Financial Statements Analysis and Reporting

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Lecture - 15
Financial Statements with Adjustments Part-IV

Welcome students. So, we are talking about the adjustments to be taken care of in the financial statements and till my last lecture; previous lecture, we have discussed; we have learned about that how to deal with the adjustments. Some adjustments means some additional information which is given outside the trial balance and so far we have discussed some 10-12 parts of the adjustments items of the adjustments and now for the remaining 3-4 more adjustments we will learn about and after that we will try to learn that how to implement or how to make adjustments in preparing the financial statements and that additional information.

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Say for example, if you look at this problem here, you are given here something like say one table is given here and some additional information is given here and it is written here that from the following trial balance extracted from the books of waterfalls private limited prepare the trading and profit and loss account for the year ended on 31st; 30th September 2011 and the balance sheet as on that date.

So, if it is say financial statements to be prepared without adjustments, it means that information will end up here when the table is ending; when the table is ending, but you see that after this table also some additional information is given to us. This additional information is given to us and this additional information we call it as adjustments. Means if you look at both the sides, if you these are the different balances and this table; total table is called as trial balance right trial balance. It means we have 2 kind of balances here we have the debit balances we are starting with the debit balances here all the balances are going on and here till this cash in hand; 850 rupees till this item, you all have the debit balances and after that we have the credit balances.

So, if you total up total up the debit side till this you are starting from this 6480 and if you are coming up to this point, 850, it means total of the debit balance is this certainly will be equal to the total of the credit balances. So, debit and credit balances are equal here, it means we have followed the double entry accounting system and if this additional information is not there for a second then it means whatever the transactions; business transactions we have recorded in the journal and posted that in the ledger that has been arithmetically done correctly, there is no mistake, there is no numerical problems, there is no numerical mistakes and we have correctly recorded these figures here.

Because trial balance the debit and credit balances are equal with each other if you total the debit balances and you total up the credit balances, you will find here that the total will be 2,04,950; 2,04,950 rupees is the balance of both the sides which is equal. But now that situation means that problem does not end here. We have some additional information here also and we have to adjust for this additional information and if we talk about this additional information this information demands adjustments. And that is what we are talking about, we have discussed the 10-12 figures; 10-12 items of the adjustments and remaining we will be discussing.

So, 3-4 today more and once we complete the list of adjustments and learn how to deal with the adjustments in the financial statements then we will deal with this entire problem and from this entire problem as it is required that we have to prepare the profit and loss account and balance sheet. So, we will prepare we will use first this information then we will adjust this information and a detailed financial set of financial statements profit and loss account and balance sheet we will prepare. So, we will we are carrying on right now we are carrying on with the process of some remaining adjustments and the next adjustment is the reserve fund.

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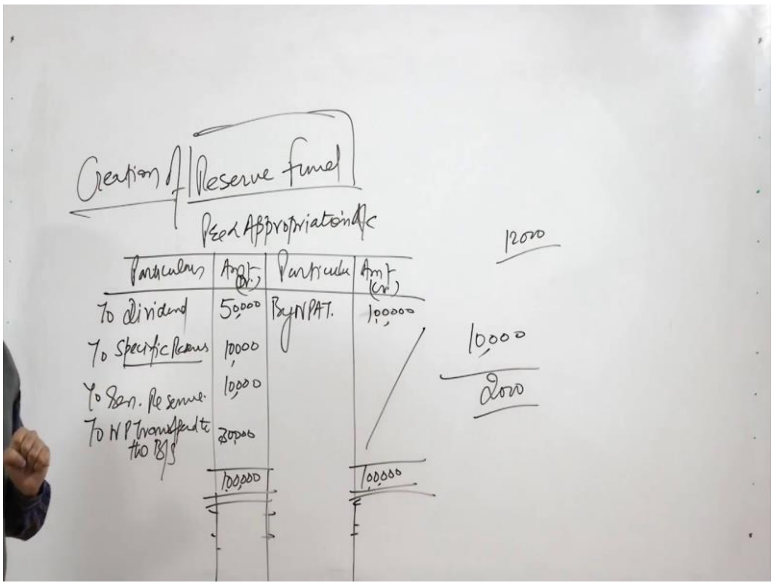

