

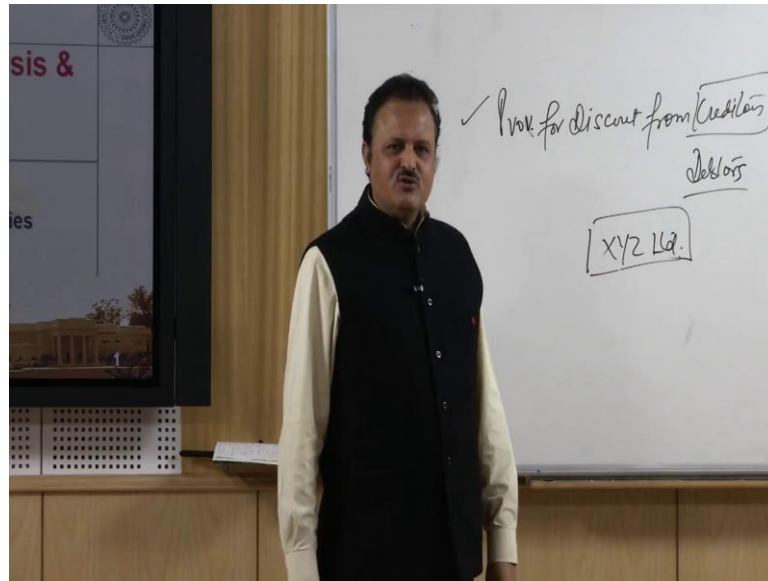
Financial Statements Analysis and Reporting
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Lecture - 14
Financial Statements with Adjustments Part-III

Welcome students. So, we are discussing the adjustments to the financial statements. And in my previous lecture, I discussed with you some of the adjustments. And some more adjustments are remaining which we will be discussing today in this lecture. And after this, we will move to learn how to prepare the financial statements that is the profit and loss account and balance sheet with the adjustments. So, now I will take up the remaining adjustments. And yesterday in my previous part, I was talking to you that some adjustments we did, and one was that is the say bad debts and then provision for doubtful debts and then we talked on the discount on debtors.

So, all these three adjustments when we take into account for preparing the financial statements. We assume that the total credit sales which have been made in the past and will be recovered on some future date will not be recovered in full. Part of that has already become bad debt on the date of preparing the balance sheet. For furthermore some part is expected which we call it as doubtful debts may not be recovered. And the third is that to prompt the people to make the payment may be on the due date or before the due date we have to get some discount. So, we have to make the provisions for that also and we discussed that how to deal with these three adjustments bad debts, provision for doubtful debts and provision for discount on debtors in the financial statement. So, we saw that one effect was in the profit and loss account, and the second effect was in the balance sheet.

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Now, the next adjustment I am going to discuss with you is that is the provision for discount on creditors, provision for discount from creditors. So, it means here first you have to focus upon who are the creditors. Earlier we talked about the term debtors. So, debtors means to whom any firm has sold on credit they are sold on one particular date and that amount will be recovered in future date; so from that the payment will be recovered they are called as the debtors. And similarly, if the firm is selling their production their finished goods on credit and the payment will be received in future.

Similarly, the firm who is seller now we are talking about to whom they are selling means to the debtors, they can be the themselves debtors also means it is a process manufacturing process is first the firm buys the raw material. They process it convert that into the finished goods, and these finished goods then are sold in the market. So, when the goods are sold in the market on credit, we create debtors in the balance sheet, but similarly the firm who is selling they can be the buyers also. Buyers means first they buy the raw material and then they process that raw material and convert that into finished product and sell that in the market.

