Financial Statements Analysis and Reporting
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Lecture - 19
Financial Statements with Adjustments Part-VIII

Welcome students. So, we are discussing the preparation of financial statements with adjustments and we will now carry forward with when where we left in our last lecture. So, we prepared this balance sheet and before that we prepare the profit; trading and profit and loss account, so 2 financial statements we prepared and we have checked that yes both the sides are balanced, so financial position of the company is ok, it is balanced.

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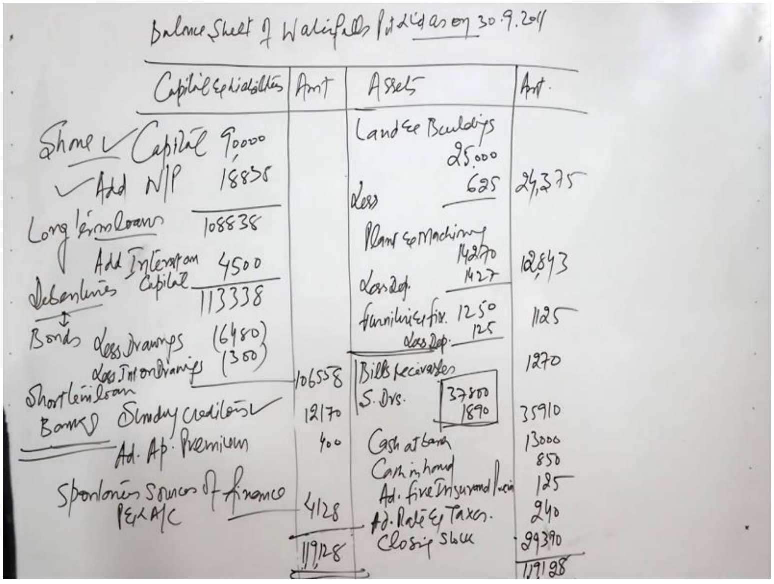

Here some points of concern are which I would like to discuss with you before we remove this balance sheet and prepare a new balance sheet - number one as I told you the headings are different in the profit and loss account it is the profit and trading and profit and loss account of the company for the year ending on I already told you that it is the, it depicts the profit or loss situation of the firm means the total transactions and profit and loss situation of the firm for one accounting period or the one full year, 12 months. It can be any accounting periods starting from January to December, April to march, it may be from October to September, it may be from July to June, anything it can be, but it has to a period of 12 months.

But in case of the balance sheet we put the word as on means this statement is depicting the financial position only for one day and not even on say for example, I have written 30th September 2011, the balance sheet position may be different on 29th September, it may be different on first October.

Maybe this side can be more, this side can be less, it can be imbalanced balance sheet on 29th September, it can again get disturbed on first October, but on 30th September, this balance sheet should be balanced because this is the date of the finalization of the balance sheet. If you are able to prove it that on 30th September on the date of balance sheet we have a balanced position of asset and liabilities, it means we are not worried about what was the situation; financial position one day before and what was the position one day after. So, we have not to worry about that.

Now this is the one thing, second thing is we are saying that depreciation; we charged because for the say reduction in the value of the fixed assets, we charged the depreciation. We charged the depreciation only on all the fixed assets because we have the assets normally of the 2 categories; one category of the assets is the long term assets and the other category of the assets is the short term assets. Long term assets are called as fixed assets and the short term assets are called as current assets. Generally we put the long term assets on the upper part of the balance sheet starting from here to somewhere here and then in the lower part it is the current assets we put the current assets here how we decide that which asset is a fixed asset and which asset is a current asset.

The basis of describing or distinguishing between the 2 categories of the assets is that the assets which have long life long means, how long it is; a period of more than one year. Any asset, any property of the firm which has a life of more than one year; 12 months, sorry, yeah more than 12 months, one year that asset is considered as a long term fixed assets and any asset which has the life for the firm of say up to one year or less than one year that asset is considered as current asset.

