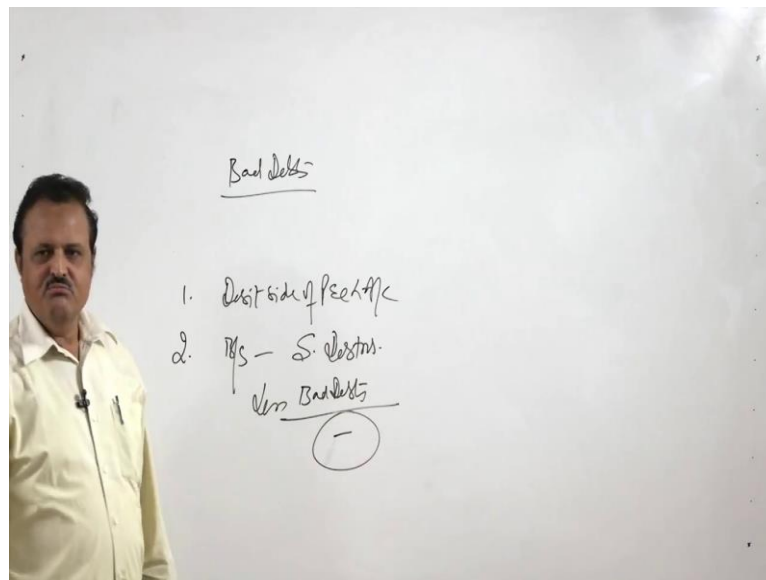


Financial Statements Analysis and Reporting
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Lecture - 13
Financial Statements with Adjustments Part-II

Welcome students. So, we will proceed further what we discussed in my previous lecture we will proceed further from there. And we were talking about the adjustments different type of adjustments are to be done in the financial statements after say learning how to prepare the financial statements without adjustments. Now, we are learning about the adjustments, and we have learnt about the first six adjustments that additional information, adjustments mean the additional information which is given to us, how to adjust that in the financial statements and then finally, take the effect of that to the say profit and loss account and the balance sheet. So, I will take up now the remaining different type of the adjustments.

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And today we will talk about one more adjustment that adjustment is called as the bad debts. Bad debts means, what is a bad debt, bad debt is basically a kind of a loss you would say a kind of a loss which is on the credit sales. When the firm sells on credit, they are selling on one day and sale proceeds will be received at some future date. So, it happens sometimes that 100 percent of the credit sales are not recovered, part of the

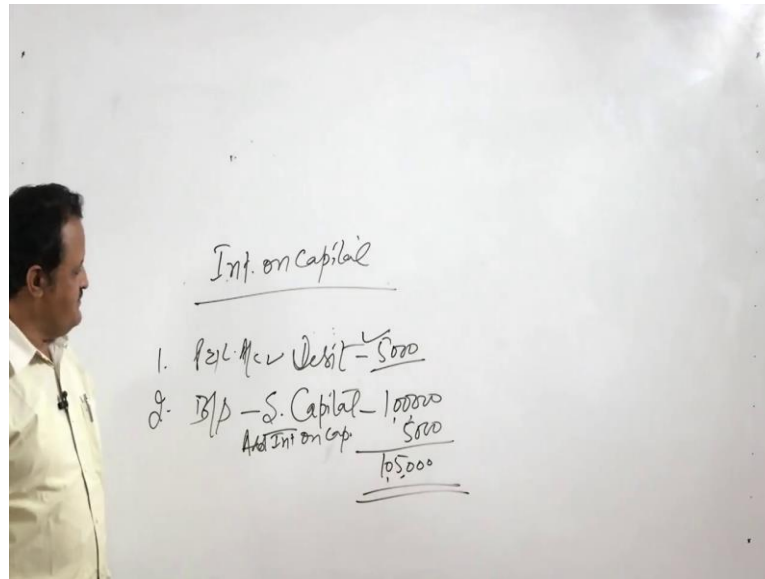
credit sales remain unrecovered, and there is a kind of the loss to the firm, it is a kind of the loss to the company and that is called as the bad debt.