This is next adjustment is the reserve fund or you can say creation of the reserve fund; creation of the reserve fund. So, these are the 2 different things reserve fund and the creation of reserve fund. So, first we will learn what is the reserve fund? We will learn, what is the reserve fund? Reserve fund is basically a fund which is created and kept for some specific purpose which is created and kept for some specific purpose and how it is created that is the point of concern here. For creation of this fund reserve fund we will have to learns one new thing here that is along with the profit and loss account; when we prepare the profit and loss account, this is the format of profit and loss account, we have already seen we have discussed the simple financial statements profit and preparation of the simple financial statements profit and loss account and balance sheet.

So, we have learned about the preparation of that and we ended up here with the 2 net profit after tax that we had done in the past, here was net profit and with this net profit we totaled up both the sides and it was equal here the total of both the sides and both the sides are equal here and the this side credit side is bigger debit side is smaller; shorter. So, the difference is the net profit after tax after adjusting the tax and everything we have calculated this net profit after tax.

For creation of the reserve fund, we have 2 ways either you can extend this profit and loss account and create the reserve fund or we can prepare another statement and that another statement is called as profit and loss appropriation account; profit and loss appropriation account, sorry! This is called as profit and loss appropriation account profit and loss appropriation account. This is basically extension of the profit and loss account, when you prepare calculate the profit net profit after tax it means that profit is available with the firm for use for the different say purposes in the business or to be distributed among the different stakeholders.

So, in this case, we call it as profit and loss appropriation account which is extension of the profit and loss account itself again it also has the 2 sides like say as we are extending. So, same things will be putting here particulars amount and then the particulars amount this is debit side and this is the credit side. So, when we calculated the profit and loss after tax. So, we will put that now in the credit side of profit and loss account appropriation account. So, we will say by net profit after tax say whatever the amount comes up here we assume that amount comes up here is say 1 lakh, 100,000, we will be taking it to the now the credit side.

And now our job is that we have to distribute this profit amongst the different stakeholders or for the different purposes. So, first important head is that we pay the return to the shareholders and when we pay the return to the shareholders we give the return to the shareholders. So, first head of this appropriation is dividend we pay the dividend. So, we debit that by that amount this account that say for example, out of this we pay 50,000 rupees as dividend to the shareholders of the company after this we create some reserves from the profit we have earned we create some reserves means some part of the profit is kept reserved for some unforeseen purposes.

Now, there can be 2 kinds of purposes, either it is an unforeseen purpose, you call it as the say general reserve or the foreseen purpose; you call it as the specific reserve. So, one reserve, we create here as the specific reserve; specific reserve and then is the general reserve; general reserve. So, we create 2 kinds of reserves here; specific reserve here is for example, that company has issued some debentures in the market and they are due to be redeemed this year. So, we will have to set aside certain amount. So, that it can be used at the end of the year when the debentures have to be redeemed. So, if we are creating a reserve for the redemption of the debentures that is called as a specific reserve for a specific purpose.

Or you can create a reserve for the replacement of the assets when we buy plant building machinery within through the process of depreciation we depreciate those assets and at the end of the life of the asset we have the life of the asset becomes 0 and on the depreciation fund we have the sufficient amount, but sometime what happens that there is a difference in the depreciation amount the balance in the depreciation fund account and then in the market price of the new machine which we are going to replace means use for the replacement of the old machine. So, in that case we create here some specific reserve and that is called as a asset replacement reserve that when that difference will come up that the new for example, in that depreciation fund you have 10,000 rupees total with interest everything and the new price of the machine is say 12,000 rupees. So, we know it that when we will be replacing this machine in the market we will have to pay 12,000 rupees, but in the depreciation fund account we have only 10,000 rupees.