For example, now you talk about the land and building, they are the longest life, land has the longest life, but this is basically we have talking about the land and building is that part which that particular piece of land on which the building is constructed because number one, we do not charge any depreciation on land, land value never depreciates, normally it appreciates, but that appreciation is never recorded here because we prepare the financial statements of the firms on the basis of historical cost. And with that concept of our historical cost, we prepare the balance sheet and profit and loss account on the basis of the book value, not on the basis of the market value of that asset. So, at what price that asset has been purchased that we will keep on showing in the balance sheet may be any asset. So, for example, this land and building today is of you know 25,000, it is of 25, 00,000.

It has gone up. So, it may be a different situation, but in the book in the books of accounts will keep on showing at a price at which it has been acquired or it has been purchased. So, we show, it means we are showing here the means it means on this particular head we are showing depreciation it means this is that land on which the building is constructed, it is not the other open land and that land on which the building is constructed that land is known by the building and land is land disappears. So, it means this is basically the price of the building the cost of the building; 25,000 rupees. 26-25 worth it has depreciated. So, it means the final value of the building is 24,375. So, it means this is the fact worth noting that on the land we never charge any depreciation, land value never depreciates it appreciates, but since we never record the appreciation because these accounts are prepared on the basis of the book value, we only show the land on the basis of the historical cost or at which at we purchase and we never depreciate it also.

All other assets; fixed assets always depreciate when the time passes because of the wear and tear, because of the use, because of the obsolescence, because of any other reason, oxidation, because of any other reason, the prize or the value of that asset goes down decreases. So, we will never account for that. So, it means finally, if the value of the asset decreases we will have to charge depreciation on that. So, other than land all fixed assets are subject to deterioration in their value and that is recorded in the books of accounts by way of depreciation. So, we charge the depreciation on the fixed assets here. Then when our fixed assets are over say for example, land and building has a life of more than one year, similarly plant and machinery has a life of more than one year, then in this case furniture and fixtures have the life of more than one year. So, we have shown first and we have charged depreciation on them and then after that we have from this particular point, the current assets have started we have the current assets here, currents assets means now here onwards we have the current assets.

Bills receivables, as I discussed with you at length, bills receivables are only for few months, their life is for only few months, not for years. So, it means it is a current asset. Sundry debtors are also for a few years. So, it means it is a current asset, cash is limited. Today you have cash, tomorrow you spend it. So, it goes away. Cash in hand, cash at bank, it is finished, similarly the fire insurance; the premium is paid only for a year not more than that. So, maximum is if it is paid in advance; advance for the next few months. So, it will be over. Rates and taxes are paid monthly basis. So, they are paid in advance for a few months. So, they will be over and similarly the closing stock closing stock of the previous year is to be sold in the current year and maximum in a few next months. So, it also has a life of less than one year. So, those assets which has a life of less than is maximum of one year and less than one year, they are current assets, they are shown on the lower part of the balance sheet and those assets which have a life of year; one year or more then though they are called as the means the assets which have a life of more than one year there shown upper part and they are called as the permanent or the fixed assets.

So, this is all about the asset side of the balance sheet and or the titles you have to be very careful means in the in the say learning accounting and preparation of financial statements, it is generally said that your this figures may be wrong it is acceptable do not worry about it, total may not tally acceptable, but if the format is not correct format is not correct. Say for example, you are writing here balance sheet of waterfalls limited private limited for the year ending on it means everything is wrong it may be your output and everything right here and you tallied both the sides also, but that is found as incorrect wrong nobody can consider it as a correct balance sheet you will get 0 marks.

Similarly in the profit and loss account, if you write here say for example, balance sheet of sorry profit or loss trading and profit and loss account of waterfalls private limited as on 30th September 2011, it means everything is gone is wrong you have calculated. You put the items on the debit side correctly, on the credit side correctly, you have shown all the items, you have calculated profit and loss correctly, everything is right, but if the format is wrong, you are gone. So, we have to be very very careful that our format should be correct and then figure should also be figures should also be correct, but in any case if there is some problem in the figures that is acceptable, but format should be very very correct.