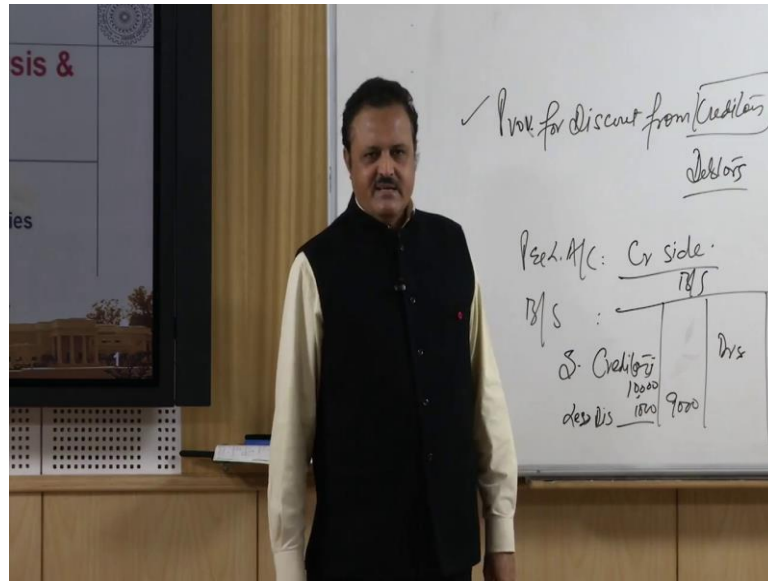
So, now, when they are buying the raw material on credit, when they are buying, if they can sell on credit they have the right also to buy on credit. When they are buying on credit, for example, raw material it means they become the debtors to the suppliers of the raw material; and the supplier of the raw material is a creditor to a firm who is buying on

credit. So, as the firm in question, say for example, we assume here the firm is XYZ limited earlier that firm XYZ limited was seller in the market in that way they are the creditors. But now we are talking about for this particular adjustment provision for discount from creditors, this firm XYZ limited has purchased raw material from these suppliers; and that raw material purchased is on credit. When it is bought on credit, it means this firm XYZ has to pay to them if they are buying material today, but they have to pay them on a future date. And when they have to pay them on the future date it means they have to pay to their creditors.

So, as we discussed provision for discount for debtors, when this firm can give discount to their debtors to prompt them to pay the due amount on the due date or before the due date, so they give some discount. Similarly, this firm can also be given some discount by these creditors to prompt this firm to either make payment on due date, so that there is no default by this firm, or this firm can be persuaded by these creditors that if you pay us before date we will give you this much of discount. So, as we have made the provision we discussed in the previous lecture about the discount to the debtors. Similarly, we have to make a provision for receiving that discount from the creditors, so that is why this adjustment is there provision for discount from creditors. So, creditors can also give some discount to this firm who is now a buyer not a seller, buyer of the raw material.

So, if that provision we have to make if the provision is there and we have to make financial statements, then again we have to have it record it in the profit and loss account and balance sheet. And it has a double effect.

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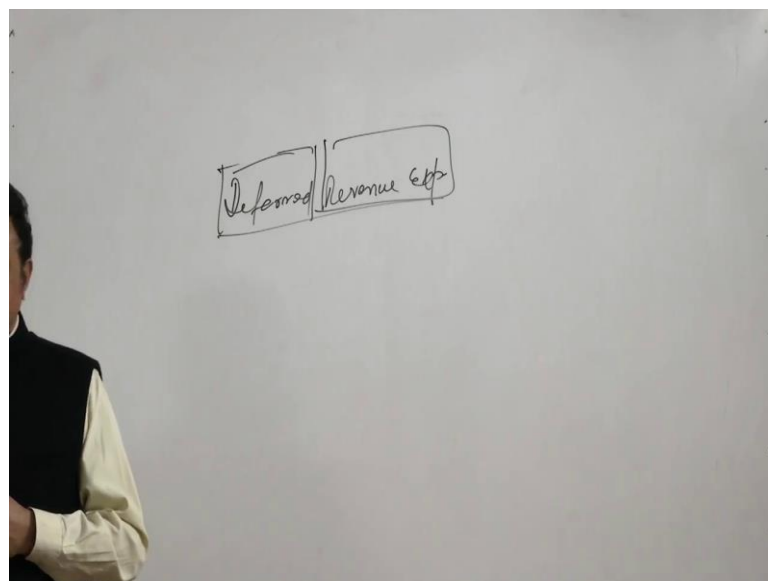
And the first effect of this will be we will take here again the profit and loss account and second is the balance sheet. So, first effect here profit and loss account means when the discount provision to the debtors was made, we debited the profit and loss account because that was a future loss or expected loss right. But now then discount is expected to be received by this firm from their suppliers, in that case, it is expected future gain. And when it is a gain we will be crediting the credit side, crediting the profit and loss account because this is the expected income discount is a income kind of, and we will be showing that provision in the credit side of profit and loss account, and the second effect will be in the balance sheet.