Now, there are two kinds of the bad debts. One is the bad debt which is the company is sure the firm is sure that the bad debt has happened and that part of the credit sales will never come back. Means that will be never be received by the firm the person or the company who has bought from the selling firm, they will not pay to the selling firm and the buyer has either refused the payment or the buyer is not in the position to make the payment back to the company to the selling firm. So, that is called as the bad debt. So, bad debt is basically if it is given in adjustments we have to treat it as a as a loss.

So, we have already discussed that profit and loss account is a nominal account is a nominal statement and we debit that statement with all expenses and losses and we credit that statement with all incomes and gains. So, it is a loss kind of a loss on the sales. So, we are not going to recover it. So, again it will also have a double effect. And the first effect of this will be that this will be shown in the bad debts. First effect will be debit side, debit side of P and L account or statement profit and loss account or the profit and loss statement we will show this bad debts amount in the debit side of profit and loss account, this is the first effect. And the second effect is the balance sheet. And in the balance sheet, we will show this amount as means after deducting, subtracting it from the sundry debtors.

So, we will show one item there in the balance sheet as sundry debtors, and less we will show in the balance sheet this is on the asset side, sundry debtors are assets and we will show current assets and we will show these current assets sundry debtors after subtracting the bad debts loss. So, it is less bad debts. So, sundry debtors, less bad debts and finally, whatever the amount comes that will be shown in the balance sheet. So, your asset means current assets which is the recovery which is the receipt of credit sales on some future date by the amount of the bad debt that receipt that recovery bill come down. So, sundry debtors will be reduced by that amount of the bad debts, and we will show in the balance sheet sundry debtors minus bad debts, and the remaining figure will be shown as a asset in the balance sheet. So, first effect is in the profit and loss account and second effect is in the balance sheet, this is about the bad debts.

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Next thing is the interest on capital next adjustment is the interest on capital interest on capital. It is again a kind of a financial charge. It is a kind of for example, we pay the interest on loan, so that interest on loan we show it on the again the debit side of the profit and loss account. Because interest on the loan is a financial expense and that financial expense has to be recorded and shown in the debit side of profit and loss account. And sometimes we are given an item in the adjustment that interest on the capital also has to be paid. If the interest on capital has to be paid, so what happens if we basically book entry in the real sense firm never pays interest on its capital to its owner or to the shareholder, but if it is to be made book provision then we will have to show it in the books of accounts. So, interest on capital is also shown like the interest on loan and with that amount of interest on capital we debit the profit and loss account.

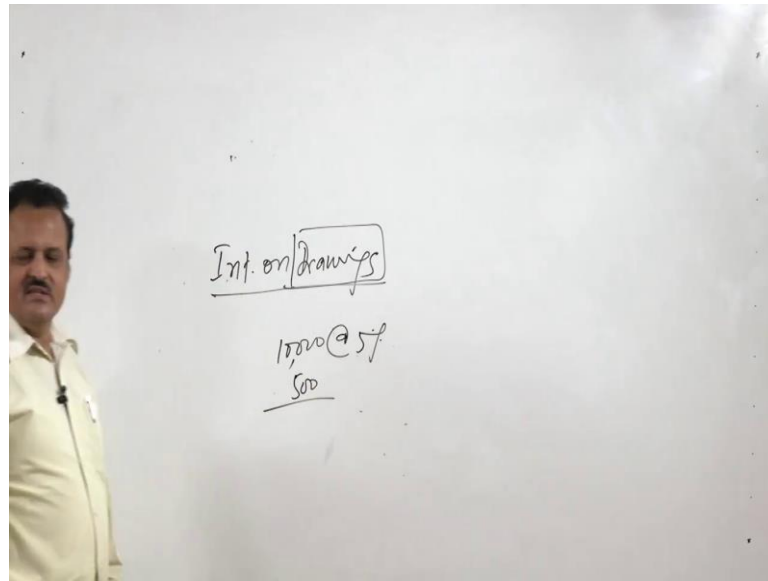
So, again if the interest on capital is given to us in the adjustments, we will have to say make a proper record of that and we have to take the effect of the interest on capital on the financial statements also. So, again the two effects, first effect will be in the profit and loss account, and second effect will be in the balance sheet. So, both the statements both the financial statements get affected because of the interest on capital. First effect in the profit and loss account will be, we will be debiting the profit and loss account with the amount of interest on capital to be calculated that percentage will be given to us in the adjustment that interest at the rate of 5 percent has to be provided on the capital. And it is like the interest on loan. So, we have to show it as expense in the debit side of profit

and loss account, and we have to debit the profit and loss account by that amount of the interest.