Now, we will come to the liability side for a while and I will discuss certain things with you which you will not find in the books generally at this level which you have studied and you are learning financial statement preparations and their analysis when we talk about the sources side. This is the sources side, I told you that is sources and applications sources side when we talk about sources of funds now generally as I told you the assets, they are generally of 2 categories, long term assets and short term assets that is the fixed assets and current assets. Similarly the sources of the funds are also of not 2 categories, but of 3 categories, sources of funds are of 3 categories. They are long term sources, permanent sources you can say, then there are short term sources and the third category of the sources of finance is spontaneous sources of finance; spontaneous self adjusting sources of finance because all that self adjusted adjusting sources of finance short term means it is shorter than short term sources of finance they are called as spontaneous finance.

Now, what are the how to identify it? Say for example, we talk about the capital, capital is a very long term source means capital will come on the one first day when the business will start, the business and capital will be paid back to the owner when the firm is closed. So, it is a permanent source longest life and capital will never be withdrawn by anybody. It will not be reduced it will never be paid to anybody. So, it is a longest most source that is why we put it on the top of the balance sheet you call it as capital or in public limited companies you will find it share capital.

So, share capital is the longest item and we put it on the top then we keep on adjusting it by way of the net profit sometime it increases or decreases or something if the profit is there capital will appreciate if loss is there capital will go down, but loss cannot be allowed to be there in the firm for a longer duration because otherwise there will be continuous capital arousal and the capital will come down to 0. So, that is not allowed it there can be loss in 1 year, 2 years, but after that when there will be profit capital will be appreciating, but the capital will be a permanent most of source then in the next balance sheets we will learn about the other sources say for example, after this the second longest source is the long term loans borrowed finance long term loans.

We will put here in this problem long term loans were not there, but otherwise there will be the long term loans first the owner invests his own money in the business that is called as capital. Then if there is a shortfall, he borrows the money from the financial institutions in the form of the long term loans and those long term loans become the second source of finance long term means the funds borrowed for a period of 3 to 5 years. They become the long term loans; similarly you must have heard about the term debentures, debentures are again the long term borrowings.

In the common language we call it sometime bonds. So, they are bonds also debentures means a kind of bonds a document which is acknowledging the borrowing of get by the firms by the business firms from the people or from the financial institution or from any other institution when any money is borrowed and any document is issued which is called as a bond that bond is source of long term funding and generally companies issue the bonds in the market for raising the funds; for the long term funds and these bonds are issued for a period of 3 to 5 or sometime 10-20 years also, very long term bonds 20, 25. 30 years bonds are also there. So, these bonds, difference between the bonds and debentures is in the different countries, different names are there, but in India if any such debt taking instrument are issued to the public or to any lender by the government if any money is borrowed by the government from the general public financial institutions or may be from any other institutions other sources of finance.

And any document is given as a recognition of that loan that borrowing that is called as bond in the government borrowings case it is called as bond, but when the private companies or public limited companies joint stock companies when they borrow money from the public and issue them a document kind of means when they issue the bonds to them recognizing that we have borrowed this money from the public and we will pay it after some period of time they are called as debentures. I will discuss with you the debentures sometime later also and we will com discuss more complex forms of the balance sheets, but the basic difference is the that if any bond is issued by the government it is called as bond.

But if it is any bond is issued by the business forms it is called as debentures that is a basic difference in the name in the Indian scenario. So, bonds and debentures are the third category of the long term source which again has a life of more than one year may be normally that is 3 to 5 years life is there for the bonds and debentures also then once these sources are and same similarly it can be say long term borrowings from the banks or financial institutions. So, you have capital you have long term loans you have debentures and bonds these are the sources of long term finance.

Then we come to the second category of the sources of funds. They are called as short term sources of the funds; short term sources of the funds means funds borrowed from those sources which have a life of total duration of that borrowing is only one year, you cannot extend that say repayment of that loan beyond one year. We have borrowed that money may be the money or anything in kind may be the goods also. So, you will have to pay within next few months you cannot keep on say delaying the payment much longer you have to pay and you have to settle that claim within a period of maximum 12 months then this borrowings are called as short term borrowings.

For example, we have taken the short term loan from financial institutions short term loan from financial institutions say banks when we borrow money from the banks they are called as the short term loans or the short term borrowings and banks borrowings are to be taken for the short term purposes. For example, if I go to buy raw material, we want to pay the salary to the employees, we want to pay the wages to the worker, we want to pay the utility bills, electricity water and other kind of things, sometime we borrow money from the banks under different arrangements that from money is borrowed for a limited period of time and that has to be paid in that period of time and that is called as the short term loan.