In the balance sheet, as we discussed that when there are the credit buyers from the firm XYZ limited, they are called as debtors, but reverse of that is that when anybody sells on credit to XYZ limited, they are creditors, and creditors are always liabilities. And liabilities are shown in the balance sheet on the liability side. So, for example, this is a balance sheet, and we are showing total debtors as assets. So, debtors are shown here as assets and creditors are liabilities. So, they are being shown here as creditors, and some particular amount will be here. Now, when we are expecting to have some discount from the creditors, so what we will do the total amount of the creditors which is given to us in the trial balance say it is 10,000, we will put it in the inner column and then we have to adjust this. So, we will subtract that amount less discount and discount will be 1000 rupees. So, it means now our creditors are left as 9,000 rupees.

It means we are not say expecting to pay them 10,000 rupees we are expecting to pay something less because creditors may also give some discount to XYZ limited. And if they give some discount say discount is 10 percent, so it is 1000 rupees and 1000 rupees less will be paid by this firm - XYZ limited to their suppliers. So, total creditors in the balance sheet to be shown will be 9,000 rupees, because creditors are liabilities and when the liabilities are reducing by the amount of discount. So, you are showing total creditors in the inner column then adjusting this 1000 rupees, and then you are putting in the outer column the 9,000 rupees will be coming here. It means the double effect of this is first is it is income expected income in the credit side of profit and loss account.

And the second thing is in the balance sheet that we have to show in the liability side of the balance sheet by subtracting it from the creditors or you call it as sundry creditors. And sundry creditors will be reduced by the amount of expected discount. So, this is how we treat the provision for discount on creditors.

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Now, we will talk about the next adjustment that is deferred revenue expenditure. This is another important adjustment we should learn and how to deal with this particular item that is deferred revenue expenditure. I would like to discuss with you that deferred revenue expenditure. What is this deferred revenue expenditure? If we talk about the deferred revenue expenditure, here are the two important parts, one is the deferred and second is the revenue expenditure. I have talked to you earlier also that what is a revenue

expenditure, revenue expenditure is the one that benefit of that expenditure is enjoyable to the firm only for a period of maximum for a period of one year that is 12 months that expenditure is called as the revenue expenditure. But now we call it as deferred revenue expenditure means that revenue expenditure which is not chargeable to the current year's profit and loss account, but that has to be deferred.

Now why we defer some expenditure some revenue expenditure, which is not chargeable to the profit and loss account of the current year, why we are deferring it we have the reasons for that. Sometimes what happens that the expenditure incurred is of a kind that the expenditure is incurred today, but the benefit of that will accrue to the firm for the next say 2, 3, 4 years much more than one year. So, it is not justified that you debit this means you take this total expenditure to the debit side of profit and loss account, and debit the profit and loss account with the total expenditure incurred in the current period means if the benefit is going to accrue in the future periods also.

So, why not to proportionately distribute to over the number of years? So that the profit of the current year is not distorted, it does not come down seriously or significantly. And if we are proportionately dividing this expenditure over the number of years, in that case the profit is shown in the current year in the next year, next to next year or may be till fourth year till that expenditures benefit will be coming to us will be proportionally adjusted will be taken care of.

So, what we do that how we deal with this in the financial statements, this adjustment is dealt within the financial statements that we use the process for treating this in the financial statement deferred revenue expenditure we use a process and that process is called as amortization.

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The image shows a handwritten T-account on a whiteboard. At the top, the word 'B/S' is written. The T-account has two main columns: 'Assets' on the left and 'Liabilities' on the right. In the 'Assets' column, 'Ad. Exp.' is written. In the 'Liabilities' column, '50,000' is written. To the left of the 'Assets' column, there is a calculation: 'Advertisement' is written, followed by '-50,000' in a circle, and then '1,00,000' in a circle below it. A bracket connects the '-50,000' and '1,00,000' to the 'Ad. Exp.' entry in the 'Assets' column.

B/S	
Assets	Liabilities
Ad. Exp.	50,000

Advertisement
-50,000
1,00,000

When we follow the process of amortization, what we do that whatever the expenditure we incur in any particular year the benefit of which or which that expenditure is called the deferred revenue expenditure total expenditure is capitalized in the balance sheet total expenditure. For example, I give you the example of that expenditure is that expenditure on account of advertising. Now, advertisement expenditure or advertising or the advertisement expenditure and firm has spent say 5 lakh rupees today, and the benefit of this advertisement expenditure or expenditure on advertising will be accrued to the firm in the next say next 5 years that is the expenditure on the advertisements and this amount is 5 lakh rupees. Now, the benefit of this will be accrued to the firm in the next for the next 5 years. So, it is not justified to put this expenditure to show this or debit the profit and loss account of the current year with this total expenditure of 5 lakhs.

