Unit 12

FINAL ACCOUNTS OF SOLE PROPRIETORS - I

Contents

AK16G6

Learning Objectives

To enable the students to

- Understand the meaning of final accounts and the purpose they serve
- Prepare trading and profit and loss account and balance sheet

Points to recall

Following points are to be recalled before learning final accounts of sole proprietors - I:

- Accounting process
- Trial balance
- Dual aspect concept, Historical cost concept, Periodicity concept and Matching concept
- Differences between capital expenditure and revenue expenditure
- Differences between capital receipts and revenue receipts

Key terms to know

- Final accounts
- Financial statements
- Income statement
- Trading account
- Profit and loss account
- Cost of goods sold
- Gross profit
- Net profit
- Financial position
- Balance sheet

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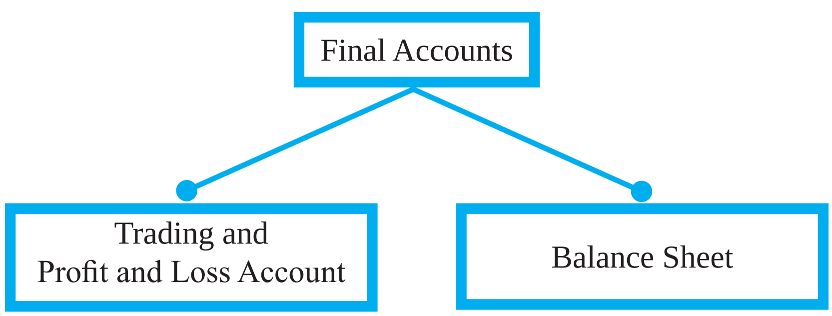
12.1 Introduction to final accounts

Student activity

Think: A trader wants to know the profit earned by him, at the end of his first year of trading. Do you think the trial balance shows the profit earned? How will he find the profit?

Business entities raise funds, acquire assets and incur various expenses for the purpose of carrying on business operations and earning income from such operations. These transactions are first recorded in the journal and then classified under common heads in the ledger. Preparation of trial balance from ledger balances helps to verify the arithmetical accuracy of entries made in the books of accounts, but it is not the end in itself. The business entities are interested in knowing periodically the results of business operations carried on and the financial soundness of the business. In other words, they want to know the profitability and the financial position of the business. These can be ascertained by preparing the final accounts or financial statements. The final accounts are usually prepared at the end of the accounting period on the basis of balances of ledger accounts shown by the trial balance.



The final accounts or financial statements include the following:

a. Income Statement or Trading and Profit and Loss Account and

b. Position Statement or Balance Sheet.

The purposes of preparing the financial statements are:

i. To ascertain the financial performance of an enterprise and

ii. To ascertain the financial position of an enterprise.

The income statement and balance sheet are prepared for these purposes respectively. Income statement gives the manner in which the profit or loss for an accounting period is arrived at. The revenues earned and expenses incurred to earn the revenues during the period are shown in the income statement under appropriate heads as per matching principle. All the nominal accounts and accounts relating to goods during an accounting period are to be considered only in the relevant accounting period and are not to be carried forward. Moreover, only these items are to be compared for determining the financial performance. Hence, at the close of the accounting period, all nominal accounts (i.e. expenses, losses, revenues, gains, purchases, purchases returns, sales and sales returns) are to be closed by transferring to the income statement or trading and profit and loss account.

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While transferring the items, it is desirable that the results of buying and selling of goods and the results of overall operations and financial performance are given separately. Hence, income statement is divided into two parts. The first part, i.e., trading account shows the results of buying and selling and the second part shows the results of overall financial performance. The second part may also be presented in such a manner to give the operating results and overall financial performance separately. All the direct expenses and items relating to goods are transferred to trading account which is the first part of income statement. All indirect expenses and losses and indirect incomes and gains are transferred to profit and loss account along with the net result of trading account.

12.2 Closing entries and Opening entry

12.2.1 Closing entries

Balances of all the nominal accounts are required to be closed on the last day of the accounting year to facilitate the preparation of trading and profit and loss account. It is done by passing necessary closing entries in the journal proper. Purchases has debit balance and purchases returns has credit balance. At the end of the accounting year, the balance in purchases returns account is closed by transferring to purchases account.

Similarly, sales account has credit balance and sales returns has debit balance. At the end of the accounting year, the balance in sales returns account is closed by transferring to sales account. The various closing entries are as follows:

1. For closing purchases returns account

Particulars		Debit ₹	Credit ₹
Purchases returns A/c	Dr.	xxx	
To Purchases A/c			xxx
(Closing of purchase returns account by transferring to purchases account)			

2. For closing sales returns account

Particulars		Debit ₹	Credit ₹
Sales A/c	Dr.	xxx	
To Sales returns A/c			xxx
(Closing of sales returns account by transferring to sales account)			

3. For closing opening stock and direct expenses, i.e., items that appear on the debit side of trading account

Particulars		Debit ₹	Credit ₹
Trading A/c	Dr.	xxx	
To Opening stock A/c			xxx
To Purchases A/c			xxx
To Carriage inwards A/c			xxx
To Wages A/c			xxx
To All other direct expenses A/c (individually)			xxx
(Closing of various items by transferring them to trading account)			