And second effect of this will be in the balance sheet and in the balance sheet it will be on the liability side of the balance sheet, because capital is a liability, it is a kind of a liability. So, how we will show this interest on capital in the balance sheet will be like say when we prepare the balance sheet which shows on the top of the balance sheet the first item on the liability side is the capital or you call it as a share capital right. So, we will show that amount of the share capital for example, the figure of the share capital is 1 lakh - 1,00,000 thousand, it is 1 lakh that would be shown in the balance sheet as 1 lakh rupees. And this interest on capital with which we have debited the profit and loss account it means we have taken that money out of the profit and loss account for example, that is 5000 rupees. So, as I told you it is only a book entry, we never pay this interest to anybody only a book entry is made. So, on the one side in debit, we debit the profit and loss account by this 5000 rupees and because it is not paid to the owner of the business or shareholder of the firm, so it is added back in the capital here.

So, the capital amount will become 1,05,000 rupees. So, you will write here add interest on capital. So, your share capital will become now 1,05,000 rupees. So, this is the one means effect that comes in the balance sheet on account of the interest on capital. So, interest on capital has to be treated like this first effect on the profit and loss account debit side with that amount which is given to us, and that because it is not paid to the shareholder its only a book entry. So, we add that amount we withdraw from the profit and loss account, and we add it in the capital account in the balance sheet. So, in the balance sheet the capital appreciates goes up by that amount of the interest on capital with which we have debited the profit and loss account. So, first effect in the profit and loss account, and second effect will be in the balance sheet.

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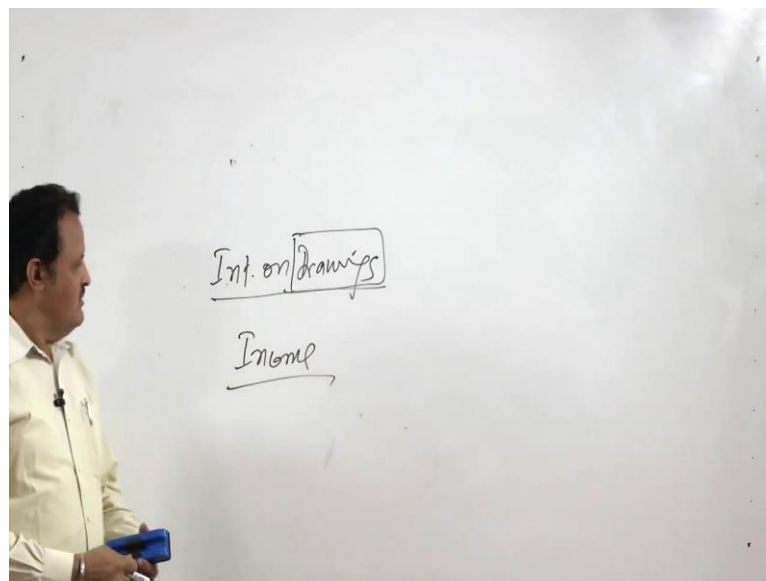
Now, we talk about the next item is interesting item that is interest on drawings. Interest on drawings, this is another item interest on capital and interest on drawings. Now, first of all we would like to understand what is the drawings. Drawings is basically that part of the funds or goods withdrawn by the owner of the business for his personal use, owner of the business for his personal use. Normally, this kind of the things, this kind of the withdrawals of the cash or the goods and services does not happen in case of the company form of organizations, but in case of the partnership firms and in case of the sole proprietor firms drawings exist. For example, now there is one person who is a sole proprietor he is the sole owner of the business, and he withdraws some goods, which he is manufacturing and selling in the market for his personal use. Now, that has to be recorded somewhere and that is called as drawings.