So, what we will do? We will capitalize this. We will take it to the asset side of the balance sheet, this is the balance sheet and this is the asset side of the balance sheet, this is the assets and this is amount. Now, we write here as that is the advertisement expense, we are capitalizing, we are showing the total amount here as 5 lakh rupees. So, it means putting it in the asset side of the balance sheet, though it is a expenditure, but it is not a asset it is a expenditure deferred revenue expenditure. So, we will be capitalizing this total expenditure by taking it to the asset side of the balance sheet and total amount is shown as 5 lakh in the balance sheet.

And now we are assuming that this benefit will come to us in the next 5 years. So, what we will do we will divide it by 5, and every year the profit and loss account will be debited with 1 lakh rupees. So, what will happen now this expenditure which is the total expenditure is 5 lakh rupees deferred revenue expenditure. So, the current year revenue expenditure will be only one-fifth of it that is only 1 lakh rupees, so the double effect of this part which we are considering for the current year, but we will do here that we will subtract that is less expenditure for current year this is 1 lakh rupees we will subtract.

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The image shows handwritten T-accounts on a whiteboard. At the top, 'P/L' is written. Below it, there are two T-accounts. The first T-account is for 'Assets' and the second is for 'P/L'.

Assets	
Machin	4,00,000
Acc Dep.	40,000
	<hr/> 3,60,000

P/L	
Ad. Exp.	50,000
Acc. Exp. P/L	1,00,000
	<hr/> 1,50,000

On the left side of the P/L T-account, there is a vertical line with 'To Ad. Exp. 1,00,000' written next to it.

So, one effect will be that out of 5 lakh rupees, 1 lakh rupees is subtracted from the balance sheet and now the balance in the balance sheet is left as 4 lakh rupees, and this 1 lakh rupees first effect will be in the profit and loss account. And when you are preparing the profit and loss account you write here to advertisement expense and this is 1 lakh rupees. So, this is the double effect we are completing. So, it means total expenditure this 5 lakh rupees is the deferred revenue expenditure, it is not a current years expenditure, deferred revenue expenditure which is capitalized and through the process of amortization for the current year amount permissible or admissible is only 1 lakh rupees. So that amount we took we withdrew from this and we debited the profit and loss account. So, balance left in the asset side of the balance sheet is 4 lakh rupees and now 1 lakh rupees is debited in the profit and loss account.

And next year we will do the same thing that we will withdraw we will subtract this one more lakh rupees from here we will put it here. So, the balance will come down to 3 lakh, then 2 lakh, then 1 lakh and at the end of the fifth year this the expenditure will go down to 0 means this will be removed from the balance sheet. And by 1 lakh expenditure each year which we incurred in the 0 year, in the next 5 years we are covering it. So, it means that the 5 lakh rupees will be recovered by the firm; and from the balance sheet, this item will be removed.

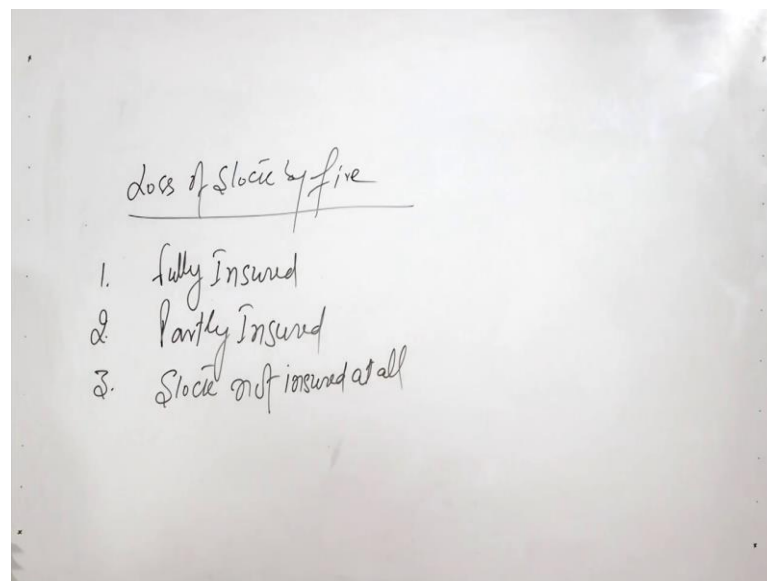
So, means this process of the amortization is almost same as the process of charging depreciation on the fixed assets. When we charge the depreciation on the fixed assets what we do. So, for example, we have purchased a particular machine, now that machine is shown as an asset in the balance sheet and the total amount we say for example, the machine is for the 4 lakhs. So, we show that we capitalize that total amount because that is the fixed asset which can be touched observed or seen. So, we show it in the balance sheet at the asset side, and when we are purchasing the machine we are capitalizing the total amount showing it in the asset side of the balance sheet.