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4. **For closing sales and closing stock, i.e., items that appear on the credit side of trading account**

Particulars		Debit ₹	Credit ₹
Sales A/c	Dr.	xxx	
Closing stock A/c	Dr.	xxx	
To Trading A/c			xxx
(Closing of various iteams by transferring them to trading account)			

5. **For transfer of gross profit or gross loss to profit and loss account**

(a) For gross profit

Particulars		Debit ₹	Credit ₹
Trading A/c	Dr.	xxx	
To Profit and loss A/c			xxx
(Transfer of gross profit to the profit and loss account)			

(b) For gross loss

Particulars		Debit ₹	Credit ₹
Profit and loss A/c	Dr.	xxx	
To Trading A/c			xxx
(Transfer of gross loss to the profit and loss account)			

6. **For closing indirect expenses and losses, i.e., items that appear on the debit side of profit and loss account**

Particulars		Debit ₹	Credit ₹
Profit and loss A/c	Dr.	xxx	
To Office expenses A/c			xxx
To Administration expenses A/c			xxx
To Selling expenses A/c			xxx
To Distribution expenses A/c			xxx
To Financial expenses A/c			xxx
To Provisions A/c			xxx
To Depreciation A/c			xxx
To Other indirect expenses and losses A/c (individually)			xxx
(Closing of various items by transferring them to profit and loss account)			

7. **For closing the indirect incomes, i.e. items that appear on the credit side of profit and loss account**

Particulars		Debit ₹	Credit ₹
Discount earned A/c	Dr.	xxx	
Commission earned A/c	Dr.	xxx	
Other indirect incomes A/c (individually)	Dr.	xxx	
To Profit and loss A/c			xxx
(Closing of various items by transferring them to profit and loss account)			

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8. For transfer of net profit or net loss to capital account

(a) For net profit

Particulars		Debit ₹	Credit ₹
Profit and loss A/c	Dr.	xxx	
To Capital A/c			xxx
(Transfer of net profit to capital account)			

(b) For net loss

Particulars		Debit ₹	Credit ₹
Capital A/c	Dr.	xxx	
To Profit and loss A/c			xxx
(Transfer of net loss to capital account)			

12.2.2 Opening entry

The balances of various accounts which are not closed at the end of the accounting period are carried forward to the next accounting period. In fact, the balances appearing in the balance sheet at the end of an accounting period becomes the opening balances for the next accounting period. Hence, at the beginning of every accounting year, an opening entry is made in the journal proper to bring forward the balances in various accounts. The entry passed is as follows:

Particulars		Debit ₹	Credit ₹
Assets A/c (individually)	Dr.	xxx	
To Liabilities A/c (individually)			xxx
To Capital A/c			xxx
(Assets and liabilities brought forward)			

12.3 Trading account

Trading refers to buying and selling of goods with the intention of making profit. The trading account is a nominal account which shows the result of buying and selling of goods for an accounting period. According to J. R. Batliboi, "The trading account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included."

Trading account is prepared to find out the difference between the revenue from sales and cost of goods sold. Cost of goods sold refers to directly related cost. Direct cost includes the purchase price of goods purchased and all other expenses which are incurred to bring the goods to the business premises or godown and to make these ready for sale. All the goods purchased during the accounting period may not be sold during the same accounting period. Hence, it is necessary to calculate the cost of goods sold during the period. Matching principle is applied here. Hence, the cost of stock not sold must be deducted, i.e., value of closing stock must be deducted. But if there is any opening stock of goods that will be sold during the accounting period, it is to be added to the cost of purchases made during the period. If there is cost of goods manufactured, it must also be added to find out the cost of goods sold.

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock

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If the amount of sales exceeds the cost of goods sold, the difference is gross profit. On the other hand, the excess of cost of goods sold over the amount of sales results in gross loss.

Sales – Cost of goods sold = Gross profit

Sales – Gross profit = Cost of goods sold

12.3.1 Need for preparation of trading account

Preparation of trading account serves the following purposes:

(i) Provides information about gross profit or gross loss

It shows the gross profit or gross loss of the business for an accounting year. This helps the business persons to find out gross profit ratio by expressing the gross profit as a percentage of sales. It helps to compare and analyse with the ratios of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.

(ii) Provides an opportunity to safeguard against possible losses

If the ratio of gross profit has decreased in comparison to the preceding years, effective measures can be taken to safeguard against future losses. For example, the sale price of goods may be increased or steps may be taken to analyse and control the direct expenses.

(iii) Provides information about direct expenses and direct incomes

All the expenses incurred on the purchase of goods are direct expenses. They are recorded in the trading account. Trading account also shows sales revenue, which is a direct income. With the help of trading account, percentage of such expenses on sales revenue can be calculated and compared with similar ratios of the previous years. Thus, it enables the management to have control over the direct expenses.

12.3.2 Preparation of trading account

Trading account is a nominal account. The opening stock, net purchases and all expenses relating to purchase of goods are shown on the debit side and the net sales and closing stock are shown on the credit side of it.

A) Items shown on the debit side of the trading account

The following are the items shown on the debit side of the trading account:

(i) Opening stock

The stock of goods remaining unsold at the end of the previous year is the opening stock of the current year. This item will not be there in a newly started business. It will not appear if it is adjusted with purchases. As opening stock would have been sold during the year, the cost of opening stock is included in trading account.

