



PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORS



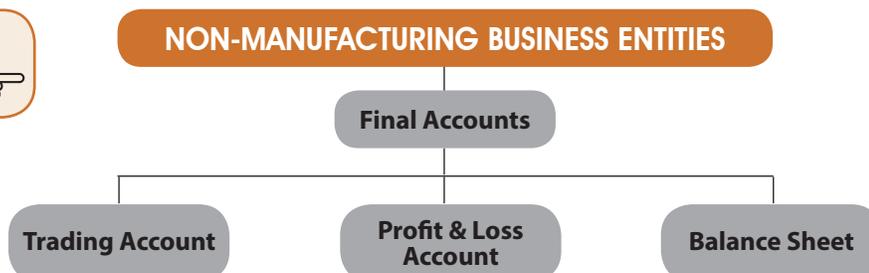
UNIT 1: FINAL ACCOUNTS OF NON-MANUFACTURING ENTITIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

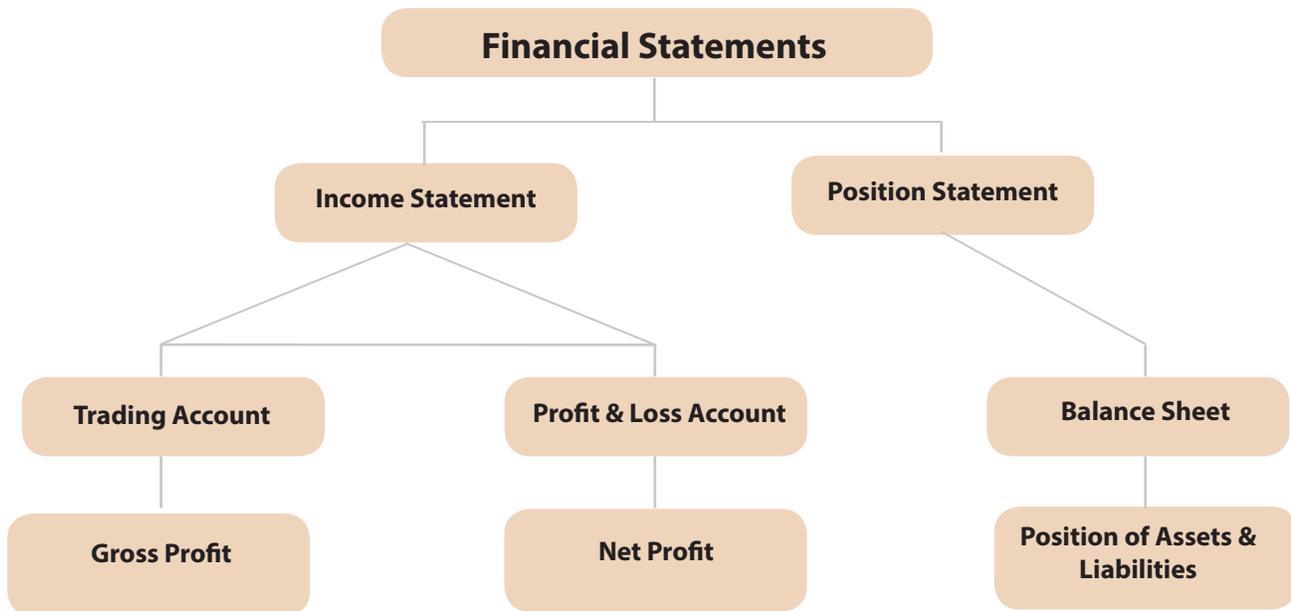
- ◆ Draw final Accounts of Non- manufacturing entities.
- ◆ Learn the relationship between Profit and Loss Account and Balance Sheet.
- ◆ Understand the Trading Account items. This will help you to learn which of the transactions and events should be shown in the Trading Account.
- ◆ Understand the items shown in the Profit and Loss Account. By that you will learn the technique of preparing Profit and Loss Account and deriving the Profit and Loss balance.
- ◆ Learn how to adjust outstanding and pre-paid expenses, accrued income and income received in advance.
- ◆ Understand the items to be shown in the balance sheet. Also learn the classification of assets and liabilities and the order by which they are put in the Balance Sheet.

UNIT
OVERVIEW 



1.1 INTRODUCTION

Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods at profit without changing the form of the goods. In other words, non-manufacturing entities do not process the goods purchased and sell them in its original form. Meanwhile it indulges in some liabilities, makes some assets and also incurs some expenses like salaries, stationery expenses, advertisement, rent etc. to run the business. At the end of the accounting year, the entity must be interested in knowing the results of the business. To ascertain the final outcome of the business i.e., the income and financial position, they prepare financial statements at the end of the year.



Financial Statements are the systematically organized summary of all the ledger account heads presented in such a manner that it gives detailed information about the financial position and the performance of the enterprise. As seen above, through categorization of Financial Statements into Income & Position Statement, the profit is measured at two levels:

- (a) Gross Profit
- (b) Net Profit

The profit of the enterprise is obtained through the preparation of **Income Statement i.e Trading and Profit & Loss A/c**

The financial position of the business enterprise is judged by measuring the assets, liabilities and capital of the enterprise and the same is communicated to the users of financial statements. Financial position of the enterprise can be known through the preparation of the **Position Statement i.e Balance Sheet.**

Comparison between Income Statement and Position Statement

Income Statement	Position statement
Profit or loss is disclosed in the Income Statement prepared at the close of the financial year	It exhibits assets and liabilities of the business as at the close of the financial year.
Income Statement is sub-divided into following two parts for a non-manufacturing concern: (i) Trading account; and (ii) Profit and Loss account	Apart from balance sheet, to judge financial position of the business, sometimes additional statements are also prepared like cash flow statement, value added statement etc. which is not mandatory for non-corporate entities. These additional statements are prepared for the better understanding of the financial position of the business.
Income Statement discloses net profit of the business after adjusting from the income earned during the year, all the expenditures of the business incurred in that year.	Position statement discloses the assets and liabilities position as on a particular date.



1.2 PREPARATION OF FINAL ACCOUNTS

The principal function of final accounts (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the profitability and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained. The **BASIC PRINCIPLES** in regard to accumulation of accounting period data are:

- (i) a distinction should be made between capital and revenue receipts and payments;
- (ii) also income and expenses relating to a period of account should be separated from those of another period.
- (iii) different items of income and expenditure should be accumulated under significant heads so as to disclose the sources from which capital has been procured and the nature of liabilities, which are outstanding for payment.

Having regard to these basic principles, the various matters to which attention should be paid for determining the different aspects of transactions, a record of which should be kept, and the different heads of account under which various items of income and expenditure should be accumulated, are stated below:

- (a) Distinction between personal and business income:-** Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditure should be separated from business income and expenditure.
- (b) Distinction between capital and revenue expenditure:-** A distinction should be made between capital and revenue, both receipts and expenditure. Different types of income and expenditure should be classified under separate heads. Assets should be included in the Balance Sheet by following accounting principles and accounting standards. Likewise, a provision for income and expenses which

have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.

- (c) **All material information to be disclosed:-** Every information, considered material for judging the profitability of the business or its financial position, should be disclosed. For example, when the labour charges have increased on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, if some of the items of inventory are not readily saleable, these should be valued at their approximate net realisable value and the basis of valuation and value of such inventory should be shown separately.
- (d) **Record only current period transactions:-** Though the record of transactions should be maintained continuously, at the end of each accounting period, the transactions of the closing accounting period should be cut off from those of the succeeding period.
- (e) **Only transactions completed before close of accounts should be given effect:-** It should be seen that only the effect of transactions, which were concluded before the close of period of account, has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

Inter-relationship of the two statements

One of the points to be remembered is that of total expenditure incurred some type of expenditure appears in the Profit and Loss Account and some in the Balance Sheet. Consider few examples,

- Salaries paid is shown on the Dr. side of Profit and Loss Account but outstanding salaries is shown on liabilities side of Balance Sheet and is added to Salaries.

Profit & Loss A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Salaries	25,000		
Add: Outstanding Salaries	<u>1,500</u>		
	26,500		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Outstanding Salaries	1,500		

- When a machine is purchased, that part of it which is attributable to the year considered as depreciation is debited to the Profit and Loss Account and the balance is shown in the Balance Sheet as an asset.

Profit & Loss A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Depreciation	50,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Fixed Assets 5,00,000	
		Less:- Depreciation (50,000)	4,50,000

These illustrations show that the two statements, the Profit and Loss Account and the Balance Sheet, are thoroughly inter-related. The assets shown in the Balance Sheet are mostly only the remainder of the expenditure incurred after a suitable amount has been charged to the Profit and Loss Account or the Trading Account. For preparing the two statements properly, it is of the greatest importance that the amounts to be charged to the Profit and Loss Account should be properly determined as otherwise both statements will show an incorrect position. The principle that governs this is called the **Matching Principle**.

Matching Principle

This principle demands that expenses incurred to earn the revenue should be properly matched. This means the following:

- If a certain revenue and income is entered in the Trading / Profit and Loss Account all the expenses relating to it, whether or not payment has been actually made, should be debited to the Trading / Profit and Loss Account. This is why at the end of the year an entry is passed to bring into account the outstanding expenses. That is also the reason why the opening inventory of goods is debited to the Trading Account since the relevant sale is credited in the same account.
- If some expense has been incurred but against it sale will take place in the next year or income will be received next year, the expense should not be debited to the current year's Profit and Loss Account but should be carried forward as an asset and shown in the Balance Sheet. It will be debited to the Profit and Loss Account only when the relevant income will also be credited. The same reason applies to depreciation of assets also. The part of the cost which is used to earn current year revenue is debited in same year.
- If an income or revenue is received in the current year but the work against it has to be done and the cost in respect of it has to be incurred next year, i.e. income received in advance the income or the revenue is considered to be of next year. It should be shown in the Balance Sheet on the liabilities side as "income received in advance" and should be credited to the Profit and Loss Account of the next year. E.g. Newspapers or magazines usually receive subscriptions in advance for a year. The part of subscription that covers copies to be supplied in the next year is treated as income received in advance.

An exception

There appears to be one exception to the rule that only such costs as have yielded or is expected to yield revenue should only be debited to Profit and Loss Account. For example, if a fire has occurred and has damaged the firm's property the loss must be debited to the Profit and Loss Account to the extent it is not covered by insurance. A loss, resulting from the fall of selling price below the cost or from some debts

turning bad, must similarly be debited to the Profit and Loss Account. If this is not done the profit will be over-stated.

(NOTE: - The relevant entries and adjustments regarding the above three items are discussed in detail later in this unit.)

1.3 TRADING ACCOUNT

At the end of the year, as has been seen above, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases. It is done as follow:-

Opening Stock	***
Add:- Purchases (Net)	**
Add:- Direct Expenses	**

Less :- Cost of Goods Sold	(**)
Closing Stock	***

Suppose, in the first year, the net purchases (that is after deducting returns) total ₹1,00,000 and that ₹15,000 worth of goods (at cost) were not sold at the end of the year. The cost of the goods sold will then be ₹ 85,000. If in the next year purchases are ₹1,50,000 and the cost of goods sold is ₹ 1,45,000 the closing stock will be ₹ 20,000 calculated as follows:

	₹
Cost of unsold goods at the beginning of the year	15,000
Purchases during the year	1,50,000
	<u>1,65,000</u>
Less: Cost of sold goods during the year	1,45,000
Closing Stock	<u>(20,000)</u>

Gross profit is usually ascertained by preparing a Trading account. The format of Trading Account can be shown as below:-

Trading Account of.....for the year ended.....