Now, these drawings when they are withdrawn only interest on drawings has to be given the double treatment. How that has to be given the double treatment like, say for example, we are given that total amount of the drawings is 10,000 rupees and we have to pay the interest on that drawing at the rate of 5 percent. Now, in this case if we take the 5 percent of 10,000 rupees, this works out as 500 rupees. So, total amount is assumed that he has not withdrawn 10,000 rupees from the business may be the cash or the goods worth rupees 10,000 rupees, but he has withdrawn the goods or the cash worth rupees 10,500 rupees because we calculate that with interest. Because had this particular amount not withdrawn by the owner, it means this would have been there in the business. And if

it is a capital, if it is a cash, if it is funds it would have been earning something for the business may be the rate of earning is 5 percent. So, and if it is a goods then we could have sold these goods in the market for 10,500 rupees. So, it means drawings are not only considered as the original amount withdrawn by the owner of the business from the business, but along with the interest.

So, we are talking about the interest on drawing means we are here concerned about this 500 rupees, this interest part. So, again we have to treat it in a double manner in a two way effect, the double effect of it will be there, two fold effect of this would there. And in that case, interest on drawings when it is means then it was interest on capital that was the expense; we treated as an expense being paid by the firm to the shareholder. But when it is drawings, it means person is taking kind of a loan for example, we are assuming it is not a loan it never comes back to the firm. Once it is something is withdrawn it is withdrawn by the owner, but we say that it is a kind of the loan and it is drawn with the interest.

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So, interest in that case, the interest on drawings is a income interest on drawings is a income. So, first effect of means again it has to have the twofold effect and twofold effect if you talk about first effect here is in the profit and loss account, and in the profit and loss account you show it on the credit side.

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The image shows handwritten T-accounts on a whiteboard. The first T-account is titled 'Int. on drawings'. Its credit side (right) has an entry '1. Prod. Acc Cr side = 500'. The second T-account is a balance sheet calculation. On the left side (debit), there is '2. D/S - 10,000' and '500' below it, with a total of '10,500' at the bottom. On the right side (credit), there is 'Capital - 1,00,000', '10,000' below it, and '500' below that, with a total of '89,500' at the bottom.

Int. on drawings	
	1. Prod. Acc Cr side = 500

Balance Sheet Calculation	
2. D/S - 10,000	Capital - 1,00,000
500	10,000
10,500	500
	89,500

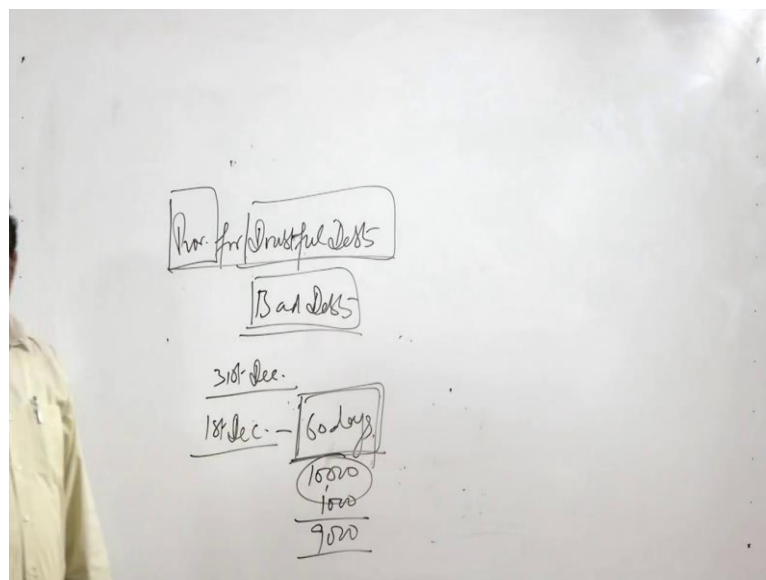
This effect is shown on the credit side. And when you show it on the credit side it is shown as the income. For example, the interest on drawings as income of the firm, and we will show it on the credit side of the profit and loss account.