And now at the end of the first year, for example every year we have to charge 10 percent depreciation. So, every year we will be subtracting. So, what we do here less depreciation that is say 40,000 rupees. So, we subtract it. So, at the end of the first year the balance will be left is that is 3,60,000 rupees. So, every year we will be subtracting forty thousand rupees each after 10 years the balance in the machine account or the machinery account will come down to 0 or if there is any scrap value left then we will take care of that. And finally, that total amount which is spent on say buying a machine is recovered and that can be used for replacing the old machine with the new machine and we already have got the money in the depreciation fund account.

So, same is the case with the amortization of the deferred revenue expenditure also, because it is not justified to show that expenditure in that year's profit and loss account. So, it is better that you capitalize it, take it to the asset side of the balance sheet and show it capitalize the total amount that is advertising expenses here and then it is deferred revenue expenditure. And every year we see that in the next five year this amount should be recovered in the equal proportions. So, in the first year, you debit means subtract this that is say 1 lakh rupees; and with that you debit the profit and loss account; second year 1 lakh, third year 1 lakh, fourth year 1 lakh fifth year 1 lakh and that way.

So, the first effect of that will be that the total amount will go to the asset side of balance sheet and only 1 lakh for the current year that is equal to the current years expenditure that will be subtracted. And that 1 lakh which is subtracted from the capitalized part will be taken to the second effect will be in the profit and loss account and that will be debited in the profit and loss account. And that way the treatment of the deferred revenue expenditure will be over. So, this is the, this adjustment that how to deal with the adjustment of the deferred revenue expenditure.

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Now, the next adjustment we will be talking about is the loss of stock by fire, loss of stock by fire. If any fire occurs in the warehouse of the company, and loss of the stock takes place, part of the stock is destroyed. Now, how that has to be treated in the books of accounts in the financial statements. Loss of stock by fire can be treated in three ways, three important ways. Three ways means there can be three different situations first situation is there is a loss of stock by fire, but the stock was fully insured. So, first situation is fully insured. The stock is fully insured it can be. Second situation can be the stock is partially or partly insured, the stock is partly insured. And third situation can be stock is stock not insured at all insured, it is not insured at all, there is no insurance taken by the firm. Three different situations - fully insured, partly insured or not at all insured.

Now, if either of the three situations is there what will we do, and how to treat this loss of stock by fire in the financial statements. Now, let us consider one-by-one. Stock is

fully insured; stock is fully insured. If it is fully insured then it is not a loss because it will be compensated by the insurance company to the firm, this loss will be compensated by the insurance company to the firm. So, in that case, what we have to do is it has again a double effect, but the effect here comes only in two accounts.

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Loss of Stock by fire

1. Fully Insured

Trading A/c		Profit & Loss A/c	
1. Trading A/c		By Sales	1,50,000
2. B/S		By C.S.	50,000
		By Insurance	2,00,000
			<u>2,00,000</u>

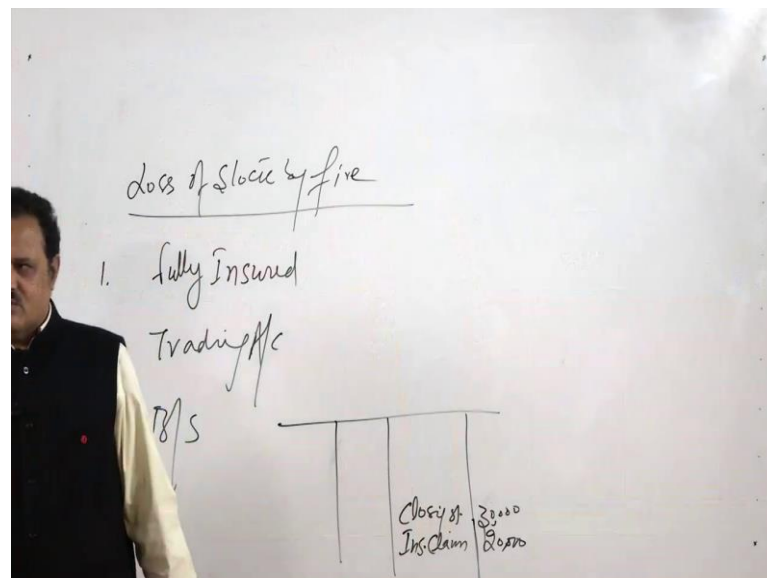
One is in the first effect is going to be there in the trading account not in profit and loss account, it is in the trading account which is the upper part of the profit and loss account the income statement. It has two parts trading account and profit and loss account, and in total we call it as a income statement.