		₹			₹
To Opening Stock		XXX	By Sales	XXX	XXX
To Purchases	XXX		Less: Returns Inwards	XXX	XXX
Less: Returns outwards	XXX	XXX	By Closing Stock		
To Direct expenses:		XXX	By Gross Loss c/d*		
Freight & Carriage		XXX			

Customs & Insurance	XXX			
Wages	XXX			
Gas, Water & Fuel	XXX			
Factory Expenses	XXX			
Royalty on production	XXX	XXX		
		XXX		XXX
To Gross Profit c/d*				

*Only one will appear

If in the above example net sales, i.e., after adjustment for sales returns, is ₹ 2,00,000 then the gross profit will be ₹ 55,000, i.e., ₹ 2,00,000 – ₹ 1,45,000. This profit is called gross profit since from it indirect expenses have still to be deducted for knowing the net profit. Now, for the same example Trading account will appear as follows:-

Trading Account for the year ending

	₹		₹
To Opening Inventory	15,000	By Sales Account	2,00,000
To Purchase Account	1,50,000	By Closing Inventory	20,000
To Gross Profit carried to P & L A/c	55,000		
	2,20,000		2,20,000

Points to Remember:-

- ◆ The opening inventory and purchases are written on the debit side.
- ◆ Sales and the closing inventory are entered on the credit side.
- ◆ If there are any direct expenses then they should also be written on the debit side of the Trading account.
- ◆ If the balance of credit side is more, the difference is written on the debit side as gross profit. This amount will also be carried forward to the Profit and Loss Account on the credit side.
- ◆ In case of gross loss, i.e., when the debit side of the Trading Account exceeds the credit side, the amount will be written on the credit side of the Trading Account and transferred to the debit side of the Profit and Loss Account.

Trading Account Items

In a trading firm like a wholesaler, the main business consists of buying and selling the same goods. In addition to the amount of the opening inventory, the trading account will also be debited with all expenses incurred in bringing the goods to the godown of the firm and in making them ready for sale.

For example, freight paid on purchases, cartage, octroi, etc. will all be debited to the Trading Account. The rule is that this account will be debited with all expenses incurred in bringing the goods to their present location and condition.

We shall now consider individual items:

- (1) Opening Inventory:** Since this was closing inventory of the last year, it must have been entered in the opening inventory account, through the opening entry. Therefore, it will be found in the trial balance. This item is usually put as the first item on the debit side of the Trading Account. Of course, in the first year of a business there will be no opening inventory.

Trading A/c	Dr.
To Opening Stock A/c	

- (2) Purchases and Purchase Returns:** The purchases account will have debit balance, showing the gross amount of purchases made of the materials. The purchase returns account will have credit balance showing the return of materials to the supplier. On the debit side of the trading account the net amount is shown as indicated (with assumed figures) :

	₹
To Purchases	3,00,000
Less : Purchase Returns	(10,000)
	2,90,000

Closing entry for this purpose is follows:

Purchases Return A/c	Dr.
To Purchases A/c	

(This Net Purchases is transferred to Trading account)

Trading a/c	Dr.
To Purchase a/c	

It happens sometimes that goods are received but the relevant invoice is not received from the supplier. On the date of the closing of the account, an entry must be passed to debit the purchases account and credit the supplier with the cost of goods.

- (3) Carriage or Freight Inwards/Freight:** This item should also be debited to the Trading Account, as it is incurred to bring the materials to the firm's godown and make them available for use. However, if any freight or cartage is paid on any asset, like machinery, it should be added to the cost of the asset and not debited to the Trading Account.

To ascertain value of the closing inventory, it is necessary to make a complete inventory or list of all the items in the godown together with quantities. Of course, damaged or obsolete items are separately listed. To the list of finished goods, one should also add the goods lying with agents sent to them on consignment basis and also the goods sent on approval to customer .

The valuation principle is cost or net realisable value whichever is lower.

Taking inventory is quite a lengthy process. Strictly, immediately at the end of the year the taking of inventory should be completed. Sometimes, however this is done either a few weeks before or a few weeks after the closing. In such a case the value of the inventory thus taken must be adjusted to relate it to the closing date. The adjustment will be necessary because, in the meantime, purchases and sales must have been made. The main point to remember is that in respect of sales their cost has been established. Cost will be sales less gross profit.

ILLUSTRATION 1

Trial Balance for financial the year (FY) ended 31st March 2017 of M/s Deepakshi shows following details:

Particulars	Debit (₹)	Credit (₹)
Purchase & Sales	10,00,000	12,00,000
Debtors & Creditors	5,00,000	4,00,000
Opening Stock	2,00,000	
Closing Stock	3,00,000	
Other Expenses & Incomes	7,00,000	9,00,000
Fixed Assets & Long Term Liabilities	25,00,000	6,00,000
Capital		21,00,000
	52,00,000	52,00,000

Additional Information: Creditors balance as on 1st April, 2016 is ₹ 3,00,000.

You are required to calculate cost of goods sold and amount paid to creditors during the year.

SOLUTION

i) Calculation of Cost of Goods sold:

Particulars	₹
Opening Stock	2,00,000
Add: Purchases (Closing stock already adjusted)*	10,00,000
Cost of Goods Sold	<u>12,00,000</u>

*Since, closing stock appears in Trial Balance, it means following entry has already been passed in books:

Closing Stock A/c	Dr.	3,00,000	
To Purchases A/c			3,00,000

So, we can see purchases have already been reduced by the amount of unsold stock, therefore no more adjustment needs to be made on account of closing stock for computing Cost of goods sold (COGS).

ii) Calculation of amount paid to creditors:

Date	Particulars	₹	Date	Particulars	₹
31.3.17	To Bank A/c (Balancing Figure)	12,00,000	1.4.16	By Balance b/d	3,00,000
	To Balance c/d	4,00,000		By Purchases A/c (Note:1)	13,00,000
		16,00,000			16,00,000

Note: 1) Purchases made during the year can be computed as:

Particulars	₹
Purchases as per Trial Balance	10,00,000
Add: Closing Stock already adjusted	3,00,000
Purchases made during the year	13,00,000

Students may note that in case Closing Stock is not mentioned in Trial Balance, then it means Opening Stock and Purchases appearing in Trial Balance include the value of unsold stock. Since, we prepare our financial statements using matching concept such unsold stock should not form part of cost and therefore is deducted. Therefore, in this case to compute Cost of goods sold (COGS) we will have to use:

$$\text{COGS} = \text{Opening Stock} + \text{Purchases} - \text{Closing Stock} - \text{Purchase Returns}$$

CLOSING ENTRIES IN RESPECT OF TRADING ACCOUNT

The following entries will be required:

(i) **For opening Inventory:** Debit Trading Account and Credit inventory Account.

(ii) **For purchases returns:** Debit Returns Outward Account and Credit Purchases Account.

For returns inward: Debit Sales Account and Credit Returns Inwards Account. (In the trading account information is usually given both in respect of gross sales; and purchases and the respective returns).

(iii) **For purchases account:** Debit Trading Account and Credit Purchases Account, the amount being the net amount after return.

(iv) **For expenses** to be debited to the Trading Account, for example wages etc. Debit Trading Account and credit the concerned expenses accounts individually.

(v) **For sales:** Debit Sales Account with the net amount after returns, and Credit Trading Account.

The student will see that all the accounts mentioned above will be closed except for the Trading Account.

(vi) **For closing Inventory:** Debit Inventory Account and Credit Trading Account. The inventory Account will be carried forward to the next year.

Except entries mentioned in (ii) above, the other entries are usually summarised as follows:

(1) Trading Account Dr.

To Opening Inventory Account
To Purchases Account
To Wages Account
To Freight on Purchases Account, etc.

(2) Sales Account Dr.

Closing Inventory Account Dr.
To Trading Account

At this stage Trading Account will reveal the gross profit, if the credit side is more, or gross loss if the credit side is less. The gross profit will be transferred to the Profit and Loss Account by the entry:

Trading Account Dr.
To Profit and Loss Account

The entry for gross loss, if there be any is :

Profit and Loss Account Dr.
To Trading Account



ILLUSTRATION 2

	₹
Opening Inventory	1,00,000
Purchases	6,72,000
Carriage Inwards	30,000
Wages	50,000
Sales	11,00,000
Returns inward	1,00,000
Returns outward	72,000
Closing Inventory	2,00,000

Required

From the above information, prepare a Trading Account of M/s. ABC Traders for the year ended 31st March, 2017 and Pass necessary closing entries in the journal proper of M/s. ABC Traders



In the books of M/s. ABC Traders
Trading Account for the year ended 31st March, 2016

Particulars	₹	Amount ₹	Particulars	₹	Amount ₹
To Opening Inventory		1,00,000	By Sales	11,00,000	
To Purchases	6,72,000		Less : Returns Inward	(1,00,000)	10,00,000
Less : Returns outward	(72,000)	6,00,000	By Closing Inventory		2,00,000
To Carriage Inwards		30,000			
To Wages		50,000			
To Gross profit		4,20,000			
		12,00,000			12,00,000

Journal Proper in the Books of M/s. ABC Traders

Date	Particulars	Amount ₹	Amount ₹
Mar. 31	Returns outward A/c To Purchases A/c (Being the transfer of returns to purchases account)	Dr. 72,000	72,000
	Sales A/c To Returns Inward A/c (Being the transfer of returns to sales account)	Dr. 1,00,000	1,00,000
	Sales A/c To Trading A/c (Being the transfer of balance of sales account to trading account)	Dr. 10,00,000	10,00,000
	Trading A/c To Opening Inventory A/c To Purchases A/c To Wages A/c To Carriage Inwards A/c (Being the transfer of balances of opening Inventory, purchases and wages accounts)	Dr. 7,80,000	1,00,000 6,00,000 50,000 30,000
	Closing Inventory A/c To Trading A/c (Being the incorporation of value of closing Inventory)	Dr. 2,00,000	2,00,000
	Trading A/c	Dr. 4,20,000	

			4,20,000
To Gross Profit (Being the amount of gross profit)			
Gross profit	Dr.	4,20,000	
To Profit and Loss A/c (Being the transfer of gross profit to Profit and Loss Account)			4,20,000

1.4 PROFIT AND LOSS ACCOUNT

The Profit and Loss Account starts with gross profit on the credit side. If there is gross loss, it will be written on the debit side. After that all those expenses and losses, which have not been entered in the Trading Account, will be written on the debit side of Profit and Loss Account. Incomes and gains, other than sales, will be written on the credit side.

If we understand word 'expenses' properly, there should be no difficulty in distinguishing between items that will be debited to the Profit and Loss Account and those that will be shown as Assets in the balance sheet. Further, it may be noted that the expenses which are personal in nature will not be charged to Profit and Loss A/c. Only those revenue expenses and losses which are related to the current year, are debited to Profit and Loss Account.

It is desirable, according to modern thinking that the Profit and Loss Account should be prepared in such a manner as will enable the reader to form a correct idea about the profit earned or loss suffered by the firm during the period together with the significant factor. Too many details will prevent a person from knowing properly the factors leading to the profit earned. Therefore, items should be according to the various functions, such as administrations, selling and financing. The profit/loss A/c appears as follows:-

Dr.	Profit and Loss Account for the year ended.....		Cr.
Particulars	₹	Particulars	₹
To Gross Loss b/d		By Gross Profit b/d	
Management expenses		Other Income	
To Salaries (administrative)		By Discount Received	
To Office rent, rates and taxes		By Commission Received	
To Printing and stationery		Non-trading Income	
To Telephone charges		By Bank Interest	
To Postage and telegrams		By Rent of property let-out	
To Insurance		By Dividend from shares	
To Audit Fees		Abnormal Gains	
To Legal Charges		By Profit on sale of machinery	
To Electricity Charges		By Profit on sale of investment	
Maintenance expenses			
To Repairs & renewals		By Net Loss (transferred to capital A/c)	
To Depreciation on:			
Office Equipment			
Office Furniture			
Office Buildings			
Selling and Distribution expenses			
To Salaries (selling staff)			
To Advertisement			
To Godown rent			
To Carriage Outward			
To Bad Debts			
To Provision for bad debts			
To Selling commission			
Financial expenses			
To Bank charges			
To Interest on loans			
To Discount on bills			
To discount allowed to customers			
Abnormal Losses			
To Loss on sale of machinery			
To Loss on sale of investment			
To loss by fire			
To Net Profit (transferred to Capital A/c)			

Note:

- (i) Gross loss appears in the debit side of the Profit and Loss Account at the top; while Gross Profit on the credit side.
- (ii) Net loss appears in the credit side of the Profit and Loss Account; while Net profit on debit side as balancing figures.