And second effect of this will come in the balance sheet. And in the balance sheet, we will now talk about both the amounts principal amount he is withdrawn is 10,000 rupees, but he is considered to have withdrawn this amount with interest, so that interest we will add 500 rupees. So, total drawings amount will work out as 10,000 and 500 rupees, and that total amount of 10,500 rupees is considered as withdrawn from the business and it has to be shown in the balance sheet on the liability side in the capital.

So, we will have to subtract whatever for example, the amount of the capital is 10,0000 - 1 lakh, and 10,000 rupees at the rate of with that 5 percent interest he has withdrawn. So, it means he has withdrawn from the business is less capital less drawings less drawings this amount will be 10,500 rupees along with the interest. So, we will show it as less drawings or you can show independently also less drawings 10,000 rupees and then you would say another entry less interest on drawings will be 500 rupees. So, total amount he has withdrawn he invested 1 lakh rupees in the business and out of that he has withdrawn 10,000 plus interest on this 500 rupees. So, it has come down. So, it will be now the balance amount in the capital will be left as 89,500 rupees this is the concept of drawings.

So, when any amount may be the cash or goods or services are withdrawn they are to be recorded in the business in the books of accounts. And maybe it is being withdrawn by the owner, but the owner also is not entitled you have to record that this much of the loss or the erosion of the capital has taken place. So, 1 lakh rupees minus drawings 10,000 and less interest on drawings is 500 rupees. So, total is 89,500 rupees will be now the balance in the capital account. So, first effect is the interest on drawings is income that is to be in the credit side of profit and loss account. And second is in the balance sheet, by subtracting it from the capital basic amount principal amount of the drawings plus interest on that total amount these two 10,500 stands withdrawn from the capital. So, 1 lakh minus 10,500 the balance amount in the capital account to be shown in the balance sheet will be 89,500 rupees.

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Next, we will be talking about some these other adjustments also we have many adjustments. So, we will be taking care of almost all the adjustments and we will be talking about the other adjustments also and then we had now the next is the provision for doubtful debts. Next adjustment is provision for doubtful debts. Provision for doubtful debts, just another adjustment - 10th adjustment. Provision for doubtful debts, number one first you have to understand what are the doubtful debts. Doubtful debts are we had just now we discussed one item that was bad debts. And provision means doubtful debts is also a part of the bad debts is a kind of a bad debts, but this is a

provision, this is not actual bad debts this is a provision for the bad debts, so that is why now I am taking it separately after the bad debts.

Bad debts as I told you is that kind of the credit sales part which will never be recovered by the firm, the buyer has refused to make the payment or he is not able to make the payment or any other reason. So, firm is not going to receive that particular part which has become a bad debt for us or for the firm and firm will never receive it, it is for sure. It has become for sure that they have discussed both the buyer and seller and buyer is not able to pay, so firm has to write it off and they will have to consider it as their loss.

But doubtful debts is the next part to the bad debts. Firm, every firm is allowed as per the Indian company's act all the firms are allowed that as bad debts are happening and all the credit sales are not recoverable by the firms. So, bad debts are taking place. So, it means bad debts should not be considered as only which has happened till the date of balance sheet or profit and loss account that become sure that it will not be recovered.

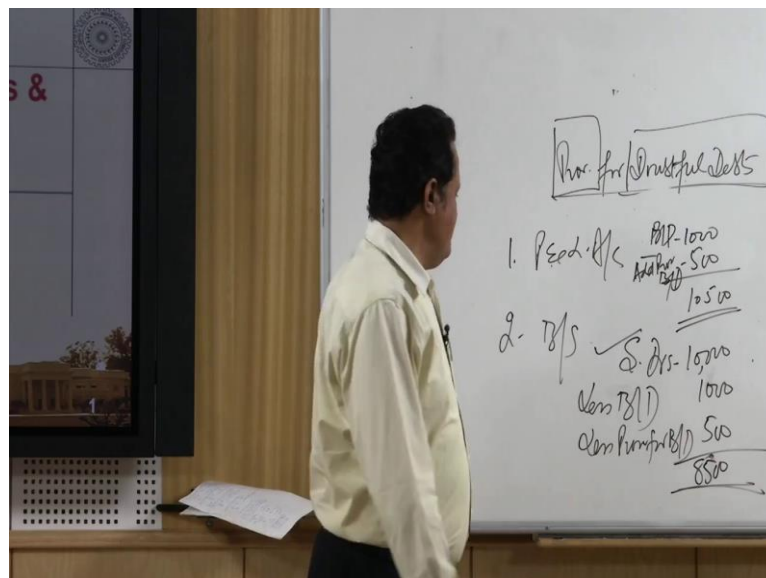
One part is that which will not be recovered, but there are certain amounts that on the date of balance sheet, there will be further more credit sales, part of which will be means doubtful to be recovered. Because we are preparing the balance sheet and the profit and loss account on the last day of the accounting period, may be a year you can say. So, it means if the firm is preparing their balance sheet on say 31st December on any year, and firm has sold on 1st of December to somebody on credit. And he has been given that credit period of 60 days right. So, it means the sales which are made on 1st December he will be they are made in this year, but he will be paying for those after two months it means December one full and January full. So, he will pay somewhere on 31st January next year or 1st February next year.