So, we will be running short of 2,000 rupees. So, we create a specific reserve here from the profit and loss account of that if it is a small amount we create the reserve from the that particular year's profit and loss account in which we are going to replace the machine, but if it is a bigger amount then it is divided over number of years and may be 5 years before the replacement of the asset we start creating some reserve. So, either for the redemption of the debentures or bonds or for the replacement of the assets we have to create some reserve and if some reserve which is created with some specific purpose debenture redemption or asset replacement or anything then that reserve is called as the specific reserve and if any reserve is created for any kind of contingencies unforeseen purposes that is called as general reserve both the reserves are created from the profit which we have earned the company has earned.

So, for example, we have got 1,00,000 rupees profit, 50,000 rupees, we distributed as dividend to the shareholders and we are left with the 50,000 rupees out of this we have transferred say 10,000 rupees to the specific reserve and 10,000 rupees to the general reserve. So, how much now? We have already consumed these 70,000 rupees and the remaining will be to net profit transferred to the balance sheet and that amount will be 30,000 rupees. So, total of both the sides will be 1,00,000 here, 1,00,000 and it is again 1,00,000. So, your distribution of the profit is over now 50,000 rupees will be paid as dividend, 10,000 will be transferred to specific reserves, 10,000 will be transferred to the general reserves, remaining 30,000 will be transferred to balance sheet and when we transfer it to balance sheet, we add it up in the share capital.

You might have seen in the first balance sheet when we prepared the simple balance sheet, we have shown there that is the capital in the liability side of balance sheet plus the profit which we have earned in that particular year if no dividend is paid nothing is paid then that is transferred and added in to the balance sheet and added in the capital. So, that is shown here.

So, now you see reserve funds means when we have created a reserve fund creation of the reserve fund. So, what we are doing here first effect is coming up as debiting the profit and loss account we are though it is a profit and loss appropriation account, but it is a extension of the profit and loss account. So, we call it as that when we create the reserve fund. So, we debit with that fund the profit and loss account this is the first effect of that and second effect of that comes up as that it is shown as a in the balance sheet this is the balance sheet and it is shown as a liability reserve fund whether it is specific or general it is shown as reserve fund it is shown here as a liability if it is a say for example, specific. So, we will write here debenture redemption reserve here or if it is general reserve we call it as reserve and surplus. So, it is kept here in the liability side of the balance sheet.

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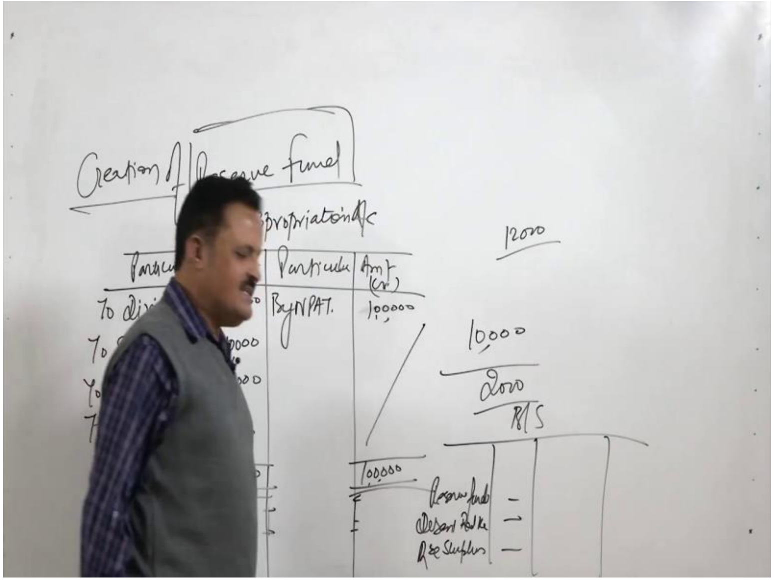

Because why we call it as a liability that this profit when it is when some reserve is created and it is created by say the debiting profit and loss account or the profit and loss appropriation account it means it is this amount is set aside with some specific purpose until and unless that purpose is achieved that amount cannot be utilized for any other purpose if it is a specific reserve and if it is general reserve then it has to be used for any unforeseen purpose or any contingency. But both are the liabilities because this is the liability of the firm to use this money for as specific purpose or for a general purpose and till the time this fund is used it is shown as a liability in the balance sheet.