It will be good idea to either show these expenses in a separate schedule or to indicate the total of these prominently in the Profit and Loss Account. This rule should be followed wherever the number of items is rather large.

On the income side of the Profit and Loss Account, besides the gross profit, there may be interest received, discount received, rent from subletting of premises, miscellaneous incomes such as from sale of junk material etc., It would be desirable to show the totals only under each of the main categories of income. However, interest on fixed deposits, interests or income from investments and other interest should be shown separately. Similarly, items which have to be debited/credited to the proprietor should be segregated from other items. Examples would be interest charged on drawings, interest allowed on capital and charges for services rendered by the firm to the proprietor personally.

We shall now consider a few items individually:

- (i) **Drawings:** Drawings are not expenses for the firm but reduction of capital and therefore should not be debited to the Profit and Loss Account but to Capital account of the proprietor.

Capital A/c	Dr.
To Drawings	

If the proprietor has enjoyed some benefit personally, like use of the firm's car, a suitable amount should be treated as drawing and to that extent the charge to the Profit and Loss Account will be reduced, Drawings are debited to the proprietor's capital account.

- (ii) **Income Tax:** In case of companies, the income tax payable is treated like other expenses. But in the case of sole proprietorship, income tax is treated as a personal expense. It is debited to the Capital Account and not to the Profit and Loss Account.

Capital A/c	Dr.
To Income Tax A/c	

This is because the amount of the tax will depend on the total income of the partners or proprietor besides the profit of the firm. In case of partnership business, firm's tax liability is to be debited to profit and loss account of the firm but partners' tax liability are not to be borne by the firm. Therefore if the firm pays income tax on behalf of partners, such payment of personal income tax should be treated as drawings.

(iii) Discount received and allowed: We have already seen that discount is of two types. Trade discount and Cash discount. Trade discount is allowed when the order for goods is not below a certain figure. It is deducted from the invoice. Only the net amount of invoice is entered in books. There is no further treatment of the trade discount. Cash discount is allowed to a customer if he makes the payment before a certain date. It is allowance made to him for prompt payment and is recorded in the books. Therefore, Trade discount is not debited to P/L account, but cash discount is.

Discount received is really in the nature of interest received and similarly, discount allowed really means interest paid. Discount received is a gain and is credited to the Profit and Loss Account while discount allowed is debited.

Profit/Loss A/c	Dr.
To Discount Allowed A/c	

Discount Received A/c	Dr.
To Profit/Loss A/c	

(iv) Rebate: It is the allowance given to a customer when his purchases during a period, say one year, total upto a certain figure. Suppose a firm allows a rebate of 4% to those customers whose purchases during the year are at least ₹ 5,000. One Customer's purchases are ₹ 4,500, he will not get any rebate. Another customer's purchases total ₹ 5,100, he will get a rebate of ₹ 204. The entry for rebate is made only at the end of the year. The Rebate Account is debited and is later written in the profit and Loss Account on the debit side. Various customers who have earned the rebate are credited.

Initially when Rebate is given

Rebate A/c	Dr.
To Customer A/c	

In the year end

Profit/Loss A/c	Dr.
To Rebate A/c	

(iv) Bad Debts: When a customer does not pay the amount due from him and all hopes of recovering the amount are lost, it is said to be a bad debt. It is a loss to the firm. Therefore, the bad debts account is debited, which is later on written in the Profit and Loss Account on the debit side. Since it is no use showing the amount due still as an asset, the account of the customer concerned is closed by being credited. The entry

Bad Debts Account	Dr.
To Debtor's / Customer (by name) Account	

Profit/Loss Account	Dr.
To Bad Debts A/c	

In case of Provision for Bad debts has already been prepared then bad debts should be written off first from it. Entry for it will be:

Provision for Bad Dents A/c	Dr.
To Bad Debts A/c	

If later on, the amount is recovered, it should be treated as a gain. It should not be credited to the party paying it. It should be credited to Bad Debts Recovered Account. It will be entered in the Profit and Loss Account on the credit side.

Bad Debts Recovered Account	Dr.
To Profit/Loss Account	

CLOSING ENTRIES

The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries. We have already seen the entries required for preparing the Trading Account and for transferring the gross profit to the profit and Loss Account. Now to complete the Profit and Loss Account, the under mentioned three entries will be necessary.

- (a) For items to be debited to the Profit and Loss Account this account will be debited and the various accounts concerned will be credited. For example,

Profit and Loss Account	Dr.
To Salaries Account	
To Rent Account	
To Interest Account	
To Other Expenses Account	

- (b) Items of income or gain such as interest received or miscellaneous income will be credited to Profit and Loss Account.

Discount Received Account	Dr.
Bad debts Recovered Account	Dr.
To Profit and Loss Account	

- (c) At this stage, the Profit and Loss Account will show net profit or net loss. Both have to be transferred to the Capital Account. In case of net profit, i.e., when the credit side is bigger than the debit side, the entry is:

Profit and Loss Account	Dr.
To Capital Account	

In the case of net loss, the entry will be

Capital Account

Dr.

To Profit and Loss Account

 **ILLUSTRATION 3**

Revenue, Expenses and Gross Profit Balances of M/s ABC Traders for the year ended on 31st March 2016 were as follows:

Gross Profit ₹4,20,000, Salaries ₹1,10,000, Discount (Cr.), ₹18,000, Discount (Dr.) ₹ 19,000, Bad Debts ₹17,000, Depreciation ₹65,000, Legal Charges ₹ 25,000, Consultancy Fees ₹32,000, Audit Fees ₹ 1,000, Electricity Charges ₹17,000, Telephone, Postage and Telegrams ₹ 12,000, Stationery ₹ 27,000, Interest paid on Loans ₹70,000.

Required

Prepare Profit and Loss Account of M/s ABC Traders for the year ended on 31st March, 2016. Show necessary closing entries in the Journal Proper of M/s. ABC Traders also.

 **SOLUTION**

**In the Books of M/s. ABC Traders
Profit and Loss Account
For the year ended 31st March, 2016**

Particulars	Amount ₹	Particulars	Amount ₹
To Salaries	1,10,000	By Gross Profit	4,20,000
To Legal Charges	25,000	By Discount received	18,000
To Consultancy Fees	32,000		
To Audit Fees	1,000		
To Electricity Charges	17,000		
To Telephone, Postage & Telegrams	12,000		
To Stationery	27,000		
To Depreciation	65,000		
To Discount Allowed	19,000		
To Bad Debts	17,000		
To Interest	70,000		
To Net Profit	43,000		
	4,38,000		4,38,000

Journal Proper in the Books of M/s. ABC Traders

Date 2016	Particulars	Amount ₹	Amount ₹
March 31	Profit & Loss Account Dr.	3,95,000	
	To Salaries A/c		1,10,000
	To Legal Charges A/c		25,000
	To Consultancy Fees A/c		32,000
	To Audit Fees A/c		1,000
	To Electricity Charges A/c		17,000
	To Telephone, Postage & Telegrams A/c		12,000
	To Stationery A/c		27,000
	To Depreciation A/c		65,000
	To Discount Allowed A/c		19,000
	To Bad Debts A/c		17,000
	To Interest A/c		70,000
	(Being the transfer of balances of various expenses accounts)		
	Discount Received A/c Dr.	18,000	
	To Profit & Loss A/c		18,000
	(Being the transfer of discount received account balance)		
	Gross Profit A/c Dr.	4,20,000	
	To Profit & Loss A/c		4,20,000
	(Being the transfer of gross profit from Trading Account)		
	Profit & Loss A/c Dr.	43,000	
	To Net Profit A/c		43,000
	(Being the ascertainment of net profit)		
	Net Profit A/c Dr.	43,000	
	To Capital A/c		43,000
	(Being the transfer of net profit to Capital A/c)		

Adjustments

The fundamental principle of accounting is that the period to which various items of income and expenditure pertain should be co-extensive with the period of account. As such before Final Accounts are drawn up. It must be ensured that the accounts, which require adjustment on this consideration, have been adjusted, both by providing for expense accrued and including income outstanding and excluding expenses the benefit of which extends beyond the year of account as well as the income received in advance. The entries that must be passed for adjusting various accounts of income and expenditure are shown below:

- (1) Expenses accrued and accruing, e.g., Rent, Interest, Local Taxes, Wages etc.

Appropriate Expense Account Dr.
To Expenses Accrued/outstanding Account

For Example, if Rent Paid is ₹ 50,000 for a year and Outstanding Rent is ₹ 14,000. It will be treated as follows:-

- (3) **Carrying forward income received in advance e.g.,** Subscription in the case of a club or fees in case of professional person.

Appropriate Income Account

Dr.

To Income Received in Advance Account

For Example Subscription Received in advance is ₹ 70,000 and total subscription received is ₹ 1,75,000.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
		By subscription	1,75,000
		Less: Advance	(70,000)
			1,05,000

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Advance Subscription	70,000		

- (4) **Carrying forward of payments made in advance e.g.,** Telephone, Rent, Insurance etc.,

Expenses Prepaid Account

Dr.

To Appropriate Expenses Account

Suppose out of the total Rent of ₹ 50,000. ₹ 14,000 pertains to the next year.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Rent	50,000		
Less: Prepaid Rent	(14,000)		
	36,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Prepaid Rent	14,000

- (5) **Adjustment of Inventory of materials in hand**, e.g., Stationery, Advertisement, Material, Manufacturing Stores, etc., the cost whereof already has been debited to expense account.

Inventory of Materials Dr.
 To Appropriate Expenses Account

For Example if opening stock of stationery is ₹ 15,000 and direct expenses on it is ₹ 1,700. It is also given outside the Trial Balance. Closing stock of stationery is ₹ 5,000. The treatment is as follow:-

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Stationery:			
Opening stock	15,000		
Add: Expenses	1,700		
Less: Closing Stock	(5,000)		
	11,700		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Closing Stock	5,000

Note: Next year in the beginning entries No. (1) to (5) should be reversed.

- (6) **Provision for Bad and doubtful Debts :** When it is feared that some of the amount due from customers will not be collected it is prudent to recognise the expected loss by reducing the current year's profit and placing the amount to the credit of a special account called "Provision for Bad and Doubtful Debts Account". The entry is;

Profit and Loss Account Dr.
 To Provision for Bad and doubtful Debts Account

Note: The accounts of the customers concerned are not affected until the amount is actually written off for which the entry is,

Bad Debts Account Dr.
 To Customer's A/c

Bad Debts when written off are debited to the provision in this respect where such a provision exists or directly to the Profit and Loss Account the corresponding credit being given (ultimately) to the trade receivable's account. If, on the other hand, a provision is required to be created, the amount of provision is also debited to the Profit and Loss Account. Where an examination problem requires that certain bad debts

should be written off and a provision for doubtful debts made, the amount of bad debts to be written off should be first debited against the existing balance of the provision and the resulting balance in the account afterwards should be raised to the required figure. The method is illustrated below:

ILLUSTRATION 4

On 1st Jan. 2017 provision for Doubtful Debts existed at ₹ 40,000. Trade receivables on 31.12.2017 were ₹ 15,00,000; bad debts totalled ₹ 1,00,000. It is required to write off the bad debts and create a provision equal to 5% of the Trade receivables' balances.

Required

Show how you would compute the amount debited to the Profit and Loss Account.