But they are sales of this year which will be recovered later on. So, now, we can say that as part of the previous sales has become bad debts, part of these sales may also part of means I am not saying full a part of these sales may also become bad debts. Because for example, we have sold to this person for 10,000 rupees, and he has to pay sold in this year, but he has to pay next year in the month of January or February 10,000 rupees, but when the time of payment comes, he says that I am not able to pay you 10,000 rupees. So, we would have to now negotiate with him that how much you can pay, he can say give me a discount of 10 percent and I will pay you not 10,000, but 9,000 rupees. Or he

may say that either you accept 9,000 rupees or I will not pay you anything. In that case firm considers that it is always better to have a loss of 1,000 rupees rather than having a loss of 10,000 rupees. So, they may say that we will give you discount of 1,000 rupees, you pay us 9,000 rupees, and we will close your account.

So, it means this kind of the debts or the credit sales which are to be received in future, they are receivable in future as some part of the sales have become bad debts in the past. So, it means the credit sales to be recovered in the future may a part of that also become the bad debts. But and at that time it becomes the bad debts; and in this year, we are showing as the income of this year it means the firm is in topper. So, under the convention of conservatism, if you remember those conventions, four conventions one convention was the convention of conservatism. So, under the convention of conservatism, firms are allowed under the Indian company's act that they can make provision for the doubtful debts because bad debts are happening in the business. So, they can make the provision for the doubtful debts. So, what we will do we will have to make a provision for doubtful debts, and this provision again has a twofold effect.

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So, first effect of this will be in the profit and loss account. And second effect of this will be again in the balance sheet twofold effect of the provisions. There are two parts one is the bad debts which has already happened, second is the provision further bad debts may also take place. So, firms should be given the benefit of that. So, in the profit and loss

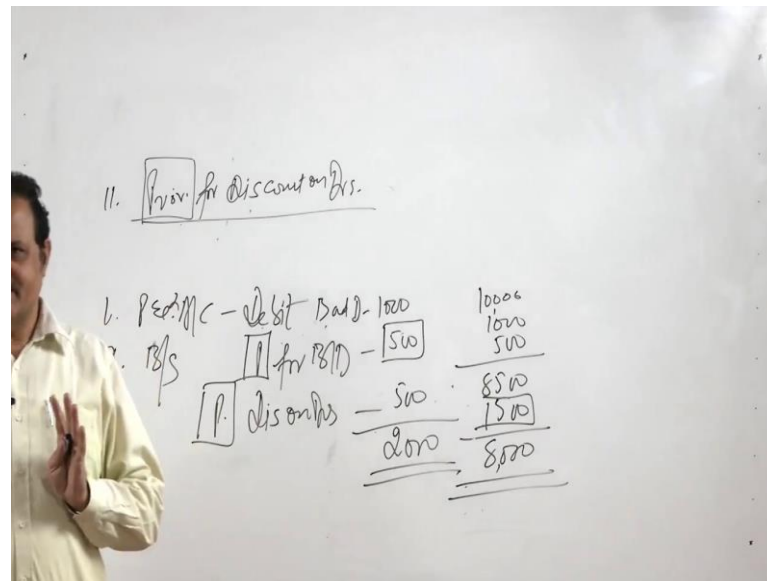
account, what we are doing, we are debiting again now we are debiting the profit and loss account with the provisions amount also, again we debited for the bad debts. For example, now bad debts amount was 1,000 rupees. So, we had debited it and we have in the balance sheet we have subtracted it from the sundry debtors. So, whatever the figure of sundry debtors will be that will be coming down as an asset by 1,000 rupees one part.