So, the double effect will be something like first effect will be when we create the reserve fund we debit the profit and loss appropriation account or the profit and loss account and the second effect is that reserve fund is shown as a liability in the balance sheet. So, this is how we deal with the reserve funds or the adjustments relating to the reserve funds adjustments relating to the reserve funds.

Then next we have the next adjustment, we have as the goods distributed as free samples, next adjustment is what goods distributed as free samples, this is the and after that we will be talking about the 2 more adjustments. So, this is the adjustment next adjustment we are going to talk about it for the goods distributed as free sample goods distributed as free sample say sometimes what happens that when we manufacture anything new which is not known to the people or sometimes it is known in the one market, but not in the other market. So, when the firm thinks of expanding its market or thinks of say entering into a new segment of the market in that case initially before starting selling that product officially means for price selling that product in the market they introduce that product with the people or potential buyers and they distribute it as free as a free sample they give it. So, it is not a sale it is production and the distribution is free.

So, if there is some free distribution of the some goods for any purpose may be say introducing a new product in the market or may be entering the new market where the product is already not selling in the market. So, that is just to lure the people just to make people aware about that product just to say make people feel about that yes they should buy this product also. So, companies distribute as free sample.

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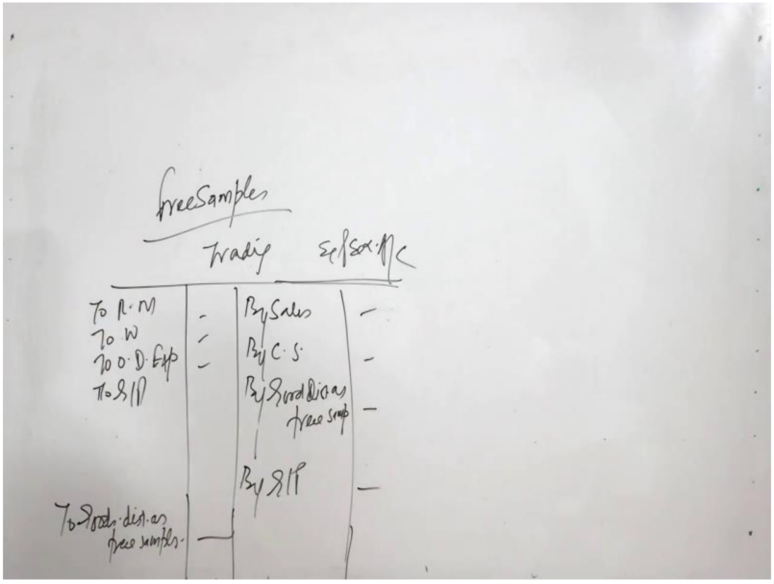

So, goods distributed as free sample; if this adjustment comes we will have to deal with this adjustment also and for dealing with this adjustment we will have to again have to have 2 effects in the 2 financial statements, but here because of this adjustment or because of this particular item we do not make any change or any adjustment in the balance sheet both the effects are shown in the one in the trading and trading account and second effect is shown in the profit and loss account. So, for example, here it is the trading account we are preparing the trading account. So, trading and profit and loss account you can say trading and profit and loss account because we prepare the common pro-forma for that. So, upper part is known as the trading account and lower part is known as the profit and loss account.

So, goods distributed as free sample. So, what we show here in the trading account? We show here to raw material to wages and to other direct expenses, we are showing the expenses on this side as we have already seen, we have prepared the simple trading account this side what we show we show here by sales by closing stock and now if this item is there goods distributed as free sample. So, it will also be shown in the credit side of profit and loss account like by goods distributed as free sample as free sample. So, this normally we will have 3 items on the credit side of trading account 3 items on the credit side of trading account.