SOLUTION

PARTICULARS	₹
Opening Provision (Cr.)	40,000
Bad Debts written off (Dr.)	1,00,000
Short Provision	60,000
Provision required (Dr.) (5% of ₹14,00,000)	70,000
Additional amount required for debit to the Profit and Loss Account (Dr.)	1,30,000

The account will appear as follows:

Provision for Doubtful Debts Account

2017		₹	2017		₹
Dec. 31	To Bad Debts Account	1,00,000	Jan. 1	By Balance b/d	40,000
	To Balance c/d (required)	70,000	Dec. 31	By Profit and Loss A/c (Balancing Figure)	1,30,000
		1,70,000			1,70,000
			2018		
			Jan 1	By Balance b/d	70,000

(7) **Provision for Discount:** This provision is created in the same manner, discussed above but the amount of provision is required to be calculated after deducting the Provision for Bad Debts from the total trade receivables. This is because Provision for discount is created only on good debtors.

For Example if Trade Receivables is ₹ 5,20,000 and provision for doubtful debt is ₹ 1,20,000. You are required to create a 10% provision for discount on debtors.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Provision For Discount (10% of 4,00,000)	40,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Debtors	5,20,000
		Less:- Provision for Doubtful debts	(1,20,000)
		Less:- Provision for Discount	(40,000)
			3,60,000

(8) **Provision for Depreciation:** It is made either by debiting Depreciation Account and crediting the Provision for depreciation account concerned and afterwards closing of the Depreciation Account by transfer to the Profit and Loss Account or by directly debiting the profit and loss Account and crediting provision for depreciation account and explaining the nature of adjustment by recording a detailed narration in the Journal.

Profit/Loss account Dr.
 To Depreciation/Provision for depreciation.

The amount of depreciation is deducted from the concerned asset and is then shown in the Balance sheet.

For Example if machinery Cost ₹ 15,00,000 and 10% depreciation is to be provided. The treatment is as follow:-

Depreciation a/c Dr. ₹ 1,50,000
 To Provision for Depreciation a/c ₹ 1,50,000

Depreciation is now charged to P&L a/c as:

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Depreciation	1,50,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Machinery	15,00,000
		Less: Provision for Depreciation	(1,50,000)
			13,50,000

(9) **Other Provisions:** Whenever it is expected that a loss, the amount of which is not certain will occur, the proper course is to create a provision for meeting the loss if and when it occur. This would be the case, for example, if compensation has to be paid for the late delivery of goods. The entry is to debit the Profit and Loss Account and credit an account suitably named.

All accounts showing provisions may appear in the Balance Sheet on the liability side but it should be noted that:

- (i) The provision for Bad and Doubtful Debts and the Provision for Discount on Trade receivables are deducted from the total book debts; and
- (ii) The provision for Depreciation is deducted from the cost of the assets concerned.

(10) **Transfers, involving correction of errors,** are made by debit or credit to the accounts affected, the corresponding effect being recorded either in a Suspense Account of some other account.

Transfers in respect of special charges to the Profit and Loss Account e.g., partner's salaries, interest, etc., and in respect of appropriation of profits are recorded by debit to the Profit and Loss Account and credit to the parties concerned.

While making adjustments, it is important to remember that every entry has a two-fold aspect, debit and credit. For example, if an adjustment is required to be made on account of prepaid insurance charges, the Insurance Charges Account would be credited, and, to complete the double entry, Prepaid Expenses Account is debited with the same amount. The last mentioned balance would be included on the debit side of the Trial Balance.

Students should, as a matter of course, record on the rough working sheets, adjustments in respect of various items stated in a question and then give their effect in the Trial Balance, before proceeding to draw up the Final Accounts.

1.5 CERTAIN ADJUSTMENTS AND THEIR TREATMENTS

- 1. Abnormal loss of Inventory by accident or fire :** Sometimes loss of goods occurs due to fire, theft, etc. If due to accident or fire, a portion of Inventory is damaged, the value of loss is first to be ascertained. Thereafter, Abnormal Loss Account is to be debited and Purchase Account or Trading Account is to be credited.

Abnormal Loss Account is to be transferred to Profit & Loss Account. If amount of loss is recoverable from insurance company, then insurance company is to be debited instead of Profit & Loss Account. Till the money is not received from the insurance company, Insurance Company's Account will be shown in the Assets side of the Balance Sheet. If any part of the loss is recoverable from the insurance company, then the portion not compensated by the insurance company should be debited to Profit & Loss Account. For example, if goods worth ₹ 6,000 are destroyed by fire and the insurance company admits the claim for ₹ 4,500, the Journal entries will be:-

(i) Loss by Fire Account	Dr.	6,000	
To Purchases/Trading Account			6,000
(ii) Insurance Company's A/c (Insurance Claim)	Dr.	4,500	
Profit & Loss A/c	Dr.	1,500	
To Loss by Fire A/c			6,000

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Loss by Fire (The amount not compensated by insurance company)	1,500		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Insurance Claim	4,500

In the Trading Account, Purchases will be reduced by 6,000.

- 2. Goods sent on Approval basis:** Sometimes goods are sold to customers on sale or return basis or on approval basis. It should not be treated as actual sale till the time it is not approved by the customer. When goods were sold we have passed the entry for actual sales. Therefore, at the year end, if the goods are still lying with the customers for approval, following entries are to be passed:

For example -

Goods costing ₹10,000 sent to a customer on sale or return basis for ₹12,000. The entry for such unapproved sale shall be-

(i) Sales A/c	Dr.	12,000	
			To Trade receivables A/c
			12,000
(ii) Stock on approval A/c	Dr.	10,000	
			To Trading A/c
			10,000

These goods should now be included in the amount of Closing Stock at their cost price.

- 3. Goods used other than for sale :** Sometimes goods are used for some other purposes, such as distributed as free samples, used in construction of any assets or used by proprietor for personal use. In such cases the amount used for other purposes is subtracted from Purchases A/c and depending upon the specific use done, the suitable account head is debited.

For example:-

When goods are given away as donation-

Donation A/c	Dr.	
		To Purchases A/c

When goods are used by the proprietor for his personal use-

Drawings A/c	Dr.	
		To Purchases A/c

When goods are distributed as free samples :-

Free Samples / Advertisement A/c	Dr.	
		To Purchases A/c

When goods are used in business for construction of Building or the Machinery :-

Building A/c / Plant & Machinery A/c	Dr.	
		To Purchases A/c

When goods are used for maintenance of business premises/ Machinery :-

Repair & Maintenance A/c	Dr.	
		To Purchases A/c

4. **Commission based on profit:** Sometimes commission is payable to manager based on net profit; in such a case calculation is done as follows:

(i) Commission on net profit before charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100}$$

(ii) Commission on net profit **after** charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100 + \text{Rate of commission}}$$

Commission is recorded by following journal entry

Commission A/c	Dr.
To Commission Payable A/c	

(Being commission payable to Mr @% on net profit after charging such commission, net profit before charging commission being ₹.....)

Commission will be debited in the Profit & Loss Account and Commission Payable Account will be shown in the Balance Sheet on liability side.

Profit/Loss Account	Dr.
To Commission A/c	

For Example if Net profit before Commission is ₹ 1,00,000 and Manager is entitled to a Commission of 10% of Net Profit before charging such commission. The amount of Commission is = ₹ 10,000 (10% of ₹ 1,00,000). It will be shown as follow:-

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Commission	10,000		
To Net Profit transferred to Capital A/c	90,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Commission Payable	10,000		

Now, let us assume that 10% commission is payable on Net Profit after charging such commission. The amount of commission now is = 9,090.90 or 9091 (approx) (₹ 1,00,000 x 10/110)

**ILLUSTRATION 5**

The following is the Trial Balance of C. Wanchoo on 31st Dec. 2017.

Trial Balance on 31st December, 2017

Particulars	₹	₹
Capital Account		10,00,000
Inventory Account	2,00,000	
Cash in hand	1,44,000	
Machinery Account	7,36,000	
Purchases Account	18,20,000	
Wages Account	10,00,000	
Salaries Account	10,00,000	
Discount Allowed A/c	50,000	
Discount Received A/c		30,000
Sundry Office Expenses Account	6,00,000	
Sales Account		50,00,000
Sums owing by customer (Trade receivables)	8,50,000	
Trade payables (sums owing to suppliers)		3,70,000
Total	64,00,000	64,00,000

Value of Closing Inventory on 31st Dec. 2017 was ₹ 2,70,000

Required

Prepare closing entries for the above items and Prepare Trading and Profit and Loss Account.

 SOLUTION

Date 2017	Particulars	L.F.	₹	₹
Dec. 31	Trading Account To Inventory Account To Purchase A/c To Wages A/c (Being the accounts in the Trial Balance which have to be transferred to the Trading Account debit side)	Dr.	30,20,000	2,00,000 18,20,000 10,00,000
Dec. 31	Sales Account To Trading A/c (Being the amount of Sales transferred to the credit of Trading Account)	Dr.	50,00,000	50,00,000
Dec. 31	Inventory (Closing) A/c To Trading A/c (Being the value of Inventory on hand on 31st Dec. 2016)	Dr.	2,70,000	2,70,000
Dec. 31	Trading A/c To Profit and Loss A/c (Being the transfer of gross profit.)	Dr.	22,50,000	22,50,000
Dec. 31	Profit and Loss A/c To Discount Allowed Account To Salaries A/c To Sundry Office Expenses A/c (Being the various expense accounts transferred to the P & L Account)	Dr.	16,50,000	50,000 10,00,000 6,00,000
Dec. 31	Discount Received A/c To P & L Account (Being the credit balance of discount received transferred to Profit and Loss A/c)	Dr.	30,000	30,000
Dec. 31	Profit and Loss A/c To Capital A/c (Being the transfer to Net Profit to the Capital Account)	Dr.	6,30,000	6,30,000
			1,28,50,000	1,28,50,000

C. WANCHOO**Trading Account of the year ended December 31, 2017**

Particulars	₹	Particulars	₹
To Inventory A/c	2,00,000	By Sales A/c	50,00,000
To Purchases	18,20,000	By Inventory (Closing)	2,70,000
To Wages	10,00,000		
To Gross profit trfd. to P & L A/c	22,50,000		
	52,70,000		52,70,000

Profit and Loss Account for the year ended December 31, 2017

Particulars	₹	Particulars	₹
To Salaries	10,00,000	By Gross profit trfd. From the Trading Account	22,50,000
To Discount Allowed	50,000	By Discount Received	30,000
To Sundry Office Expenses	6,00,000		
To Net Profit transferred to Capital A/c	6,30,000		
	22,80,000		22,80,000



1.6 BALANCE SHEET

The balance sheet may be defined as “a statement which sets out the assets and liabilities of a firm or an institution as at a certain date.” Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word “as at.”

The assets are shown on the right hand side and liabilities and capital on the left hand side.

CHARACTERISTICS

The balance sheet has certain characteristics, which should be noted. These are the following:

- (i) It is prepared at a particular date, rather the close of a day and not for a period. It is true only on that date and not later. Suppose, in the example given above, a part of the goods were sold on 1st January, 2017. This will mean that the value of the Inventory will be reduced, the cash in hand will increase and the capital account will be reduced or increased depending upon loss or profit on sale.
- (ii) The balance sheet is prepared only after the preparation of the Profit and Loss Account. This is the reason why the Profit and Loss Account (including the Trading Account) and the Balance Sheet are together called Final Accounts (Of course, the Balance Sheet is not an account, the two sides are not the debit and the credit sides.) Without being accompanied by the Profit and Loss Account, the Balance Sheet will not be able to throw adequate light on the financial position of the firm. For that purpose an appreciation of the profits of the firm is necessary.

- (iii) Since capital always equals the difference between assets and liabilities and since the capital account will independently arrive at this figure, the two sides of the Balance Sheet must have the same totals. If it is not so, there is certainly an error somewhere.