And second effect of this will be in the balance sheet. So, in this case, when we talk about this, so we will have to think about how to deal with this. And in this case, trading account because in the trading account, what you show this is a trading account. Trading and profit and loss account, we write like this you have seen when we prepare the trading and profit and loss account of the firms without adjustments. And we put here all direct expenses that is direct material, direct labor and direct other expenses. And we write here by sales by closing stock. And the difference of these two we calculate is to gross profit this is the difference we have been doing which you if you recall we have been discussing, we have already discussed we have already talked about it.

Now, when there is no loss of stock by fire or anything, we call it as closing stock. But say for example, total sales amount is 150,000 and the stock is 50,000. But when the fire

broke out stock worth rupees 20,000 was burnt in fire, it means that the stock worth rupees 20,000 is burnt in fire it means this 50,000 remained as 30,000 rupees. So, by closing stock will be 30,000. And by insurance claim you write here by insurance claim 20,000 rupees will be shown here. It means we have now sold 150,000 rupees goods 30,000 goods are now with us in the stock which can be verified, and 20,000 worth of the stock was destroyed, and now that is going to be recovered from insurance company. So, finally, we have the total balance of 200,000 rupees here - 2 lakh rupees here, and there is no loss actually to the firm right there is no loss to the firm at all. But we have to show it under three heads sales, closing stock and by insurance claim. This is the treatment in the trading account, if the loss is fully or the loss of fire is fully insured.

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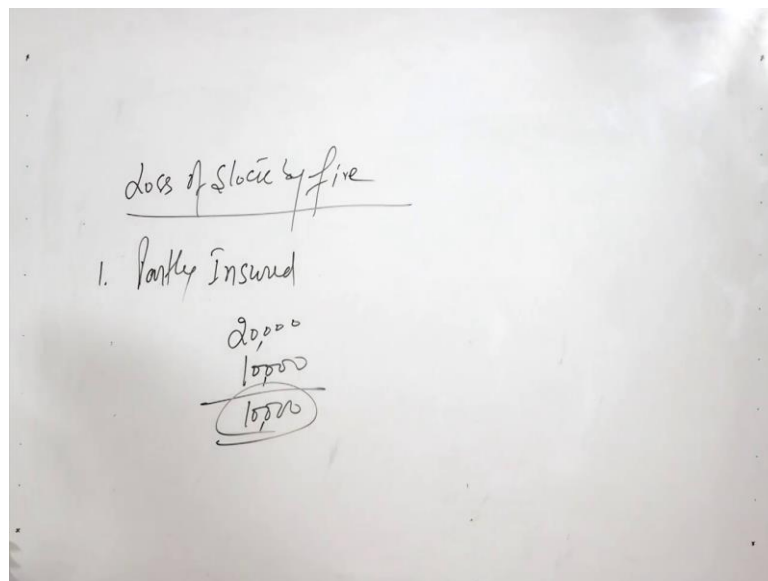


Second part of or second effect of this will be in the balance sheet. In the balance sheet, you will be showing it on the asset side, because where we show normally if there is no loss this is a balance sheet where do we show the closing stock. We show closing stock as an asset here and we write here closing stock and closing stock is say for example, 50,000 rupees. So, this is shown here closing stock as 50,000 rupees and if there is no loss, but if there is a loss then the stock is has come down to 30,000 rupees. We will say here as 30,000 rupees. And there will be second head that is insurance claim, insurance claim which we have received and shown in the trading account will be shown in the balance sheet also 20,000 rupees. So, if it is no loss it is 50,000 closing stock is 50,000,

but if it is a loss and insurance company is going to compensate that loss then it is shown as 20,000.