Second part is now the provisions for the doubtful debts that after the bad debts further more bad debts can also be there. And if those bad debts take place, for example, provisions are again for 500 rupees that 500 more may not be recovered by the firm when the actual due date will arrive. So, it will what will happen you will first show in the profit and loss account bad debts, bad debts B oblique D 1,000 rupees and then you would write there add provision for bad debts provision for bad debts. So, total amount will become 10,500 rupees. This is the first effect of the provisions like bad debts bad debts have happened provisions made further bad debts may take place.

And second effect is in the balance sheet, again when you show the sundry debtors in the balance sheet as an asset, first you will say sundry debtors for example, the amount is 10,000 rupees, total amount is total credit sales. So, first what we have already learnt about less bad debts B oblique D bad debts this is 1,000 rupees, we will write in the balance sheet. Now, one more less, less provision for bad debts BDs, this is 500 rupees. So, total now the reduction will be by 1,500 rupees. So, now we will not be recovering total amount will be 8,000 total amount which we will not be recovering will be 8,500 rupees sorry which will be not be recovering 1,500 rupees, and total amount which will be recovered expected to be recovered by the firm on account of the credit sales will be 8,500 rupees. Means 1,500 has means 1,000 has become the bad debt already and 500 more will become the bad debt. So, total amount which is unrecoverable by the firm is going to be 1,500 rupees, this plus this. And the balance amount which will be recovered by the firm expected by the firm on the credit sales is 8,500 rupees.

So, provisions for the bad debts are also like bad debts and means one has already happened another may happen, but the treatment is same. Both will be debited in the profit and loss account and both will be subtracted from the sundry debtors in the balance sheet, but step-by-step not together, step-by-step we have to show the independent entries individual entries. And we have to show it independently separately in the profit and loss account as well as in the balance sheet.

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Next is the provision for discount on debtors, this is the 11th adjustment, but again related to the bad debts, provision for discount on debtors. Provision for discount on debtors, again this is a number one to be learnt this is again going to be a provision. Provision means this loss may further happen to the firm. So, we have to make the provision in the current year profit and loss account because these are the sales pertaining to the current year. So, this is the third thing in the row pertaining to miss, it is a kind of a bad debt or possible bad debts which has to be treated not a possible bad debts, but has to be treated like bad debts.

So, provision for discount on debtors will be again having two fold effect. First effect is in the profit and loss account profit and loss account; second effect will be in the balance sheet. And as we are talking about the two effects profit and loss account will be having the same effect as we could see in case of the bad debts. So, with this amount also provision for the discount on debtors, we will be debiting the profit and loss account, it is also again considered a possible loss. And second effect will be as we have treated the first two items bad debts and provision for the bad debts, we will be treating the same in the balance sheet by subtracting it from the sundry debtors.

So, first effect it will be shown in the profit and loss account that by this amount of discount debiting the profit and loss account. So, as I told you there are now there are three amounts. First amount was bad debt as we have discussed and bad debt is as we

assumed that it is 1,000 rupees, provision for bad debts provision for bad debts is as we have seen the figure, we have assumed the figure is 500 rupees. And now discount on debtors, provision for discount on debtors will be again say for example, 500 rupees. So, total amount with which we are going to debit the profit and loss account is 2,000 rupees. It means this amount has already become bad debts will never be recovered for sure, this may not be recovered, and this may also become the bad debts clear then third is the provision for discount on debtors means.