In the illustration no. 5 worked out above it will be seen that the under mentioned accounts have not been closed even after preparation of the Profit and Loss Account and the transfer of the net profit to the capital account.

	₹	
Cash in Hand	1,44,000	Debit balance
Capital Accounts (₹10,00,000+ ₹6,30,000)	16,30,000	Credit balance
Machinery Account	7,36,000	Debit balance
Trade receivables	8,50,000	Debit balance
Trade payables	3,70,000	Credit balance
Inventory Account	2,70,000	Debit balance

Looking at these accounts, one would know that various assets: Cash balance in hand, cash at bank, machinery, furniture etc. that the firm possesses and the amounts that are owing as liability to trade payables and to the proprietor as capital. The capital, of course, will be the difference between the total of assets and of liabilities. The assets, liabilities and capital are usually presented in a statement called the Balance Sheet. This is given below for the accounts mentioned above.

C. WANCHOO

Balance Sheet as at December 31, 2017

Liabilities	Amount ₹	Assets	Amount ₹
Trade payables	3,70,000	Cash in Hand	1,44,000
Capital	16,30,000	Trade receivables	8,50,000
		Inventories	2,70,000
		Machinery	7,36,000
	20,00,000		20,00,000

ARRANGEMENTS OF ASSETS AND LIABILITIES

- (1) **Assets:** Assets may be grouped in one of the following two ways:
- (i) **Liquidity:** Under this approach, the asset, which can be converted into cash first, is presented first. Those assets, which are most difficult in this respect, are presented at the bottom. As per Liquidity the balance sheet can be prepared as follow:-

Balance Sheet as at...

Liabilities	Amount ₹	Assets	Amount ₹
Bills Payable		Cash in Hand	
Trade Creditors		Cash at Bank	
Loans		Government Securities	
Outstanding Expenses		Other Investments	
Reserves & Surplus		Bills Receivable	
Capital		Sundry Debtors	
		Stock	
		Furniture & Fixtures	
		Plant & Machinery	
		Land and Building	

(ii) **Permanence:** Assets, which are to be used, for long term in the business and are not meant to be sold are presented first. Assets, which are most liquid, such as cash in hand, are presented at the bottom.

Balance Sheet as at...

Liabilities	Amount ₹	Assets	Amount ₹
Capital		Land and Building	
Reserves & Surplus		Plant & Machinery	
Outstanding Expenses		Furniture & Fixtures	
Loans		Stock	
Trade Creditors		Sundry Debtors	
Bills Payable		Bills Receivable	
		Other Investments	
		Government Securities	
		Cash at Bank	
		Cash in Hand	

Note:- Some of the assets may be capable of being sold easily like investment in government securities or shares of some companies. They should be treated as liquid or permanent according to the intention of the firm.

- (2) **Liabilities:** Liabilities may also be shown according to the urgency with which payment has to be made. One way is to first show the capital, then long-term liabilities and last of all short term liabilities like amounts due to suppliers of goods or bills payable. The other way is to start with short-term liabilities and then show long term liabilities and last of all capital.

CLASSIFICATION OF ASSETS AND LIABILITIES

Assets are basically of two types:

Current Assets: - these assets are meant to be converted into cash as quickly as possible. Generally within one year. For Example:- Cash in hand, Cash at Bank, Trade receivables, Inventories.

Long Term Assets: - Those that are meant to be used by the firm over a long period and not sold the former type of assets is also called fixed assets. For Example Machinery, Building, Long term Investment.

Intangible Assets: - the assets which have no physical existence and cannot be seen or touched are called as Intangible Assets. For example Patents, Copyrights etc.

It is desirable that in the balance sheet the two types of assets should be shown separately and prominently. This would give meaningful and logical information.

Liabilities to outsider will be of two types:

Current Liabilities: - this liability must be settled in one year or less. It is also called as short term liability. For Example:- Creditors, Bills Payable etc.

Long Term Liability: - those liabilities which exists for more than one year are Long term liabilities. For example long term loans from banks. Of course, it will include undistributed profits also.

Sole proprietors generally present Balance Sheet in a horizontal form with “Capital and Liabilities” on the left hand side and ‘Assets’ on the right-hand side. In the Balance Sheet the various items should be grouped suitably as indicated below:

Balance Sheet as on.....

Liabilities	Amount ₹	Assets	Amount ₹
Capital A/c: Balance <i>Add: Net Profit/Less: Net Loss</i> <i>Less: Drawings</i>		Tangible Fixed Assets : Land and Building Plant and Machinery Furniture and Fixture Vehicles	
Long Term Loans : Term Loans Other Loans		Intangibles : Goodwill Patent Rights Designs and Brand Names	
Short Term Loans : Cash Credit Overdrafts Other Loans		Investments Long term investments	
Current Liabilities : Trade payables		Current Assets :	

Outstanding Expenses		Inventory in Trade	
Advances Taken		Trade receivables	
Provision :		Short term investments	
Provision for Bad debts		Prepayments	
Provision for Retirement Benefits		Advances	
Provision for Taxation		Bank Balances	
		Cash In Hand	

If course, there is no hard and fast rule regarding presentation of assets, liabilities and equities in the Balance sheet. However, the model presentation shown above has been designed considering the nature of Balance Sheet elements and categorizing them appropriately.

Proper presentation of Balance Sheet items improves understandability of the information desired to be communicated to the users of account.

ILLUSTRATION 6

Given below Trial Balance of M/s Dayal Bros. as on 31st March, 2017 :

Particulars	Debit Balances ₹	Credit Balances ₹
Capital A/c		7,00,000
Land and Building	3,00,000	
14% Term Loan		4,00,000
Loan from M/s. D & Co.		4,60,000
Trade receivables	4,20,000	
Cash in hand	20,000	
Inventories in Trade	6,00,000	
Furniture	2,00,000	
Trade payables		40,000
Advances to Suppliers	1,00,000	
Net Profit		1,00,000
Drawings	60,000	
	17,00,000	17,00,000

Required

Prepare Balance Sheet as on 31st March, 2017.

SOLUTION

**In the Books of M/s Dayal Bros.
Balance Sheet
as on 31st March, 2017**

Liabilities	Amount ₹	Assets	Amount ₹
Capital: Balances	7,00,000	Land & Building	3,00,000
Add: Net Profit	1,00,000	Furniture	2,00,000

	8,00,000		Inventories in Trade	6,00,000
Less: Drawings	(60,000)	7,40,000	Trade receivables	4,20,000
14% Term Loan		4,00,000	Advances to Suppliers	1,00,000
Loan from M/s D & Co.		4,60,000	Cash in Hand	20,000
Trade payables		40,000		
		16,40,000		16,40,000

ILLUSTRATION 7

The balance sheet of Thapar on 1st January, 2017 was as follows:

Liabilities	Amount ₹	Assets	Amount ₹
Trade payables	15,00,000	Plant & Machinery	30,00,000
Expenses Payable	1,50,000	Furniture & Fixture	3,00,000
Capital	50,00,000	Trade receivables	14,00,000
		Cash at Bank	6,50,000
		Inventories	13,00,000
	66,50,000		66,50,000

During 2017, his Profit and Loss Account revealed a net profit of ₹15,30,000. This was after allowing for the following :

- Interest on capital @ 6% p.a.
- Depreciation on Plant and Machinery @ 10% and on Furniture and Fixtures @ 5%.
- A provision for Doubtful Debts @ 5% of the trade receivables as at 31st December, 2017.

But while preparing the Profit and Loss Account he had forgotten to provide for (1) outstanding expenses totaling ₹1,80,000 and (2) prepaid insurance to the extent of ₹20,000.

His current assets and liabilities on 31st December, 2017 were : Inventories ₹ 14,50,000; Trade receivables ₹ 20,00,000; Cash at Bank ₹ 10,35,000 and Trade payables ₹ 11,40,000.

During the year he withdrew ₹6,00,000 for domestic use.

Required

Draw up his Balance Sheet at the end of the year.

**SOLUTION****Profit and Loss Account (Revised)**

Particulars	₹	Particulars	₹
To Outstanding expenses	1,80,000	By Balance b/d	15,30,000
To Net profit	13,70,000	By Prepaid insurance	20,000
	15,50,000		15,50,000

**Balance Sheet of Thapar
as on 31st December, 2016**

Liabilities		₹	Assets	₹	₹
Capital	50,00,000		Cash at Bank		10,35,000
Add: Net Profit	13,70,000		Trade receivables	20,00,000	
	63,70,000		Less: Provision for doubtful debts	(1,00,000)	19,00,000
Less: Drawings	(6,00,000)		Plant and Machinery	30,00,000	
	57,70,000		Less: Depreciation	(3,00,000)	27,00,000
Add: Interest on capital	3,00,000	60,70,000	Furniture & Fixtures	3,00,000	
Outstanding expenses		1,80,000	Less: Depreciation	(15,000)	2,85,000
Trade payables		11,40,000	Inventories		14,50,000
			Prepaid insurance		20,000
		73,90,000			73,90,000

**1.7 SEQUENCE OF ACCOUNTING PROCEDURE OR THE ACCOUNTING CYCLE**

What has been done so far shows that the accounting process in the following order :

- (i) recording the transactions in the journal or journalising;
- (ii) preparing ledger accounts on the basis of the journal or posting into the ledger;
- (iii) taking out the trial balance to check arithmetical accuracy;
- (iv) preparing the trading and profit and loss account or the income statement for the period concerned;
and
- (v) preparing the balance sheet to show the financial position at the end of the period.

1.8 OPENING ENTRY

We have seen that on commencing a new business one debits the cash account and credits the capital account with the amount introduced. A firm closes the books of account at the end of each year and starts new books in the beginning of each year. The first entry in the journal is to record the closing balances of various assets and liabilities at the end of the previous year as the opening balances in the beginning of the new year. The balance sheet prepared at the end of the year records these balances and is the basis for this first entry. It is called the opening entry.

The assets shown in the balance sheet are debited and the liabilities and the capital account credited.

ILLUSTRATION 8

BALANCE SHEET
As at 31st December, 2017

Liabilities	₹	Assets	₹
Mahendra & Sons	5,60,000	Cash in hand	43,000
Capital	20,00,000	Cash at Bank	2,67,500
		Trade receivables	7,49,500
		Closing Inventory	9,00,000
		Machinery and Equipment	6,00,000
	25,60,000		25,60,000

Required

From the above given balance sheet prepare the relevant opening entry.

SOLUTION

The Opening Entry :01-01-2018

		Dr.	Cr.
		₹	₹
Cash A/c	Dr.	43,000	
Bank A/c	Dr.	2,67,500	
Trade receivables	Dr.	7,49,500	
Inventory A/c	Dr.	9,00,000	
Machinery and Equipment A/c	Dr.	6,00,000	
To Mahendra & Sons A/c			5,60,000
To Capital A/c			20,00,000
(Being the balances brought forward)		25,60,000	25,60,000

Posting the Opening Entry

All the assets show debit balance. Such accounts are opened and the relevant amounts written on the debit side as "To Balance b/d". Following is the cash account arising from the entry given above.

Cash Account

Date	Particulars	Amount	Date	Particulars	Amount
2018		₹			₹
Jan. 1	To Balance b/d	43,000			

Similarly account should be opened for all other assets and relevant amount should be posted on the Dr. side.

The accounts of liabilities show credit balances. An account for each liability is opened and the relevant account is written on the credit side as "By Balance b/d". This is shown below by opening the accounts of Mahendra & Sons mentioned in the entry given above.

Mahendra & Sons

Date	Particulars	Amount	Date	Particulars	Amount
		₹	2018		₹
			Jan. 1	To Balance b/d	5,60,000

By posting the opening entry completely all the accounts of assets and liabilities in the beginning are opened. We illustrate below a complete cycle of journalising, posting and trial balance.