Similarly, you have say other kind of say you can call it as other source if from where we are borrowing the short term any not banks may be financial institutions or any other institutions who are lending to the business firms for the short term purposes means for a purpose of say short term duration a few months and it has to be returned back within a few months then it is called as a short term loans. So, here in the balance sheet top of it is a capital then long term loans then debentures or bonds then the short term borrowings short term loans from banks or other financial institutions. Then we talk about the third category of the finance and that is the spontaneous finance spontaneous sources of finance spontaneous sources of finance these are the third category you must not have heard in the anywhere that we are the spontaneous sources of finance also. and spontaneous sources of finance when we talk about we have spontaneous sources of finance and what are the spontaneous sources of finance I told you that the second name of the spontaneous sources of finance is self adjusting sources of finance.

Means for that you need not to say ask every time we need not need to go to the bank, do the documentation every time, apply for the loan, get the loan, return the loan that is not required. In this case of the sources, this is automatic means funds keep on coming and they are paid also on the due date. Now they are not funds in the real sense they can be a kind of services kind of goods kind of material that keeps on coming and that is used by the firm converted in to finished goods and then the payment is made to the suppliers.

Now for example, who are the spontaneous sources of finance suppliers of raw material we have written here one item that is sundry creditors they provide us raw material suppliers we have a long term arrangement with the suppliers that you will supplies the raw material regularly you will supplies raw material, we will use that raw material and you will be paid from the date of supplies from the date when we receive the material in the firm when it will come will reach us and will receive it within 60 days, means after 60 days from the date of receipt will make you the payment. So, it is automatic firm material is coming is being received kept in the warehouse or in the store and on the 60th day automatically either the online payment will be transferred to supplier's account or that cheque will be issued or whatever it is and. So, it means some (Refer Time: 20:01) is going on he is supplying the material and the payment was going on the due date and no need to say you can call it as have the fresh negotiations of the fresh documentation fresh application anything nothing is to be done.

But when you to borrow long term funds you have to go to bank or financial institution negotiate with them apply for the loan and then to take that loan and then to do this and that. So, so many formalities and once you return the loan that account is closed same is the case with the short term funds you have to borrow money from the banks you go to bank you apply you get the funds you use the funds you return the funds back and after that sources closed provided if it is not a cash credit limit we will discussed it later on what is the cash credit limit.

So, we talk here about the spontaneous source it means there is a regular supply supplier is supplying material he is being paid on the due date and this cycle is going on no fresh negotiations. So, it is spontaneous self adjusting for example, certain example we talk about the wages we are paying to workers when the workers start working in the firm or in the plant they work on the day one and we pay them after 30 days or 31 days at the end of the month they are giving the services to the firm for 30-31 days without asking for any money you are getting a virtual credit of 31 days 30 days or 31 days you getting that credit automatic that automatically that credit is coming to you are you going is asking the worker negotiating every month no we are not negotiating with them.

So, they are working and they know it after 30-31 days, I will get the payment. So, we say self adjusting spontaneous source of finance, he is giving you every workers giving you a credit equal to his wages for a period of 30 days talk about the office employees when they are getting salaries they are getting salaries after one month. So, they are giving a spontaneous credit to the firm for a period of one month.

Talk about these utility bills we are getting power supply from the power board we are getting water supply from that water supplying organization you getting. So, many other kind of supplies more supplies lubricants oils something we pay them after one month. So, it is a self adjusting source of finance when we pay the power bills, it is automatically in our mind the power will come after one month and we will pay it. So, we never think it about we never renegotiate we did not do this or that thing and we pay it when it became due. So, they are called as the spontaneous sources of finance. So, it means they are the spontaneous sources of finance and means we have the 3 category of the sources of finance first is the long term source of finance second is the short term source of finance and the third is the spontaneous finance self adjusting source of finance that automatically we pay them and they supply raw material they give their services something like that and automatically the that process goes on. So, this way you have the 2 sides, one is the your liabilities and capital side other is the asset side and when we put these sides on each other then it is called as a balanced balance sheet.