Now whatever the left over sundry debtors are left credit sales are left how much sales were left sundry debtors were left with us as we assumed it was 10,000 in the beginning. We had 1,000 as the bad debt 500 as provision for the bad debt. So, now, how much is recoverable 8,500 rupees is recoverable. But now we are talking about the third item also that for recovering this 8,500 rupees to persuade the buyers, who have bought in the past to pay in future, we may have to persuade them that sometime we have to request them that you make the payment on the due date or some time even before the due date. And if you do so, we will give you discount of 500 rupees. So, now 500 more kind of a loss the firm has to bear and the total recovery on account of the 10,000 rupees credit sales will be 8,000 rupees, total recovery will be 8,000 rupees.

So, it means all almost they belong to the same category. This is a loss to the firm, because they sold on the credit sometime in the past and they are going to recover those credit sales in future may be even after the date of balance sheet. So, how much they are sold for 10,000 rupees, and it is assumed that by 31st December of the current year when we are preparing the profit and loss account 1,000 has become the bad debt, but it is not recorded in the profit and loss account so far. So, we have to record it on the day of profit and loss account.

So, it means it came down to recovery came down to 9,000 possible recovery then we are saying that as 1000 has already happened, 500 further may happen it will become further loss it is 1500. So, it is 8,500 rupees now the possible recovery. And when it may be possible we are assuming that when the due date will arrive may be in January or February next year, we will have to persuade the credit buyers that please make the payment either on the due date or before that. And if you do so we will give you a further discount of 500 rupees. So, we will have to make a provision for that also for example, if

you have not made the provision in the current year profit and loss account for the discount.

And on the due date or before getting the money before due date, we have to give them the discount, it means from where this 500 rupees will come. So, we have already anticipated that situation and we have already made the provision here. And we have that provision of 500 rupees, so we can give 500 rupees discount to that buyer and to different kind of buyers and finally, the total amount to be received by the firm will be on the due date will be 8,000 rupees on account of the credit sales.

Now, if for example, this discount is not required to be given in future on the due date, and this 500 provision we have made, where this 500 rupees will go number one. Second thing is we have made one more provision here for bad debts further 500 rupees, but on the due date there is no further bad debt, and all buyers pay on the due date honestly they pay on the due date and this 500 rupees is also left. So, what to do with this amount of the 500 rupees, this and this which we made two provisions, but they were not required on the due date people paid honestly, and we could recover out of 10,000 rupees, 1000 was the bad debt 500 rupees provisions are not required people have paid honestly 9,000 rupees back to the firm. So, it means we had made the provisions, but it was not utilized.

So, what do with that 1,000 rupees 500 plus 500 that I will discuss with you that is called as the provision for doubtful debts, but we have to reverse it. As we have debited with these two amounts of profit and loss account, we will have to now credit the profit and loss account. And we will have to pass a reverse entry next time; next year if that amount does not become a bad debt, and this discount is not required to be given a reverse entry has to be passed. And while providing making a provision we debited the profit and loss account then while not utilizing this amount returning, this amount back to the firm, we will be making a reverse entry in the profit and loss account showing it as a income or a credit balance in the profit and loss account. But how to do it when I will be talking about the provision for the debtors as a credit balance in the trial balance, we will be given two kind of balances; one balance will be the debit balance, second balance will be the credit balance.

Debit balance means the loss of the year actually which with which we have to debit the profit and loss account. And the credit balance means this provision was made last year,

but it has not been utilized. So, it has to be adjusted. So, we will have to show it as a income in the or gain in the credit side of the profit and loss account. How to do that? I will discuss with you when I will be talking about the credit balance of the bad debt provisions. It means or even if you must be clear here that if you give trial balance, we are given information that the balance of the bad debts is this much which is normally debit balance. And if credit balance is also given it means that credit balance we have to adjust we had provided in the previous year, but that has not happened as the bad debt and we had not to give any discount also. It means that money is saved 1,000 rupees saved, and we will have to pass a reverse entry show it as a income in the credit side of the profit and loss account.

So, when we make a provision, we show it in the debit side, but when we do not utilize those that money set aside by provisions and that is saved we have to reverse it back to the firm we have to return it to back in the next year's profit and loss account. And we show as a income or a gain in the credit side of the next year's profit and loss account. This is all for today in this lecture up to these adjustments eleven adjustments we have talked so far; remaining part of the adjustments, I will be talking to you in my next lecture.

Thank you very much.