Students should work through the following illustration given by way of practice on the method of making adjustments in some of the accounts contained in a Trial Balance and afterwards preparing the final Account.

ILLUSTRATION 9

Shri Mittal gives you the following Trial Balance and some other information:

Trial Balances as on 31st March, 2017

Particulars	Dr.	Cr.
	₹	₹
Capital		8,70,000
Purchases and Sales	6,05,000	12,10,000
Opening Inventory	72,000	
Trade receivables and Trade payables	90,000	1,70,000
14% Bank Loan (loan taken at year end)		2,00,000
Overdrafts (overdraft taken at year end)		1,12,000
Salaries	2,70,000	
Advertisements	1,10,000	
Other expenses	60,000	

Returns	40,000	30,000
Furniture	4,50,000	
Building	8,90,000	
Cash in Hand	5,000	
	<u>25,92,000</u>	<u>25,92,000</u>

Closing Inventory on 31st March, 2017 was valued at ₹1,00,000.

Required

Prepare final accounts of Shri Mittal for the year ended 31st March, 2017.

 **SOLUTION**

**In the books of Shri Mittal
Trading Account
for the year ended 31st March, 2017**

Particulars		Amount ₹	Particulars		Amount ₹
To Opening inventory		72,000	By Sales	12,10,000	
To Purchases	6,05,000		Less: Returns	(40,000)	11,70,000
Less: Returns	(30,000)	5,75,000	By Closing inventory		1,00,000
To Gross Profit		6,23,000			
		<u>12,70,000</u>			<u>12,70,000</u>

**Profit and Loss Account
For the year ended 31st March, 2017**

Particulars	Amount ₹	Particulars	Amount ₹
To Salaries	2,70,000	By Gross profit	6,23,000
To Advertisement	1,10,000		
To Other expenses	60,000		
To Net profit	1,83,000		
	<u>6,23,000</u>		<u>6,23,000</u>

Balance Sheet as on 31st March, 2017

Liabilities	₹	Amount ₹	Assets	Amount ₹
Capital	8,70,000		Building	8,90,000
Add: Net profit	1,83,000	10,53,000	Furniture	4,50,000
14% Bank Loan		2,00,000	Trade receivables	90,000
Trade payables		1,70,000	Closing inventory	1,00,000
Overdrafts		1,12,000	Cash in hand	5,000
		15,35,000		15,35,000

Note: As loan and overdraft taken at year end so no interest shown.

**ILLUSTRATION 10**

Mr. Mohan gives you the following trial balance and some other information:

Trial Balance as on 31st March, 2017

Particulars	₹	₹
Capital		6,50,000
Sales		9,70,000
Purchases	4,30,000	
Opening Inventory	1,10,000	
Freights Inward	40,000	
Salaries	2,10,000	
Other Administration Expenses	1,50,000	
Furniture	3,50,000	
Trade receivables and Trade payables	2,10,000	1,90,000
Returns	20,000	12,000
Discounts	19,000	9,000
Bad Debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and Cash at Bank	1,87,000	
	18,31,000	18,31,000

Other Information:

- (i) Closing Inventory was ₹ 1,80,000;
- (ii) Depreciate Furniture @ 10% p.a.

Required

Prepare Trading and Profit and Loss Account for the year ended on 31.3.2017 and Balance Sheet of Mr. Mohan as on that date.

 **SOLUTION**

**In the books of Mr. Mohan
Trading Account
for the year ended 31st March, 2017**

Particulars		Amount ₹	Particulars		Amount ₹
To Opening Inventory		1,10,000	By Sales	9,70,000	
To Purchases	4,30,000		Less: Returns	(20,000)	9,50,000
Less: Returns	(12,000)	4,18,000	By Closing Inventory		1,80,000
To Freight Inwards		40,000			
To Gross profit		5,62,000			
		11,30,000			11,30,000

**Profit and Loss Account
for the year ended 31st March, 2017**

Particulars	₹	Particulars	₹
To Depreciation	35,000	By Gross profit	5,62,000
To Salaries	2,10,000	By Discount received	9,000
To Administration expenses	1,50,000		
To Discount allowed	19,000		
To Bad debts	5,000		
To Net profit	1,52,000		
	5,71,000		5,71,000

**Balance Sheet
as on 31st March, 2017**

Liabilities		Amount ₹	Assets		Amount ₹
Capital	6,50,000		Furniture	3,50,000	
Add: Net profit	1,52,000	8,02,000	Less: Depreciation	(35,000)	3,15,000
Trade payables		1,90,000	Closing Inventory		1,80,000
			Trade receivables		2,10,000
			Investment in Govt Securities		1,00,000
			Cash in Hand and Cash at Bank		1,87,000
		9,92,000			9,92,000

ILLUSTRATION 11

The Balance Sheet of Mr. Popatlal, a merchant on 31st March, 2017 stood as below:

Liabilities	Amount ₹	Assets	Amount ₹
Capital	2,40,000	Fixed Assets	1,25,600
Trade payables	1,64,000	Inventories	2,06,400
Bank Overdraft	1,46,000	Trade receivables	1,88,000
		Less: Provision	(6,200)
		Cash	36,200
	5,50,000		5,50,000

Required

Show opening journal entry on 1st April, 2017 in the books of Mr. Popatlal.

SOLUTION

Opening entry

			(Dr.) ₹	(Cr.) ₹
1.4.2017	Fixed Assets A/c	Dr.	1,25,600	
	Inventories A/c	Dr.	2,06,400	
	Trade receivables A/c	Dr.	1,88,000	
	Cash A/c	Dr.	36,200	
	To Trade payables A/c			1,64,000
	To Bank Overdraft A/c			1,46,000
	To Provision for Doubtful Debts A/c			6,200
	To Capital A/c			2,40,000

ILLUSTRATION 12

The following is the schedule of balances as on 31.3.17 extracted from the books of Shri Gavaskar, who carries on business under the same name and style of Messrs Gavaskar Viswanath & Co., at Bombay:

Particulars	Dr. ₹	Cr. ₹
Cash in hand	14,000	
Cash at bank	26,000	
Sundry Debtors	8,60,000	
Stock on 1.4.2016	6,20,000	
Furniture & fixtures	2,14,000	
Office equipment	1,60,000	
Buildings	6,00,000	
Motor Car	2,00,000	

Sundry Creditors		4,30,000
Loan from Viswanath		3,00,000
Provision for bad debts		30,000
Purchases	14,00,000	
Purchase Returns		26,000
Sales		23,00,000
Sales Returns	42,000	
Salaries	1,10,000	
Rent for Godown	55,000	
Interest on loan from Viswanath	27,000	
Rates & Taxes	21,000	
Discount allowed to Debtors	24,000	
Discount received from Creditors		16,000
Freight on purchases	12,000	
Carriage Outwards	20,000	
Drawings	1,20,000	
Printing and Stationery	18,000	
Electricity Charges	22,000	
Insurance Premium	55,000	
General office expenses	30,000	
Bad Debts	20,000	
Bank charges	16,000	
Motor car expenses	36,000	
Capital A/c		16,20,000
TOTAL	47,22,000	47,22,000

Prepare Trading and Profit and Loss Account for the year ended 31st March 2017 and the Balance Sheet as at that date after making provision for the following:

1. Depreciate: (a) Building used for business by 5 percent; (b) Furniture and fixtures by 10 percent; One steel table purchased during the year for ₹ 14,000 was sold for same price but the sale proceeds were wrongly credited to Sales Account; (c) Office equipment by 15 percent; Purchase of a typewriter during the year for ₹ 40,000 has been wrongly debited to purchase; and (d) Motor car by 20%.
2. Value of stock at the close of the year was ₹ 4,40,000.
3. Two month's rent for godown is outstanding.
4. Interest on loan from Viswanath is payable at 12 percent per annum, this loan was taken on 1.5.2016.
5. Reserve for bad debts is to be maintained at 5 percent of Sundry Debtors.

6. Insurance premium includes ₹ 40,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.2016 to 30.6.17

**SOLUTION**

M/s Gavaskar Viswanath & Co.
Trading for the year ended 31st March 2017

Particulars	Details	Amount ₹	Particulars	Details	Amount ₹
To opening Stock		6,20,000	By Sales	23,00,000	
To Purchases	14,00,000		Less: Sale of furniture included in sale	14,000	
Less: Typewriter included in purchases	40,000		Less: Sales Returns	42,000	22,44,000
Less: Purchase Returns	26,000	13,34,000	By Closing Stock		4,40,000
To Freight on purchase		12,000			
To Gross Profit c/d		7,18,000			
		26,84,000			26,84,000

M/s Gavaskar Viswanath & Co.
Profit/Loss Account for the year ended 31st March 2017.

Particular	Details	Amount ₹	Particular	Details	Amount ₹
To Salaries		1,10,000	By Gross profit b/d		7,18,000
To Rent for Godown	55,000		By Discount received		16,000
Add: Outstanding	11,000	66,000			
To provision for doubtful debts(4)		33,000			
To Rent and Taxes		21,000			
To Discount Allowed		24,000			
To Carriage outwards		20,000			
To printing and stationery		18,000			
To Electricity charges		22,000			
To Insurance premium (1)		12,000			

To Depreciation (2)		1,20,000		
To general office expenses		30,000		
To Bank Charges		16,000		
To interest on loan	27,000			
Add: Outstanding (3)	6,000	33,000		
To Motor car expenses		36,000		
To Net Profit transferred to Capital a/c		1,73,000		
		7,34,000		7,34,000

**Balance Sheet of M/s Gavaskar Vishwanath & Co.
as at 31st March 2017**

Liabilities	Details	Amount ₹	Assets	Details	Amount ₹
Capital	16,20,000		Building	6,00,000	
Add: Net Profit	1,73,000		Less: Dep.	(30,000)	5,70,000
Less: Drawings	(1,20,000)				
Less: Insurance Premium	(40,000)	16,33,000	Motor Car	2,00,000	
			Less: Dep.	(40,000)	1,60,000
Loan from Vishwanath	3,00,000				
Add: Outstanding	6,000	3,06,000	Office equipment	2,00,000	
			Less: Dep.	(30,000)	1,70,000
Sundry Creditors		4,30,000			
Outstanding rent		11,000	Furniture & Fixture	2,00,000	
			Less: Dep.	(20,000)	1,80,000
			Stock in Trade		4,40,000
			Sundry Debtors	8,60,000	
			Less: Provision for doubtful debts	(43,000)	8,17,000
			Cash at hand		26,000
			Cash in bank		14,000
			Prepaid insurance (1)		3,000
		23,80,000			23,80,000

Working Notes :**(1). Insurance premium**

₹

Insurance premium as given in trial balance	55,000
Less: Personal premium	(40,000)
Less: Prepaid for 3 months	
$\left(\frac{15,000}{15} \times 3 \right)$	(3,000)
Transfer to P/L a/c	12,000

(2). Depreciation

Building @ 5% on 6,00,000	30,000
Motor Car @ 20% on 2,00,000	40,000
Furniture & Fittings @ 10% on 2,00,000 (2,14,000-14,000)	20,000
Office Equipment @ 15% on 2,00,000 (1,60,000 + 40,000)	30,000
Total	1,20,000

(3). Interest on Loan

Interest on Loan (3,00,000 x 12% x 11/12)	= 33,000
Less : interest as per Trial Balance	(27,000)
P/L account (Outstanding)	6,000

(4)

Provision for bad debts a/c

Particulars	Amount ₹	Particulars	Amount ₹
To bad debts a/c	20,000	By balance b/d	30,000
To balance c/d	43,000	By P&L a/c	33,000
	63,000		63,000


1.9 PROVISIONS AND RESERVES

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy". A provision is a liability which can be measured only by using a substantial degree of estimation.