So, first effect of these goods distributed as a free sample will be that is we are showing it on the credit side because we have to give a proper account of it that all these expenses which are incurred here for manufacturing something part of that we have already sold in the market that is sales part of that. We have already kept in the warehouse as a closing stock and the third remaining part of the goods has gone where because the expenses side we have to justify why we have used this much of raw material how much goods we have produced labor and other direct expenses it means if this is the input the output should be properly justified. So, we are justifying the output here part of the output we have already sold in the market part of the output is yes with us in the closing stock and then the part of the output is with us as which we have distributed as a free sample. So, first effect will be in the trading account credit side that is one thing and the second effect.

Now, when you will come down the lower part is known as. So, when we calculate the difference we call it to GP gross profit and that gross profit comes this side which becomes here by GP. So, here and second effect of this item will be this item will be this will be shown in the debit side of profit and loss account to goods distributed as free sample to goods distributed as free sample we will be showing it in the debit side of the profit and loss account it means one effect in the trading account giving the details of this input, this is the output.

Second is because we have distributed this free of cost in the market we are not going to get any revenue out of this particular distribution of the goods it means this distribution of the goods as the free sample is shown as a kind of advertising expense in the by debiting the profit and loss account by the same amount. So, by first effect there, second effect here and here when you debit the profit and loss account, we treat it as the advertising expenditure this is advertising expenditure. So, goods distribution as free sample and here it is treated as a advertisement expenditure and with that expenditure we are debiting the profit and loss account. So, first effect is coming in the credit side of trading account second effect of this particular adjustment will be in the debit side of profit and loss account.

Next second last adjustment is the commission paid to manager commission paid to manager or managers now see sometimes what happens managers are given some incentives for better performance by the companies for better performance by the company some incentives are given to the managers and managers are given this allurement that if you perform well a certain part of the profit will be given to you as a commission now commission will be treated in 2 ways commission is because normally you will be given or we are given in this kind of the problems some percentage here something will be written like that the manager will be allowed a commission at the rate of 5 percent of the profit right if it is written here.

Now, 5 percent of the profit can be understood in 2 different ways first manner is that 5 percent of the profit which profit before giving the commission or after giving the commission it can be possible both ways profit after the commission or profit before the commission if this is profit after the commission then it has to be treated differently if it is profit.

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Before the commission it has be treated differently. So, means the adjustment is commission to managers; commission to managers and if it is there we have to deal it in a in proper manner and for dealing with it in a particular manner we will have to make again a double entry and we will have to treat it in a double entry mode. So, first effect of this will be whatever the amount of manager's commission is worked out we will be debiting with that amount the profit and loss account because commission is also a kind of expense or commission is also a kind of loss.

So, when you are putting all the expenses here if it is written that commission will be paid to the manager on the profit before charging the commission on the profit before charging the commission it means in that case this is not a difficult thing we can simply calculate it means whatever the given percentage of the profit is we will have to charge that say you are given that 10 percent commission is given to the manager on 10 percent commission is given to the manager on the profit before charging the commission to the profit or charging the commission to the profit and loss account.

It means simple it is that before this you will calculate all the incomes here and whatever the income amount comes here you will total it up here and then you will add one more head here to manager commission to manager commission and we are saying that it is 10 percent and for example, that 10 percent works out as say some of the some profit and say profit is the 33,000 profit before because we have to provide here something. So, what you will do you total it up this side this side is known to us now.

Now, this side minus up to this you will have to subtract the items and for example, this amount is the profit which is before paying the commission is 33,000 and 10 percent of this will simply we will be calculating 10 percent, 10 by 100. So, it means it works out as simply the commission amount is 3,300 rupees. So, you will be debiting furthermore, you will be debiting the profit and loss account with the 3,300 rupees and after that you will be calculating the net profit before tax; something will come here then you will be providing to income tax or corporate tax; corporate income tax. We will be seeing and after that we will be seeing to net profit after tax that will be calculated here.