(ii) Purchases and purchases returns

Goods which have been bought for resale are termed as purchases. Goods purchased which are returned to suppliers are termed as purchases returns or returns outward. Purchases include both cash purchases and credit purchases. Net purchases, i.e., purchases minus purchases returns are shown in the debit side of the trading account.

(iii) Direct expenses

All the expenses incurred on the purchase of goods and for bringing the goods to the go down or place of business and to make them to saleable condition are known as direct expenses. They are debited to trading account. Direct expenses include the following:

(a) Carriage inwards or Freight inwards

Amount paid for transporting the goods purchased to the godown or business premises is called carriage inwards or carriage on purchases or freight inwards.

(b) Wages

Amount paid to workers who are directly engaged in loading, unloading and handling of goods purchased is known as wages.

(c) Dock Charges

These are the charges levied for shipping the cargo while entering or leaving docks. When they are paid on import of goods, they are treated as direct expenses.

(d) Octroi

This is a tax levied by the local authority when the purchased goods enter the municipal limits.

(e) Import duty

Taxes paid on import of goods are known as import duties.

(f) Royalty

This is the amount paid to the owner of a mine or a patent for using owner's right. When the royalty is based on cost of production or output, it is treated as a direct expense.

(g) Coal, gas, fuel and power

Cost incurred towards coal, gas and fuel to make the goods saleable is also considered as direct expenses.

(iv) Cost of goods manufactured

If the sole proprietor is also engaged in manufacture of goods, a separate account, namely, manufacturing account is to be prepared in which expenses incurred for manufacture of goods will be entered. Examples of such expenses are raw materials, coal, gas, fuel, water, power, factory rent, packaging, factory lighting, royalty on manufactured goods, etc. The total cost of goods manufactured is transferred to the debit side of trading account.

B) Items shown on the credit side of the trading account

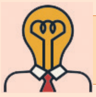
Following are the items shown on the credit side of the trading account:

(a) Sales and Sales returns

Both cash and credit sales of goods will be included in sales. The sales account will show credit balance whereas the sales returns account will show debit balance. The amount of net sales is shown on the credit side of the trading account by deducting sales returns from sales.

(b) Closing stock

The goods remaining unsold at the end of the accounting period are known as closing stock. They are valued at cost price or net realisable value (market price) whichever is lower as per Accounting Standard 2 (Revised).



Student activity

Think: 'Closing stock need to be valued at cost price or market price whichever is less'. Which is the accounting principle applied here?

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12.3.3 Closing of trading account

The difference between the totals of two sides of the trading account indicates either gross profit or gross loss. If the total of the credit side is more, the difference represents gross profit. On the other hand, if the total of the debit side is higher, the difference represents gross loss. The gross profit or gross loss is transferred to profit and loss account.

12.3.4 Format of trading account

Dr. **Trading account for the year ended . . .** **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		xxx	By Sales	xxx	
To Purchases	xxx		Less: Sales returns	xxx	xxx
Less: Purchases returns	xxx	xxx	By Closing stock		xxx
To Direct expenses:			By **Gross loss c/d***		xxx
Carriage/Freight inwards		xxx			
Wages		xxx			
Dock charges		xxx			
Octroi		xxx			
Royalty		xxx			
Import duty		xxx			
To Cost of goods manufactured		xxx			
To **Gross profit c/d***		xxx			
		xxx			xxx

* The difference in trading account will be either gross profit or gross loss.

The heading of the trading account contains the words 'for the year ended……' as it discloses the sales and cost of goods sold of the business for the whole accounting year.

Illustration 1

From the following information, prepare trading account for the year ended 31.12.2016.

Particulars	₹
Opening stock (1.1.2016)	10,000
Purchases	26,100
Sales	40,600
Closing Stock (31.12.2016)	13,500

Solution

Dr. **Trading account for the year ended 31st December, 2016** **Cr.**

Particulars	₹	Particulars	₹
To Opening stock	10,000	By Sales	40,600
To Purchases	26,100	By Closing stock	13,500
To Gross profit c/d	**18,000**		
	54,100		54,100

Student activity

Think: Do you think a business that provides service such as a travel agency, insurance and an auditing firm needs to prepare a trading account?

Illustration 2

From the following balances extracted from the books of M/s. Lavanya and sons, prepare trading account for the year ended 31st March, 2017:

Particulars	₹	Particulars	₹
Opening stock	16,500	Carriage inwards	1,200
Purchases	45,000	Wages	4,800
Sales	72,000	Fuel and power	3,200
Purchases returns	500	Closing stock	18,000
Sales returns	1,500		

Solution

In the books of M/s. Lavanya and sons

Dr. Trading account for the year ended 31st March, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		16,500	By Sales	72,000	
To Purchases	45,000		Less: Sales returns	1,500	70,500
Less: Purchases returns	500	44,500	By Closing stock		18,000
To Carriage inwards		1,200			
To Wages		4,800			
To Fuel and power		3,200			
To Gross profit c/d		**18,300**			
		88,500			88,500

Illustration 3

From the following information, prepare trading account for the year ending 31st December, 2017.