Now, the another concept I will discuss with you is that for example, I was saying that if both the sides of the balance sheet are balanced if both the sides of the balance sheet are balanced then we can say that the financial position of the firm is fine its it is good and it is balanced good, but if it is not balanced if it is not balanced what will happen if it is not balanced what will happen it means either this side is bigger and this side is short shorter or this side is bigger and this side is shorter either the 2 things will be there.

Now if this side is bigger and this side is shorter, what does it mean? Your liabilities are more your assets are less it means we have borrowed more money from the market including shareholders and we do not have a proper account of that we do not have a proper account of that. It means how long that situation can be allowed to continue if we if somebody asks because these financial statements when we prepare they are not considered as authentic financial statements until and unless, they are audited by the certified auditors and these auditors are chartered accountants, they are certified charted accountants every business form especially company form of organizations, they have to appoint their auditing forms and charted accountants are normally the certified auditors.

Now when this balance sheet is imbalanced and if it is presented by the company in front of or before the charted accountant he would say it seem the balance sheet your liabilities are more than assets. It means this firm is almost bankrupt we have borrowed more money from the market, you have misappropriated the funds, you do not have the proper funds with you and then it sends imbalanced balance sheet. So, how long this situation can be continued. So, firm has to correct this position if they want to intend to continue if the management want to continue with the business otherwise they would have to declare that we are not able to rectify this position our liabilities are more than the assets we are a bankrupt firm and we cannot correct this position right.

They can be reverse also; this side is bigger than this side and if it is happens it is a very good situation. If the assets sides are more than the liabilities side then this situation is very good now if normally what will happen if this side is more than this side it is a very strengthful balance sheet. So, what we will do for example, here we have the total of this side is say for example, this is 1,19,128 and the total of this side is 115,000.

Total of this side is 115,000; 115,000s. So, take 1,15,000; it means you have the properties worth lakh; worth 1, 19,128. You have liabilities only 1, 15,000; it means you have assets to that tune of 4,128 more than the liabilities of the firm. Now we will also note keep this kind of the balance sheet in front of the charted accountant we will balance it. Now will what happens? If this situation comes up then this is not allowed to happen firms will withdraw the extra assets from this side may be extra cash and they will transfer it to another reserve which is called as hidden reserve or the secret reserves. The concept of hidden and secret reserves I will discuss with you in my next lecture, but that will be transferred and again the, for example, that access amount here is 4128 that will be withdrawn by the firm and will be transferred to the hidden or the secret reserves. So, again the both the sides will become 115,000 rupees.

But if the firm does not want to create the hidden or secret reserves in that case what will be there? This side is 1,19,128, this side is 1,15,000. So, we will have to make both the sides equal and we will show here that we will make it 1,19,128 and the difference will be will put here, profit and loss account and that amount of 4,128 will be shown here.

Means everybody understands that if this profit and loss because we have 2 kind of profit, one is a net profit which is added here, this profit has come from the profit and loss account fine and we have added this in the capital and we have put another account here profit and loss account it means, what this account means? This profit and loss account means that this is access of assets over the liabilities and this access of assets over the liabilities we are putting in the profit and loss account side and we are showing it here.

So, the balance sheet is again balanced, but this amount is extra it means 4,128 rupees of the cash is extra if you talk about all these sources this sources will be less by 4,128 and the cash here is more. So, it means we are showing here we have earned from these resources what if whatever we have earned and shown this side it is more we have done the very good business in a good firm and then the extra profit we have earned is we are showing it here and then this is called as 4,128. So, it means we will have to again the balance sheet and we are putting extra of this side access of these assets over liabilities in this side and we are again balancing the documents.

So, there is some very interesting components which are there in the financial statements that if this side is bigger this side is smaller what it does it mean and what to do, and if this side is bigger this side is smaller what to do and again we will talk about certain other important interesting concepts and will do some more complex problems also, but that in my next lectures means remaining part more complex firms more interesting concepts about the balance sheet and profit and loss account will discuss in the next part of discussion.

Thank you very much.