So, finally, stock figure is 50,000 - 30,000 is the stock, and 20,000 we are going to recover from the insurance company as a insurance claim. So, first effect is in the trading account, second effect is in the balance sheet in the asset side and no effect in the profit and loss account.

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Now second situation if it is partly insured. If it is partly insured, in that case, we will have to now think about how to deal with it. And how to show it in the profit and loss account means how to deal with it and how to take care of that loss. So, in this case, when we talk about the partly insured part, we will be saying that for example, there is a loss of 20,000 and 50 percent of it was insured. So, we will get from insurance company 10,000 rupees and the final loss will be of 10,000 rupees, this is the case 10,000 rupees is the loss, how to deal with it in the financial statements.

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Loss of Stock by fire

1. Partly Insured	20,000	10,000
2. Trading A/c	150,000	30,000
3. P&L A/c	20,000	10,000
4. B/S	20,000	10,000

Total 20,000

For this result for this treatment and showing it in the financial statements, now you have to show this effect in the three statements. One effect will be shown in the trading account, second effect will be shown in the; first effect is trading account, second effect will be in the P and L account, and third effect will be in the balance sheet three statements. All the three statements are going to have the effect of it.

Now, in this case, the trading account this is a trading account, and profit and loss account also we take it together trading and profit and loss account. So, we are writing here by sales by closing stock. So, it means sales are again I am taking the same figures 150,000, closing stock left is 30,000s. And insurance claim now, by insurance claim the insurance claim is going to be how much it is partly insured. So, 20,000, and partly means 50,000, so it means we are going to get only 10,000 from the insurance company. So, in this case that this claim is going to be there 10,000 rupees, this I will now 100,000 and means 200,000, but 190,000, this is 190,000 rupees.

And remaining in the profit and loss account now you will come here, you will show this remaining part of 10,000 rupees here will be shown as in the profit and loss account that is to loss of stock by fire. And this will be how much 10,000 rupees, this is it means 10,000 which was insured we recovered from insurance company here in the trading account, and 10,000 which was not insured from the insurance company we were not

going to get anything that is loss here. We are going to show as a loss in the debit side of profit and loss account.

And third effect of that will be in the balance sheet. And in the balance sheet, we are going to show here as insurance claim of how much, this amount of 10,000 rupees which we are going to here that is 10,000 rupees. So, it is you are showing here closing stock 30,000 rupees and insurance claim is 10,000 rupees. So, 40,000 rupees stock you are going to have and 10,000 rupees means out of 50,000 rupees, we have now 30,000 as the closing stock, insurance claim is 10,000 we are going to receive. And finally, loss of 10,000 rupees which we have shown in the profit and loss account. So, these are the three statements going to get affected if that stock was partly insured.

So, these are the two situations, when the stock is fully insured and the stock is partly insured, and how to treat it. If it is fully insured then only total amount of the insurance claim in the credit side of trading account and asset side of balance sheet. And if it is partly insured fifty-fifty then that amount which is going to be recovered from the insurance company credit side of trading account not going to be recovered from insurance company, debit side of profit and loss account. And again the second effect will be the amount which is going to be recovered from the insurance company will also be shown in the asset side of balance sheet, because that is going to be the recovery from the insurance company of the loss which has been caused by the fire.

Now, the third situation that when the stock is not insured at all, when the stock is not insured at all, how to deal with it that means, if the stock is not insured at all in that situation only two effects will be there, only two effects will be there. First effect will be that you will write here, you will write here sales 150, closing stock 30,000s and loss of stock by fire is now 20,000 rupees. We are showing here in the trading account, we are giving the total description 200,000 rupees goods we produced, 150 we sold in the market 30,000 we have the closing stock, and 20,000 is loss by other stock by the fire, but it is not at all insured. So, total amount of this 20,000 will be shown as a loss in the profit and loss account and nothing will go in the balance sheet.

So, all these three situations, we have talked about. Stock fully insured what we will do? Partly insured, what we will do. And not at all insured, what we will do it means in that case one effect will be in the trading account 20,000 rupees loss and second effect will be

in the profit and loss account as the loss 20,000 and nothing in the balance sheet because we are not going to recover anything from the insurance company. So, this is all for today in this part, we discussed; and remaining two-three more adjustments are there which I will be discussing with you in my next lecture.

Thank you very much.