Particulars	₹	Particulars	₹
Opening stock	50,000	Dock charges on purchases	4,000
Cost of goods manufactured	12,000	Import duty on purchases	3,500
Cash purchases	60,000	Wages	11,000
Cash sales	85,000	Sales returns	3,000
Purchases returns	2,000	Credit purchases	35,000
Carriage inwards	4,000	Credit sales	60,000
Freight outwards	3,000	Other direct expenses	7,000
Coal and fuel	2,500		

Solution

Dr. Trading account for the year ended 31st December, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		50,000	By Sales:		
To Cost of goods			Cash	85,000	
manufactured		12,000	Credit	60,000	
To Purchases:				1,45,000	
Cash	60,000		Less: Sales returns	3,000	1,42,000
Credit	35,000		By Gross loss c/d		**45,000**
	95,000				
Less: Purchases returns	2,000	93,000			
To Carriage inwards		4,000			
To Coal and fuel		2,500			
To Dock charges on Purchases		4,000			
To Import duty on					
Purchases		3,500			
To Wages		11,000			
To Other direct expenses		7,000			
		1,87,000			1,87,000

Note: Freight outwards will not appear in trading account as it is not a direct expense.

Illustration 4

Compute cost of goods sold from the following information:

Particulars	₹
Opening stock	8,000
Purchases	60,000
Direct expenses	5,000
Indirect expenses	6,000
Closing stock	9,000

Solution

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock
= 8,000 + 60,000 + 5,000 – 9,000
= ₹ 64,000

Note: Indirect expenses do not form part of cost of goods sold.

Illustration 5

Find out the amount of sales from the following information.

Particulars	₹
Opening stock	20,000
Purchases less returns	70,000
Direct expenses	10,000
Closing stock	30,000
Gross profit margin (on sales)	20%

Solution

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock

= 20,000 + 70,000 + 10,000–30,000

= ₹ 70,000

Let the sales be	100
Less: Gross profit (20% on sales, i.e., 100)	20
Cost of goods sold	80

Therefore, percentage of Gross profit on Cost of goods sold is $\frac{20}{80}$ x 100 = 25 %

Gross profit = 25 % on ₹ 70,000 i.e: $\frac{25}{100}$ x 70,000 = ₹ 17,500

Sales = Cost of goods sold + Gross profit

= 70,000 + 17,500 = ₹ 87,500

DO YOU KNOW?

When gross profit is 25% on cost, it is 20% on sales

When gross profit is 33 $\frac{1}{3}$ % on cost, it is 25% on sales

12.4 Profit and loss account

Profit and loss account is the second part of income statement. It is a nominal account in nature. A business entity is interested in knowing not only the gross profit or loss but also the net profit earned or net loss incurred during the year. Hence, profit and loss account is prepared to ascertain the net profit or net loss during the year. Profit and loss account contains all the items of indirect expenses and losses and indirect incomes and gains in addition to gross profit or gross loss pertaining to the accounting period. The difference is net profit or net loss. According to Prof. Carter, "A Profit and Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice-versa".

Student activity

Think: What will be the effect on the profit, if purchase of fixed asset is shown as expense in profit and loss account?

12.4.1 Need for preparing profit and loss account

Profit and loss account is prepared for the following purposes:

(i) Ascertainment of net profit or net loss

The profit and loss account discloses the net profit available to the proprietor or net loss to be borne by him. Ascertainment of profitability helps in planning for the growth and efficiency of a business enterprise. Inter-firm comparison and intra-firm comparison of profit and loss account items help in assessing efficiency in comparison with other enterprises and other departments of the same enterprise respectively.

(ii) Comparison of profit

The net profit of the current year can be compared with the profit of the previous years. It helps to know whether the business is conducted efficiently or not.

(iii) Control on expenses

Profit and loss account helps in comparing various expenses with the expenses of the previous years. The percentage of individual expenses to net sales can be calculated and compared with

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the similar ratios of previous years. Such a comparison will be helpful in taking effective steps for controlling unnecessary expenses.

(iv) Helpful in the preparation of balance sheet

A balance sheet can be prepared only after ascertaining the net profit or loss through profit and loss account. Net profit or loss is shown in the balance sheet. Thus, it facilitates preparation of balance sheet.

12.4.2 Preparation of profit and loss account

The amount of gross profit or gross loss brought down from the trading account is the first item in the profit and loss account. All the indirect expenses and losses are debited to profit and loss account. Indirect expenses include office and administrative expenses, selling expenses, distribution expenses, etc. As the profit and loss account is a nominal account, all the indirect expenses and losses are shown on the debit side and all the indirect incomes and gains are shown on the credit side.

Items shown on the debit side of profit and loss account are as follows:

(i) Gross loss

If trading account discloses gross loss, it is shown on the debit side of the profit and loss account.

(ii) Indirect expenses

Expenses which are not connected with purchase of goods are indirect expenses, i.e., expenses incurred in administration, office, selling and distribution of goods are indirect expenses.

(a) Office and administrative expenses

Expenses incurred for office and administration such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee, depreciation and maintenance of office equipment, etc. are classified as office and administrative expenses.

(b) Selling and distribution expenses

Expenses incurred for selling, promotion of sales and distribution of goods such as advertisement charges, commission to salesmen, carriage outwards, bad debts, godown rent, packing charges, etc., are classified as selling and distribution expenses.