Thus, a provision may be either in respect of loss in the value of an asset provided or written off on the basis of an estimate or the one in respect of a liability for expenses incurred in respect of a claim which is disputed

i.e. when it is a contingent liability. On the occurrence of a diminution in asset values due to some of them having become irrecoverable or Inventory items are lost as a result of some natural calamity, amounts contributed or transferred from profit to make good the diminution also are described as provision.

The following are instances of amount retained in the business out of earning for different purposes that are described as provisions.

- (1) Amount provided for meeting claims which are admissible in principle but the amount whereof has not been ascertained.
- (2) An appropriation made for payment of taxes still to be assessed.
- (3) Amount set aside for writing off bad debts or payment of discounts.

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability is known as reserves. The reserves are primarily of two types: capital reserves and revenue reserves. Also provisions in excess of the amount considered necessary for the purposes these were originally made, are to be considered as reserves. **It is thus evident that provisions are a charge against profits, while reserve is an appropriation of profits.** Also provisions that ultimately prove to be in excess of amounts required or have been made too liberally are reserves. Such a distinction is essential for disclosing truly in the Balance Sheet the amount by which the equity of shareholders has increased with the accumulation of undistributed profits.

Reserve Fund: It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.



ILLUSTRATION 13

Crimson Ltd's profit and loss account for the year ended 31st March, 2016 includes the following information:

	₹
(i) Depreciation	57,500
(ii) Bad debts written off	21,000
(iii) Increase in provision for doubtful debts	18,000
(iv) Proposed dividend	15,000
(v) Retained profit for the year	20,000
(vi) Liability for tax	4,000

Required

State which one of the items (i) to (vi) above are – (a) transfer to provisions; (b) transfer to reserves; and (c) neither related to provisions nor reserves.

**SOLUTION**

- (a) Transfer to provisions - (i), (iii) (vi)
 (b) Transfer to reserves - (v)
 (c) Neither related to provisions nor reserves - (ii), (iv).

A summary of all adjustments are as follows:

Adjustment	If Given in Trial Balance	If Not Given in Trial Balance
1. Closing stock	Balance Sheet – Asset Side	(a) Trading A/c – Credit Side
		(b) Balance Sheet – Asset Side
2. Outstanding Expenses	Balance Sheet – Liability Side	(a) Trading/Profit & Loss A/c Debit Side. Add to the concerned expenses.
		(b) Balance Sheet – Liability Side
3. Prepaid Expenses	Balance Sheet – Asset Side	(a) Trading/Profit & Loss A/c Debit Side. Deduct from the concerned expense.
		(b) Balance Sheet - Asset
4. Income Outstanding	Balance Sheet – Asset Side	(a) Profit & Loss A/c – Credit Side. Add to the concerned income.
		(b) Balance Sheet – Asset Side.
5. Incomes Received in Advance	Balance Sheet – Liability Side	(a) Profit & Loss A/c – Credit Side. Deduct from concerned income.
		(b) Balance Sheet – Liability Side
6. Bad Debs	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from debtors.
7. Provision for Bad or Doubtful debts	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from Debtors after additional bad debts, if any.
8. Provision for Discount on Debtors	Balance Sheet – Asset Side Deduct from Debtors.	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from debtors after providing for provision for bad debts
9. Depreciation	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from Respective Asset.

10. Interest on Capital	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Liability Side. Add to Capital.
11. Interest on Drawings	Profit & Loss A/c – Credit Side	(a) Profit & Loss A/c – Credit Side.
		(b) Balance Sheet – Liability Side. Deduct from Capital.
12. Loss by Fire	Profit & Loss A/c – Debit Side	(a) Trading A/c – Credit Side (with full amount of loss)
		(b) Profit & Loss A/c – Debit Side (Actual loss, if any)
		(c) Balance Sheet – Asset Side (with insurance claim admitted by Insurance Co.)
13. Goods withdrawn for personal use	Trading A/c - Credit Side	(a) Trading A/c – Credit Side or Deduct from Purchases.
		(b) Balance Sheet – Liability Side (Deduct from Capital as Drawings)
14. Goods Distributed as free Samples	Profit & Loss A/c – Debit Side	(a) Trading A/c – Credit Side or Deduct from Purchases
		(b) Profit & Loss A/c – Debit Side
15. Sale of Goods on Approval Basis, approval not yet received	Usually it is not given in Trial Balance	(a) Trading A/c – Credit Side. Deduct from Sales the selling price of goods sold and add to stock at cost price.
		(b) Balance Sheet – Asset Side. Deduct from Debtors the selling price of such sales and show the cost price of such sales along with closing stock.



1.10 LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements suffer from a number of limitations. These must, therefore be studied with care, in order that correct inferences may be drawn. The limitations are less serious if the objective is only to appraise the performance of a single company over a period of year. Where, however, a comparison of the working of different companies for the same period is to be made. It can be misleading unless the companies concerned have followed the same system and basis of accounting. On the account, a comparison of the profitability of different industries on the basis of financial statements, should be undertaken only if it is not practicable to make such a comparison on any other basis.

The principal limitations affecting financial statements are the following:

- (a) **Historical Cost:** Accounting records and, on that account, the financial statements are prepared only on the basis of the money value prevailing at the time the transaction were entered into. Thus, the effect of subsequent changes in the value of money is not taken into account. At times this has the effect of making the statements of account quite misleading. Take the obvious example of a house built in 1980, say at the cost of ₹15,000, in 2016 the benefit receivable from its occupation will be as much as that of a house created in 2016, say at a cost of ₹14,50,000. If the house were included in the financial statements at its original cost, as normally it would not convey a true picture except to a knowledgeable person.

The limitations can be serious in the case of other fixed assets that have been working over a long period over which prices have changed radically. It is, however, not easy to get over this difficulty, since revaluation of fixed assets, apart from being costly is not practicable when the value of money is continuously falling. On this account, historical cost continues to be the accepted basis for the preparation of financial statements. Though it may not be possible to do much to remove the limitation mentioned above, one must always remember to read the balance sheet and the profit and loss account in the light of what they cannot reveal as well as what they do.

- (b) **Intangible strengths and weaknesses:** A company may have a number of strengths and weaknesses which cannot be shown in the balance sheet e.g., the loyalty and calibre of its staff. These must be kept in mind while judging the financial position of the company.
- (c) **Perpetual continuity and periodical account:** Financial statements ordinarily are drawn up at the end of each year but the accounting record is maintained on the assumption that the business undertaking shall continue to exist forever on the basis of going concern assumption. In consequence, much of the expenditure other than revenue expenditure has to be distributed arbitrarily over a number of years during which benefit of the expenditure is expected to arise. As a result, financial statements of account are not absolutely correct.
- (d) **Different accounting policies:** It is permissible for a company within certain limits to adopt different policies for the preparation of accounts, valuation of various assets and distribution of expenditure over different periods of account. For example, a company may decide to provide annually for payment of pensions and gratuities to staff and thus build up a 'fund' out of which payments will be made ultimately whereas another company may deal with these only when actual payments are made. Similarly, a company may decide whether or not to include intangible assets amongst its assets or manner in which the amounts thereof should be written off.
- (e) **Management policies:** Management can have different accounting policies for welfare of the staff and public at large.

 **SUMMARY**

- ◆ Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods at profit without changing the form of the goods.
- ◆ For accounting, profit is measured at two levels:
 - (a) Gross Profit
 - (b) Net Profit
- ◆ The principal function of final statements of account (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the profitability and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained.
- ◆ At the end of the year, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases.

 **... TEST YOUR KNOWLEDGE****Multiple Choice Questions**

- (1) A debit to an account may
 - (a) increase expense
 - (b) decrease an asset.
 - (c) increase a liability.
 - (d) increase income.
- (2) Prepayment of insurance premium will appear in the Balance Sheet and in the Insurance Account respectively as:
 - (a) a liability and a debit balance.
 - (b) an asset and a debit balance.
 - (c) an asset and a credit balance.
 - (d) a liability and a credit balance.
- (3) Gross profit is the difference between:
 - (a) sales and purchases
 - (b) sales and cost of sales.
 - (c) sales and total expenses.
 - (d) Sales and total liabilities.
- (4) Payment made to a creditor subject to cash discount will :
 - (a) reduce a liability, reduce an asset and add to expenses.
 - (b) reduce a liability, add to an asset, and add to revenue.
 - (c) reduce an asset, reduce a liability, and add to revenue.
 - (d) reduce a liability, reduce an asset and decrease expenses.
- (5) A customer returns goods already charged to him. We should:
 - (a) debit his account.
 - (b) credit his account.
 - (c) make no entry on his account.
 - (d) None of the above.

- (6) Capital is the difference between
- | | |
|----------------------------|----------------------------------|
| (a) Income and expenses | (b) Sales and Cost of goods sold |
| (c) Assets and liabilities | (d) None of the above. |
- (7) The capital of a sole trader would change as a result of:
- A creditor being paid his account by cheque.
 - Raw materials being purchased on credit.
 - Fixed assets being purchased on credit.
 - Wages being paid in cash.
- (8) A decrease in the provision for doubtful debts would result in:
- | | |
|---------------------------------|------------------------------------|
| (a) An increase in liabilities. | (b) A decrease in working capital. |
| (c) An increase in net profit. | (d) None of the three. |
- (9) A Company wishes to earn a 20% profit margin on selling price. Which of the following is the profit mark up on cost, which will achieve the required profit margin?
- | | | | |
|---------|---------|---------|---------|
| (a) 33% | (b) 25% | (c) 20% | (d) 30% |
|---------|---------|---------|---------|
- (10) If sales is ₹ 2,000 and the rate of gross profit on cost of goods sold is 25%, then the cost of goods sold will be
- | | | | |
|--------------|--------------|--------------|--------------|
| (a) ₹ 2,000. | (b) ₹ 1,500. | (c) ₹ 1,600. | (d) ₹ 1,000. |
|--------------|--------------|--------------|--------------|
- (11) Sales for the year ended 31st March, 2016 amounted to ₹ 10,00,000. Sales included goods sold to Mr. A for ₹ 50,000 at a profit of 20% on cost. Such goods are still lying in the godown at the buyer's risk. Therefore, such goods should be treated as part of
- | | |
|-----------------------|------------------------|
| (a) Sales. | (b) Closing Inventory. |
| (c) Goods in transit. | (d) None of the above. |
- (12) If sales revenues are ₹4,00,000; cost of goods sold is ₹ 3,10,000 and expenses are ₹60,000, the gross profit is
- | | |
|-----------------|-----------------|
| (a) ₹ 30,000. | (b) ₹ 90,000. |
| (c) ₹ 3,40,000. | (d) ₹ 4,00,000. |

Theory questions

- Write **shorts notes** on:
 - Balance sheet.
 - Trading account
 - Closing entries
- Distinguish between Provision and reserve fund.

Practical questions

- From the following particulars extracted from the books of Ganguli, prepare trading and profit and loss account and balance sheet as at 31st March, 2016 after making the necessary adjustments:

	₹		₹
Ganguli's capital account (Cr.)	5,40,500	Interest received	72,500
Stock on 1.4.2015	2,34,000	Cash with Traders Bank Ltd.	40,000
Sales	14,48,000	Discounts received	14,950
Sales return	43,000	Investments (at 5%) as on 1.4.2015	25,000
Purchases	12,15,500	Furniture as on 1-4-2015	9,000
Purchases return	29,000	Discounts allowed	37,700
Carriage inwards	93,000	General expenses	19,600
Rent	28,500	Audit fees	3,500
Salaries	46,500	Fire insurance premium	3,000
Sundry debtors	1,20,000	Travelling expenses	11,650
Sundry creditors	74,000	Postage and telegrams	4,350
Loan from Dena Bank Ltd. (at 12%)	1,00,000	Cash in hand	1,900
Interest paid	4,500	Deposits at 10% as on 1-4-2015 (Dr.)	1,50,000
Printing and stationery	17,000	Drawings	50,000
Advertisement	56,000		

Adjustments:

- (1) Value of stock as on 31st March, 2016 is ₹ 3,93,000. This includes goods returned by customers on 31st March, 2016 to the value of ₹ 15,000 for which no entry has been passed in the books.
- (2) Purchases include furniture purchased on 1st January, 2016 for ₹10,000.
- (3) Depreciation should be provided on furniture at 10% per annum.
- (4) The loan account from Dena bank in the books of Ganguli appears as follows:

	₹		₹
31.3.2016 To Balance c/d	1,00,000	1.4.2015 By Balance b/d	50,000
		31.3.2016 By Bank	50,000
	1,00,000		1,00,000

- (5) Sundry debtors include ₹ 20,000 due from Robert and sundry creditors include ₹ 10,000 due to him.
- (6) Interest paid include ₹ 3,000 paid to Dena bank.
- (7) Interest received represents ₹ 1,000 from the sundry debtors and the balance on investments and deposits.
- (8) Provide for interest payable to Dena bank and for interest receivable on investments and deposits.
- (9) Make provision for doubtful debts at 5% on the balance under sundry debtors. No such provision need to be made for the deposits.

