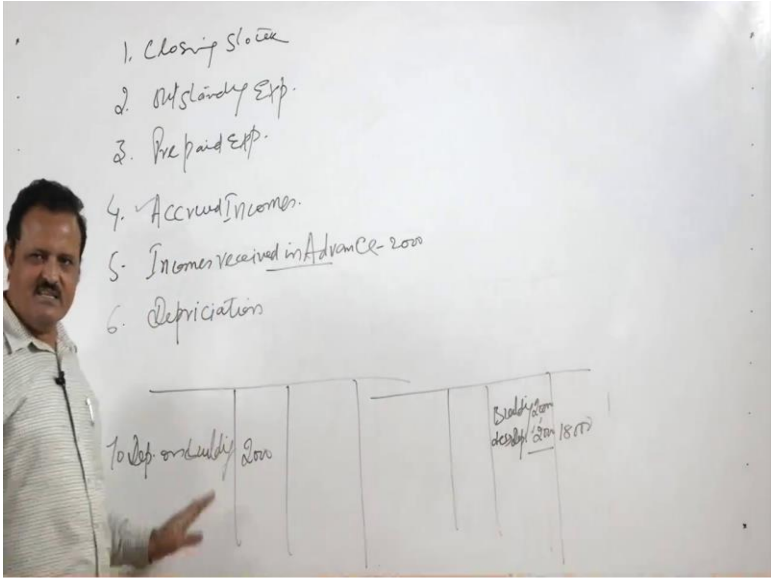

So, that will be depreciation. So, that depreciation, this depreciation is a kind of a expense and the double treatment to this will be 1st will be you will be showing this depreciation as an expense in the income statement or in the profit and loss account and you say that is depreciation on to depreciation on buildings. You will show it here and say for example, this amount is 2,000 rupees this is the 1 effect in the profit and loss account and the 2nd effect will be in the balance sheet.

So, you will write here buildings, asset you will write here buildings, and building is we have purchased the building in the 1st year for 20,000 rupees. Now, this is appreciating at the end of the 1st year by 2,000 rupees. So, less depreciation and the depreciation will be 2,000 rupees. So, building balance or the balance in the building account shown in the balance sheet will be 18,000 rupees. So, it means what will happen? 1st year it will be 18,000, 16,000, 14,000, 12,000, 10,000 and at the end of the 10th year this buildings value will come down to 0.

So, on the one side we have brought these values to 0, we have here the depreciation available here from the profit and loss account. So, on the one side it will become 0 here, it will become 20,000 here. So, 20,000 plus interest we are getting on this money which we are investing somewhere or setting it aside we will be able to purchase a new building and that building will be used by the firm for replacing this building and it means there is no problem that the old building which has become dilapidated or is in a poor state that can be used for, means that can be replaced by the depreciation amount what we have. So, same thing happens in case of the building, plant, machinery, furniture, computer systems, everything, because they are fixed assets, they have a limited life and they depreciate when we use them or because the obsolescence also they depreciate.

So, we keep on charging the depreciation and we keep on debiting the profit and loss account by that amount, depreciation amount and then that total amount we keep amount of depreciation we keep on say, subtracting from the main asset head and after some time this asset value becomes 0 here, we have the sufficient funds plus interest on that we use this money and we replace that old asset with the new asset this is the concept of depreciation.

So, depreciation 1st effect will be in the profit and loss account debit side and the 2nd effect will be in the balance sheet, that we will be subtracting that amount of depreciation from the main asset or the main head of the asset. So, these are some items 1, 2, 3, 4, 5, 6, items we have discussed that how they may be they may be in the form of the additional information available for preparing the financial statements that is there that information out is normally outside the trial balance.

So, that additional information, because double entry system has not been completed for that information so, we will have to directly treat them in the profit and loss account and then the balance sheet and that is why we always have the double treatments. So, far we have discussed the fixed items which will be having, we will be having in the form of additional information and they will require the adjustments to be done and there are many other items we are 15-20 such items. So, 6 we have discussed today and the remaining items, I will be discussing, may be say other items there are so many other items like we have the bad debts, then we have the interest on capital, we have interest on drawings, then we have say provision for the creditors, or say discount on the debtor, provision for the discount on creditors. So, many items are there.

So, all these items I will be discussing first one by one with you. First we have discussed today, then we will be talking about the other items and then we will prepare a comprehensive profit and loss account and balance sheet after adjusting that additional information, additional items and then we will be able to learn that how to prepare a complete profit and loss account and the balance sheet. This I will do in my next lecture.

Thank you very much.