(c) Other indirect expenses and losses

The expenses such as interest on loan, repair charges, depreciation, charity, loss on sale of fixed assets and abnormal losses such as loss due to fire, theft, etc. not covered by insurance are shown under this category.

Items shown on the credit side of profit and loss account are as follows:

(i) Gross profit

The first item on the credit side of profit and loss account is the gross profit brought down from the trading account if there is gross profit.

(ii) Other incomes and gains

All items of indirect incomes and gains are shown on the credit side of the profit and loss account. Income from investments, rent earned, discount received, commission earned, interest earned and dividend received are indirect incomes. Profit on sale of fixed assets and investments are examples of gains.

12.4.3 Closing of profit and loss account

After debiting indirect expenses and losses and crediting all indirect incomes and gains, if the total of the credit side of the profit and loss account exceeds the debit side, the difference is

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termed as net profit. On the other hand, if the total in the debit side exceeds the credit side, the difference is termed as net loss. Net profit or net loss is transferred to the capital account.

12.4.4 Format of profit and loss account

Dr. Profit and loss account for the year ended ……. Cr.

Particulars	₹	Particulars	₹
To Gross loss b/d	xxx	By Gross profit b/d	xxx
To Office and administrative expenses:		By Indirect incomes:	
Salaries	xxx	Rent earned	xxx
Rent, rates and taxes	xxx	Discount received	xxx
Printing and stationery	xxx	Commission earned	xxx
Postage	xxx	Interest on drawings	xxx
Legal charges	xxx	Interest on investments	xxx
Audit fees	xxx	Dividend on shares	xxx
Establishment expenses	xxx	Bad debts recovered	xxx
Trade expenses	xxx	Profit on sale of fixed assets	xxx
General travelling expenses	xxx	Apprenticeship premium	xxx
Lighting	xxx	Miscellaneous receipts	xxx
Insurance premium	xxx	By **Net loss***	xxx
		(transferred to capital account)	
To Selling and distribution expenses:			
Carriage outwards	xxx		
Advertisement	xxx		
Commission	xxx		
Brokerage	xxx		
Bad debts or provision for bad debts	xxx		
Export duty	xxx		
Packing charges	xxx		
To Other expenses and losses:			
Repairs	xxx		
Depreciation	xxx		
Interest charges	xxx		
Discount allowed	xxx		
Provision for discount on debtors	xxx		
Bank charges	xxx		
Interest on capital	xxx		
Donation and charity	xxx		
Loss on sale of fixed assets	xxx		
Abnormal loss due to fire, theft etc. not covered by insurance	xxx		
Miscellaneous expenses	xxx		
To **Net profit***	xxx		
(transferred to capital account)			
	xxx		xxx

* The balance will be either net profit or net loss.

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Tutorial note

The expenses which are not related to the business are not shown in the profit and loss account. Examples are personal expenses of the proprietor such as domestic and household expenses of the proprietor, income-tax and life insurance premium of the proprietor, etc. These expenses are classified as drawings by the proprietor and are deducted from capital on the liabilities side of the balance sheet if they are paid out of business funds

Only revenue receipts and revenue expenses are shown in the trading and profit and loss account. Capital receipts, capital gains, capital expenditure and capital losses are not shown in trading and profit and loss account. That part of capital items that relate to that accounting period only are shown. For example, depreciation on fixed assets. Purchase of fixed asset is a capital expenditure. But depreciation is a revenue item which relates to the use of the fixed asset in the current accounting period.

Student activity

Think: A furniture trader takes some furniture from his business, for his domestic use. How do you treat this transaction?

Illustration 6

From the following information, prepare profit and loss account for the year ended 31st March, 2018.

Particulars	₹	Particulars	₹
Gross profit b/d	1,50,000	Advertisement expenses	3,800
Carriage outward	25,500	Bad debts	8,500
Office rent	7,000	Dividend received	9,000
Office stationery	3,500	Discount received	4,600
Distribution expenses	2,000	Rent received	7,000

Solution

Dr. Profit and Loss Account for the year ended 31st March, 2018 Cr.

Particulars	₹	Particulars	₹
To Carriage outward	25,500	By Gross profit b/d	1,50,000
To Office rent	7,000	By Dividend received	9,000
To Office stationery	3,500	By Discount received	4,600
To Distribution expenses	2,000	By Rent received	7,000
To Advertisement expenses	3,800		
To Bad debts	8,500		
To Net profit transferred to capital account	**1,20,300**		
	1,70,600		1,70,600

Illustration 7

From the following information, prepare profit and loss account for the year ended 31st December, 2017.

Particulars	₹	Particulars	₹
Gross profit b/d	60,000	Interest received	2,100
Freight outward	15,000	Financial charges	4,000
Packing charges (on sales)	12,000	Repairs on vehicles used in office	8,000
Salesmen commission paid	1,300	Depreciation on vehicles used in office	3,000
Promotional expenses	10,200	Interest paid	9,000
Office telephone expenses	22,400	Rent received	7,000
Bad debts recovered	4,000	Carriage inwards	4,000

Solution

Dr. Profit and Loss Account for the year ended 31st December, 2017 Cr.