So, if it is the commission to be paid to the manager on the profit before charging the commission then it has to be calculated in this manner, but if it is written that the commission has to be paid to the manager on the profit after paying the commission it means whatever the amount of the commission you pay that will be paid on the profit after paying the commission. So, here the problem is that how to calculate that commission amount it is not as simple as 10 percent on 33,000, no, it is not like this. So, for this we had a set formula and we have to use that set formula is for calculating the manager's commission and for calculating the manager's commission you have say rate percentage of commission rate percentage of commission divided by 100 plus rate percentage into residual into residual profit.

So, what is the residual profit? We have already calculated; it is 33,000. This is known to us rate percentage is how much 10 percent and 100 plus 10 is 110. So, it will be something like this 10 divided by 110 into this. So, it means if you do this, it means you are left with something; this thing and this is 3000.

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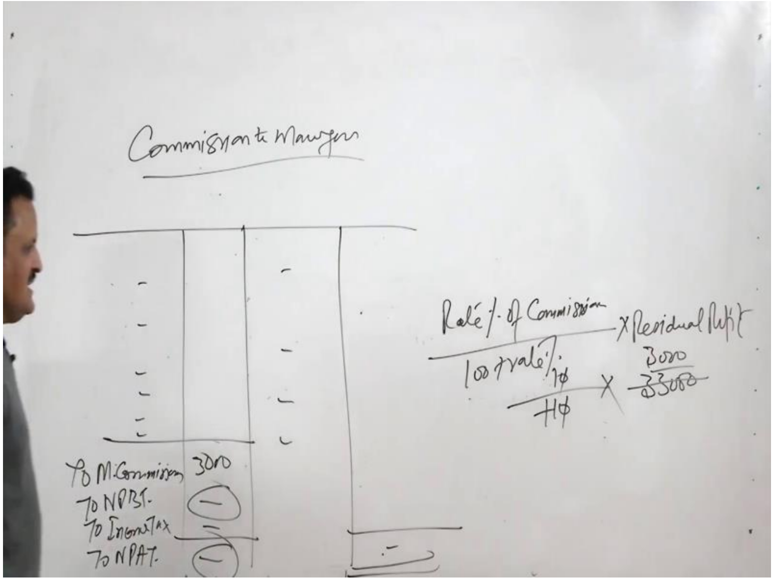

So, commission amount will not be now 33,000, but it will be 3,000 because it will be on the profit after charging the commission it will be on the profit after charging the commission. So, it will the commission amount will go down because after paying the commission profit amount will go down. So, it is to be calculated this way that is rate percentage of commission and divided by 100 plus rate percentage of commission multiplied by the residual profits. So, this way you have to calculate it and this is called as the manager commission.

So, first effect of the manager commission will be that it will be debited in the profit and loss account first effect will be by that amount that will be before or after you will be debiting the profit and loss account with the manager commission amount first effect and the second effect will come in the balance sheet and when you prepare the balance sheet manager commission is shown as liability manager's commission is shown as a liability here in the balance sheet because by setting aside by calculating and taking out this amount from the profit and loss account we are simply setting aside a certain amount we have not paid it to the manager. So, till the time it is taken out and finally, paid to the manager you will up till that time you have to show it as a liability in the balance sheet manager commission is shown as a liability in the balance sheet.

So, first effect will be in the debit side of profit and loss account and the second effect will be in the liability side of the balance sheet and for calculation of the manager commission I have told you that if it is written that some percentage of the profit before paying the commission then simple residual profit multiplied by that percentage divided by 100. But if it is after charging the commission then you have to use that formula rate percentage of commission divided by 100 plus rate percentage and multiplied by the residual profits. So, the commission amount will come down. So, this is how we treat the adjustments pertaining to the manager's commission.

Now, we will talk about the last adjustment that is this is the last adjustment and after that we will learn how to implement these adjustments in the preparation of the financial statements and this last adjustment is we are going to talk about is goods sold on the approval basis goods sold on approval basis goods sold on approval basis it means they are not final sales goods sold on approval basis they are not final sales. Some customer has asked for the goods, but he has said that first you send me the consignment lot of the goods I will see and if they are according to my requirement then I would approve it the sales I will accept it and I will pay you the money, but if I do not like it in that case I will return your goods and I will not accept it. So, they are called as goods sold on the approval basis.