2. Sengupta & Co. employs a team of eight workers who were paid ₹30,000 per month each in the year ending 31st December, 2015. At the start of 2016, the company raised salaries by 10% to ₹33,000 per month each.

On July 1, 2016 the company hired two trainees at salary of ₹21,000 per month each. The work force are paid salary on the first working day of every month, one month in arrears, so that the employees receive their salary for January on the first working day of February etc.

You are required to calculate:

- (i) Amount of salaries which would be charged to the profit and loss for the year ended 31st December, 2016.
 - (ii) Amount actually paid as salaries during 2016
 - (iii) Outstanding Salaries as on 31st December, 2016.
3. You are required, prepare a Trading and Profit and Loss Account for the year ending 31st March, 2016 and a Balance Sheet as on that date from the Trial Balance given below:

Particulars	₹	Particulars	₹
Debit Balance:			
Trade receivables	3,50,000	Salaries	2,20,000
Inventory 1st April, 2015	5,00,000	Purchases	12,50,00
Cash in Hand	5,60,000	Plant and Machinery	15,70,000
Wages	3,00,000	Credit Balance:	
Bad Debts	50,000	Capital	25,00,000
Furniture and Fixtures	1,50,000	Trade payables	9,00,000
Depreciation	1,50,000	Sales	17,00,000

On 31st March, 2016 the Inventory was valued at ₹10,00,000.

4. Mr. Kotriwal is engaged in business of selling magazines. Several of his customers pay money in advance for subscribing his magazines. Information related to year ended 31st March 2017 has been given below:

On 1.4.2016 he had a balance of ₹ 2,00,000 advance from customers of which ₹ 1,50,000 is related to year 2016-17 while remaining pertains to year 2017-18. During the year 2016-17 he made cash sales of ₹ 5,00,000. You are required to compute:

- i) Total income for the year 2016-17.
 - ii) Total money received during the year if the closing balance in advance from customers account is ₹ 1,70,000.
5. Mr. Birla is a proprietor engaged in business of trading electronics. An excerpt from his Trading & P&L account is as follows:

Trading and P&L A/c for the year ended 31st March, 2017

Particulars	₹	Particulars	₹
To Cost of Goods Sold	45,00,000	By Sales	C
To Gross Profit c/d	<u>D</u>		
	<u>E</u>		<u>F</u>
To Rent A/c	26,00,000	By Gross Profit b/d	<u>D</u>
To Office Expenses	13,00,000	By Miscellaneous Income	E
To Selling Expenses	B		
To Commission to Manager (on Net Profit before charging such commission)	2,00,000		
To Net Profit	A		
	<u>G</u>		<u>60,00,000</u>

Commission is charged at the rate of 10%.

Selling Expenses amount to 1% of total sales.

You are required to compute the missing figures.

ANSWERS/HINTS

MCQs

1.	(a)	2.	(c)	3.	(b)	4.	(c)	5.	(b)	6.	(c)
7.	(d)	8.	(c)	9.	(b)	10.	(c)	11.	(a)	12.	(b)

Theoretical Questions

- The balance sheet may be defined as "a statement which sets out the assets and liabilities of a firm or an institution as at a certain date." Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."
 - At the end of the year, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss with the helps to Trading A/c. Gross Profit is the difference between the selling price and the cost of the goods sold.
 - Closing entries: The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries.
- Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

Reserve Fund: It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.

Practical Questions

Answer 1

**In the books of Ganguli
Trading and Profit & Loss Account
for the year ended 31-3-2016**

	₹	₹		₹	₹
To Opening stock		2,34,000	By Sales	14,48,000	
To Purchases	12,15,500		Less: Returns	(58,000)	13,90,000
Less: Transfer to furniture A/c	(10,000)		By Closing stock		3,93,000
	12,05,500				
Less: Returns	(29,000)	11,76,500			
To Carriage inwards		93,000			
To Gross profit c/d		2,79,500			
		17,83,000			17,83,000
To Salaries		46,500	By Gross profit b/d		2,79,500
To Rent		28,500	By Interest		17,250
To Advertisement		56,000	By Discount received		14,950
To Printing & stationery		17,000			
To Interest		7,500			
To Discount allowed		37,700			
To General expenses		19,600			
To Travelling expenses		11,650			
To Fire insurance premium		3,000			
To Postage & telegrams		4,350			
To Provision for doubtful debts (W.N.I)		4,750			
To Depreciation on furniture		1,150			
To Audit fees		3,500			
To Capital A/c (Net profit transferred)		70,500			
		3,11,700			3,11,700

Balance Sheet as on 31-3-2016

Liabilities		₹	₹	Assets		₹	₹
Capital account:				Furniture		9,000	
Balance on 1-4-15	5,40,500			Additions during the year		10,000	
Add: Net profit	70,500					19,000	
	6,11,000			Less: Depreciation	(1,150)		17,850
Less: Drawings	(50,000)	5,61,000		Investments			25,000
Loan from Dena Bank Ltd.		1,00,000		Deposits			1,50,000
Insurance accrued on bank loan (W.N.2)		3,000		Interest accrued on investment & deposits (W.N.3)			10,000
Sundry creditors		64,000		Stock in trade			3,93,000
				Sundry debtors	95,000		
				Less: Provision	(4,750)		90,250
				Cash with Traders Bank Ltd.			40,000
				Cash in hand			1,900
							7,28,000
			7,28,000				7,28,000

Working Notes:

1.	Calculation of provision for doubtful debts:		₹
	Sundry debtors as per trial balance		1,20,000
	Less: Sales returns not recorded		(15,000)
			1,05,000
	Less: Cancellation against sundry creditors		(10,000)
	Adjusted balance of sundry debtors		95,000
	Provision for doubtful debts @ 5%		4,750
2.	Accrued interest on bank loan:		
	Annual interest @12%		6,000
	Less: Interest paid to Dena bank		(3,000)
	Accrued interest		3,000
3.	Interest accrued on investments and deposits:		
	Annual interest on investments @ 5%		1,250
	Annual interest on deposits @ 10%		15,000
			16,250
	Less: Interest received on investments and deposits		(6,250)
	Accrued interest		10,000

Answer 2

(i)	Salaries to be charged to profit and loss account for the year ended 31st December, 2016:		₹
	Salaries of 8 employees for full year @ ₹33,000 per month each		31,68,000
	Salaries of 2 trainees for 6 months @ ₹21,000 p.m.		2,52,000
			<u>34,20,000</u>

(ii) Salaries actually paid in 2016	
December, 2015 salaries paid in January, 2016 (8 x 30,000)	2,40,000
Salaries of 8 employees for January to November, 2016 paid in February-December, 2016 @ ₹33,000 for 11 months	29,04,000
Salaries of 2 trainees for July to November paid in August-December @ ₹21,000 for 5 months	<u>2,10,000</u>
	<u>33,54,000</u>
(iii) Outstanding salaries as at 31st December, 2016	
8 employees @ ₹33,000 each for 1 month	2,64,000
2 trainees @ ₹21,000 each for 1 month	<u>42,000</u>
	<u>3,06,000</u>

Answer 3**Trading and Profit and Loss Account for the year ending 31st March, 2016**

Particulars	₹	Particulars	₹
To Opening Inventory	5,00,000	By Sales	17,00,000
To Purchases	12,50,000	By Closing Inventory	10,00,000
To Wages	3,00,000		
To Gross Profit	6,50,000		
	<u>27,00,000</u>		<u>27,00,000</u>
To Bad Debts	50,000	By Gross Profit	6,50,000
To Depreciation	1,50,000		
To Salaries	2,20,000		
To Net Profit transferred. to Capital A/c	2,30,000		
	<u>6,50,000</u>		<u>6,50,000</u>

Balance Sheet as at 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
Trade payables		9,00,000	Cash in Hand	5,60,000	
<i>Capital:</i>			Trade receivables	3,50,000	
Previous Balance	25,00,000		Closing Inventory	10,00,000	19,10,000
Add: Net Profit	2,30,000	27,30,000	Furniture & Fixtures	1,50,000	
			Plant & Machinery	15,70,000	17,20,000
		<u>36,30,000</u>			<u>36,30,000</u>

Answer 4**i) Computation of Income for the year 2016-17:**

	₹
Money received during the year related to 2016-17	5,00,000
Add: Money received in advance during previous years	1,50,000
Total income of the year 2016-17	<u>6,50,000</u>

ii)

Advance from Customers A/c

Date	Particulars	₹	Date	Particulars	₹
	To Sales A/c (Advance related to current year transferred to sales)	1,50,000	1.4.2016	By Balance b/d	2,00,000
31.3.17	To Balance c/d	1,70,000		By Bank A/c	1,20,000
		3,20,000		(Balancing Figure)	
					3,20,000

So, total money received during the year is:

	₹
Cash Sales during the year	5,00,000
Add: Advance received during the year	1,20,000
Total money received during the year	6,20,000

Answer 5**A) Computation of Net Profit:**

Commission Manager = Rate of Commission X Net Profit before charging such commission

So, Commission to manager = $10/100 \times$ Net Profit before charging such commission

$\Rightarrow ₹ 2,00,000 = 10/100 \times$ Net Profit before charging such commission

\Rightarrow Net Profit before charging such commission = ₹ 20,00,000

\Rightarrow Net Profit (A) = ₹ (20,00,000 - 2,00,000) = ₹ 18,00,000

B) Computation of Selling Expenses:

Total income appearing in P&L A/c = ₹ 60,00,000

Total expenses other than selling expenses = ₹ (26,00,000 + 13,00,000 + 2,00,000)

= ₹ 41,00,000

So,

Selling Expenses + Remaining Expenses + Net Profit = Total Income

\Rightarrow Selling Expenses = ₹ 60,00,000 - ₹ 41,00,000 - ₹ 18,00,000

\Rightarrow Selling Expenses = ₹ 1,00,000

C) Computation of Sales:

We have been given selling expenses amount to 1% of Sales

$$\begin{aligned} \text{So, Sales} &= \frac{\text{Selling Expenses}}{1} \times 100 \\ &= \frac{1,00,000}{1} \times 100 \\ &= ₹ 100,00,000 \end{aligned}$$

D) Computation of Gross Profit:

In Trading A/c

Particulars	₹	Particulars	₹
To COGS	45,00,000	By Sales (from C above)	100,00,000
To Gross Profit (Balancing Figure)	55,00,000		
Total (F)	100,00,000	Total (F)	100,00,000

So, Gross Profit (D) = ₹ 55,00,000

E) Miscellaneous Income = Total Income in P&L - Gross Profit

= ₹ (60,00,000 - 55,00,000)

= ₹ 5,00,000

F = ₹ 100,00,000 (As computed in D above)

G = ₹ 60,00,000 (Total of both sides of P&L is equal after balancing has been done)