Particulars	₹	Particulars	₹
To Freight outward	15,000	By Gross profit b/d	60,000
To Packing charges	12,000	By Bad debts recovered	4,000
To Salesmen commission	1,300	By Interest received	2,100
To Promotional expenses	10,200	By Rent received	7,000
To Office telephone expenses	22,400	By Net loss transferred to	
To Financial charges	4,000	capital account	**11,800**
To Repairs on vehicles	8,000		
To Depreciation on vehicles	3,000		
To Interest paid	9,000		
	84,900		84,900

Note: Carriage inwards will not appear in profit and loss account as it is a direct expense.

Student activity

Think: From the income statement, is it possible to know how much the business owns or owes?

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12.5 Balance sheet

Balance sheet is a statement which gives the position of assets and liabilities on a particular date. Assets are the resources owned by the business. Liabilities are the claims against the business. After ascertaining the net profit or net loss of the business enterprise, a business person would like to know the financial position of the business. For this purpose, balance sheet is prepared which contains amounts of all the assets and liabilities of the business enterprise as on a particular date. The statement so prepared is called 'balance sheet' because it gives the balances of ledger accounts which are still there, after the closure of all nominal accounts by transferring to the trading and profit and loss account. Balances of all the personal and real accounts are grouped into assets and liabilities. In the balance sheet, liabilities are shown on the left hand side and assets on the right hand side.

According to J.R. Batliboi, "A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date."

12.5.1 Need for preparing a balance sheet

The purposes of preparing a balance sheet are as follows:

(a) The main purpose of preparing a balance sheet is to ascertain the true financial position of the business at a particular point of time.

(b) It helps in comparing the cost of various assets of the business such as the amount of closing stock, amount due from debtors, amount of fictitious assets, etc. Moreover as assets and liabilities of similar nature are grouped and presented in balance sheet, a comparative study of these assets and liabilities is facilitated. It helps in comparing the various liabilities of the business.

(c) It helps in finding out the solvency position of the firm. The firm's solvency position is favourable if the assets exceed the external liabilities. The firm's solvency position is not favourable it the external liabilities exceed the assets.

12.5.2 Characteristics of balance sheet

The following are the characteristics of a balance sheet:

(a) A balance sheet is a part of the final accounts. However, the balance sheet is a statement and not an account. It has no debit or credit sides and as such the words 'To' and 'By' are not used before the names of the accounts shown therein.

(b) A balance sheet is a summary of the personal and real accounts, which have balances. Personal and real accounts having debit balances are shown on the right hand side known as assets side, whereas personal and real accounts having credit balances are shown on the left hand side known as liabilities side.

(c) The totals of the two sides of the balance sheet must be equal. If the totals are not equal, it indicates existence of error. It must satisfy the accounting equation, ie., Assets = Capital + Liabilities, following the dual aspect concept.

(d) Balance sheet is prepared on a particular date and not for a fixed period. It discloses the financial position of a business on a particular date. It gives the balances only for the date on which it is prepared.

(e) It shows the financial position of the business according to the going concern concept.

12.5.3 Grouping and Marshalling of assets and liabilities in a balance sheet

The assets and liabilities shown in the balance sheet are grouped and presented in a particular order. The term 'grouping' means showing the items of similar nature under a common heading. For example, the amount due from various customers will be shown under the head 'Sundry debtors.' Similarly, under the head 'Current assets', the balance of cash, bank, debtors, stock and other current assets will be shown.

'Marshalling' is the arrangement of various assets and liabilities in a proper order. Marshalling can be made in one of the following two ways:

(a) In the order of liquidity

According to this method, an asset which is most easily convertible into cash, i.e., cash in hand is shown first and then will follow those assets which are comparatively less easily convertible, so that the least liquid asset i.e., goodwill is shown last. In the same way, the liabilities which are to be paid at the earliest will be shown first. In other words, current liabilities are shown first, then fixed or long-term liabilities and finally the proprietor's capital.

(b) In the order of permanence

This method is exactly the reverse of the first method. Asset which is more permanent, i.e., goodwill is shown first followed by assets which are less permanent. Similarly, those liabilities which are to be paid last will be shown first. In other words, the proprietor's capital is shown first, then fixed or long-term liabilities and lastly the current liabilities. Joint stock companies are required under the Companies Act to prepare their balance sheet in the order of permanence.

12.5.4 Methods of drafting a balance sheet

The balance sheet of business concern can be presented in the following two forms.

a) Horizontal form

b) Vertical form

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a) Horizontal form of balance sheet

In the horizontal form, assets are shown on right hand side of the balance sheet and the liabilities are shown on the left hand side of the balance sheet.

Balance sheet of … as on…

Liabilities	₹	₹	Assets	₹	₹
Capital	xxx		**Fixed assets:**		
Add: Net profit/ Less: Net loss	xxx		**i) Intangible assets**		
	xxx		Goodwill		xxx
Less: Drawings	xxx	xxx	Patent rights		xxx
Reserves		xxx	Copy rights		xxx
Long term loans		xxx	Trade marks		xxx
Current liabilities:			Computer software		xxx
Bank overdraft, Cash credit	xxx		**ii) Tangible assets**		
Outstanding expenses	xxx		Land		xxx
Unearned income	xxx		Buildings	xxx	
Short term loans from banks	xxx		Less: Depreciation	xxx	xxx
Sundry creditors	xxx		Plant and machinery	xxx	
Bills payable	xxx	xxx	Less: Depreciation	xxx	xxx
Provisions			Vehicles	xxx	
Provision for employee benefits		xxx	Less: Depreciation	xxx	xxx
Provision for tax		xxx	Furniture and Fittings	xxx	
			Less: Depreciation	xxx	xxx
			Investments		xxx
			Current assets		
			Stock		xxx
			Advances given		xxx
			Sundry debtors		xxx
			Bills receivable		xxx
			Prepaid expenses		xxx
			Accrued income		xxx
			Cash at bank		xxx
			Cash in hand		xxx
			Fictitious assets		
			Preliminary expenses		xxx
		xxx			xxx

b) Vertical form of balance sheet

The balance sheet of a sole proprietor can be presented in a vertical statement form as given below:

Balance sheet of ... as on...