If that kind of the situation is there goods sold on the approval basis in that case, how we have to treat it?

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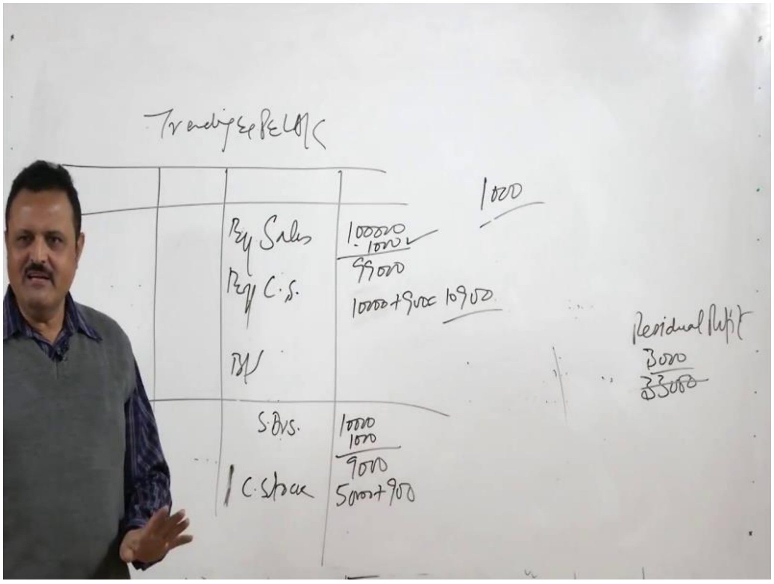

How we have to deal with it is that first effect of this will come in the credit side of trading account, this is the trading and profit and loss account. So, you have to take it on the debit sides and this is the trading account. So, you are showing here by sales then it is by closing stock and when the goods are sold on approval basis, it means first they have been included here in the sales, but they are not final sales, they will be rejected also. So, what we have to do is by that amount. So, for example, goods sold by this amount is on the approval basis is one for 1,000 rupees and the sales amount here is 1,00,000 rupees; sales amount here is 1,00,000 rupees which includes this amount also; this includes this amount also.

So, what we will do while making adjustment here? We will have to subtract this 1,000 and the final sales will be 99,000. So, this will be subtracted 1,000 at the selling price; selling price is 1,000. So, we will be subtracting it at the; we will be subtracting 1,000. It is 99,000 and it will be added in the closing stock at the cost price and the cost price may be 99,000 rupees. So, the cost price at the cost price; it will be added in the closing stock. So, closing stock may be existing closing stock is say 10,000 rupees plus 900 goods you will be adding here. So, this will become 10,900, this is the first effect.

Second effect of this will come in the balance sheet and in the balance sheet we write here one item which is called as sundry debtors. So, we will do because when we have sold and we have included in the sales we have included in the sundry debtors also. So, we will subtract. So, sundry debtors are for example, 10,000 rupees. So, we will be subtracting it at the selling price minus 1,000 because it is on the approval basis. So, sundry debtors amount will come down to 9,000 rupees and this will be added in the closing stock here also and when closing stock you are showing here in the balance sheet we will be adding this amount closing stock is say 50,000.

So, you will be adding this at the cost price 900 rupees. So, first effect in the trading account you are subtracting from the sales at the selling price adding in the closing stock at the cost price and will have to complete it.

Second effect will be you will be subtracting in the balance sheet from the sundry debtors and you will be adding it in the closing stock at the close price and this way the double entry effect will be complete for the goods sold on the approval basis.

So, these are the adjustments. So, far we have talked about say somewhere 15-16 adjustments and this is almost exhaustive list of the adjustments and if we know about that how to deal with the these adjustments and how to take care of and complete the double entry accounting system for this additional information for the adjustments also then we will be completing the preparation of the financial statements. So, now, we will learn about how to practically implement these adjustments in the preparation of financial statements that I will do in my next lecture.

Thank you very much.