Particulars	₹	₹
Current assets:		
Stock in trade	xxx	
Sundry debtors	xxx	
Marketable securities	xxx	
Prepaid expenses	xxx	
Accrued income	xxx	
Bills receivable	xxx	
Advances given	xxx	
Cash at bank	xxx	
Cash in hand	xxx	
Total Current assets		xxx
Less: Current liabilities:		
Sundry creditors	xxx	
Bills payable	xxx	
Bank overdraft	xxx	
Short term loans	xxx	
Outstanding expenses	xxx	
Total current liabilities		xxx
Net working capital		xxx
Add: Long term investments		xxx
Add: Fixed Assets:		
Goodwill	xxx	
Land and building	xxx	
Plant and machinery	xxx	
Furniture	xxx	
Total fixed assets		xxx
Capital Employed (both owner's funds and outsiders' funds)		xxx
Less: Long term liabilities:		
Loans	xxx	
Total long term liabilities		xxx
Net Assets		**xxx**
Represented by:		
Owners' Capital	xxx	
Reserves and surplus	xxx	xxx
Proprietor's fund		**xxx**

12.5.5 Preparation of Balance Sheet

There is no prescribed format for preparing the balance sheet of sole proprietor and partnership. For Joint Stock Company, the format of preparing balance sheet is given under Schedule III of Indian Companies Act, 2013. After transferring all nominal accounts, the items left out in trial balance are real account and personal accounts. These are grouped under assets (debit balance) and liabilities (credit balance) and presented in a balance sheet.

12.5.6 Classification of assets and liabilities

The resources acquired by the business entity out of funds provided by owners or creditors are called assets. These are the resources owned by the business. Assets of a business include cash, stock, plant and machinery, etc.

A) Classification of assets

According to the nature of assets, they may be classified into the following:

a) Fixed assets

Fixed assets are those assets which are acquired or constructed for continued use in the business and last for many years such as land and building, plant and machinery, motor vehicles, furniture, etc. According to Finney and Miller, "Fixed assets are assets of a relatively permanent nature used in the operations of business and not intended for sale." As the purpose of keeping such assets is not to sell but to use them, changes in their realisable values are ignored and these are always shown in the balance sheet at cost less depreciation. Fixed assets can be classifed into i) Tangible fixed assets ii) Intangible fixed assets.

i) Tangible fixed assets

Tangible fixed assets are those which have physical existence or which can be seen and felt. Examples: plant and machinery, building and furniture.

ii) Intangible fixed assets

Intangible fixed assets are those which do not have any physical existence or which cannot be seen or touched. Examples: goodwill, trade-marks, copy rights and patents. Intangible assets are as much valuable as tangible assets because they also help the firm in earning profits. For example, goodwill helps in attracting customers and patents represent the know-how which helps in producing the goods.

DO YOU KNOW?

Cash in hand and stock are tangible assets.

b) Current assets

Current assets are those assets which are either in the form of cash or can be easily converted into cash in the normal course of business or within one year. In the words of Hovard and Upton, "The current assets are usually defined as those assets which are convertible into cash through the normal course of business within a short time, ordinarily in a year." Current assets include cash in hand, cash at bank, short-term investments, bills receivable, debtors, prepaid expenses, accrued income, closing stock, etc. Among these, closing stock is valued at cost or realisable value whichever is lower and debtors are shown after deducting a reasonable provision for bad and doubtful debts.

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Tutorial note

Prepaid expenses are treated as current assets. Though cash cannot be realised from prepaid expenses, the service will be available against these without further payment.

c) Liquid assets

Liquid assets are the assets which are either in the form of cash or which can be immediately converted into cash within a very short period of time, such as cash at bank, bills receivable, short-term investments, debtors and accrued incomes. In other words, if prepaid expenses and closing stock are excluded from current assets, the balance is known as liquid assets.

d) Investments

Amount invested outside the business in shares, debentures, bonds and other securities is called investments. If it is invested for a period more than a year they are called long-term investments. If they are invested for a period less than a year they are short term investments and shown under current assets.

e) Wasting assets

These are the assets which get exhausted gradually in the process of excavation. Examples: mines and quarries.

f) Fictitious or Nominal assets

These are assets only in name but not in reality. These assets are not really assets but are shown on the assets side only for the purpose of writing off by transferring them to the profit and loss account gradually over a period of time in future. Such assets include the expenditures, the benefit of which lasts for more than a year, not yet written off, such as advertisement expenses, preliminary expenses, etc.

B) Classification of liabilities

Liabilities or equities are claims against the business entity. These are the amounts owed by a business entity to the outsiders (outsiders equity) and owners (owners equity).

Liabilities may be classified according to their nature as follows:

(a) Fixed or long-term liabilities

The liabilities which are to be repaid after one year or more are termed as long-term liabilities. Example: Long-term loans.

(b) Current or short-term liabilities

The liabilities which are expected to be paid within the normal operating cycle or one year are termed as current or short-term liabilities. These include bank overdraft, creditors, bills payable, outstanding expenses, etc.

(c) Contingent liabilities

These are the liabilities which are not certain at the time of preparation of balance sheet. These liabilities may or may not occur. These are the liabilities which will become payable only on the happening of some specific event which itself is not certain, otherwise these need not be paid. Such liabilities are as follows:

- Liabilities for bills discounted

  In case a bill discounted with the bank is dishonoured by the acceptor on the due date, the firm will become liable to the bank.

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- Liability in respect of a suit pending in a court of law
  This would become an actual liability if the suit is decided against the firm.
- Liability in respect of a guarantee given for another person
  The firm would be liable to pay the amount if the person for whom the guarantee is given fails to meet his obligation.

Tutorial note

i) Contingent liabilities are not shown in the balance sheet. They are, however, shown as a foot note just below the balance sheet so that the existence of such liabilities may be revealed.

ii) Capital: Capital is money or money's worth contributed by the owner to the business for the purpose of carrying on business. The difference between assets and liabilities is owner's equity = capital contributed + accumulated profits.

12.6 Differences between trial balance and balance sheet

The following are the differences between trial balance and balance sheet:

Basis	Trial balance	Balance sheet
1. Nature	Trial balance is a list of ledger balances on a particular date.	Balance sheet is a statement showing the position of assets and liabilities on a particular date.
2. Purpose	Trial balance is prepared to check the arithmetical accuracy of the accounting entries made.	Balance sheet is prepared to ascertain the financial position of a business.
3. Contents	It is a summary of balances of all accounts – personal, real and nominal accounts.	It is a statement showing the closing balances of only personal and real accounts.
4. Format	The trial balance contains columns for debit balances and credit balances.	The items are grouped as assets and liabilities.
5. Stage	It is prepared before the preparation of final accounts.	It is prepared after preparing trial balance and trading and profit and loss account.
6. Period	It can be prepared periodically, say at the end of the month, quarterly, half yearly, etc.	It is generally prepared at the end of the accounting period.
7. Order	Balances shown in the trial balance need not be in order.	Balances shown in the balance sheet must be in order.
8. Compulsion	Preparation of trial balance is not compulsory.	Preparation of the balance sheet is compulsory in certain cases.

Tutorial note

If a trial balance is not given in the question, trial balance has to be prepared first. If there is a difference in the trial balance, the difference is placed to 'suspense account' and shown in the balance sheet.

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Illustration 8

From the following balances of Niruban, prepare balance sheet as on 31st December, 2017.

Particulars	Dr. ₹	Cr. ₹
Plant and machinery	8,00,000	
Land and building	6,00,000	
Furniture	1,50,000	
Cash in hand	20,000	
Bank overdraft		1,80,000
Debtors and Creditors	3,20,000	2,40,000
Bills receivable and Bills payable	1,00,000	60,000
Closing stock	4,00,000	
Investments (short-term)	80,000	
Capital		15,00,000
Drawings	1,30,000	
Net Profit		6,20,000
	26,00,000	26,00,000

Solution

In the books of Niruban
Balance sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Capital	15,00,000		Land and building		6,00,000
Add: Net profit	6,20,000		Plant and machinery		8,00,000
	21,20,000		Furniture		1,50,000
Less: Drawings	1,30,000	19,90,000	Investments (short-term)		80,000
Creditors		2,40,000	Stock in trade		4,00,000
Bills payable		60,000	Debtors		3,20,000
Bank overdraft		1,80,000	Bills receivable		1,00,000
			Cash in hand		20,000
		24,70,000			24,70,000

Illustration 9

From the following trial balance of Sharan, prepare trading and profit and loss account for the year ending 31st December, 2017 and balance sheet as on that date. The closing stock on 31st December, 2017 was valued at ₹ 2,50,000.

Debit Balances	₹	Credit Balances	₹
Stock (1-1-2017)	2,00,000	Sundry creditors	12,000
Purchases	7,50,000	Purchases returns	30,000
Carriage inwards	75,000	Sales	10,20,000
Wages	3,65,000	Commission received	53,000
Salaries	1,20,000	Capital	33,00,000

Repairs	12,000		
Rent and taxes	2,80,000		
Cash in hand	97,000		
Land	21,50,000		
Drawings	1,66,000		
Bank deposits	2,00,000		
	44,15,000		44,15,000

Solution

In the books of Sharan

Dr. Trading and profit and loss account for the year ending 31st December, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		2,00,000	By Sales		10,20,000
To Purchases	7,50,000		By Stock (closing)		2,50,000
Less: Purchases returns	30,000	7,20,000	By Gross loss c/d		**90,000**
To Carriage inwards		75,000			
To Wages		3,65,000			
		13,60,000			13,60,000
To Gross loss b/d		90,000	By Commission received		53,000
To Salaries		1,20,000	By Net loss		
To Repairs		12,000	(transferred to capital account)		**4,49,000**
To Rent and taxes		2,80,000			
		5,02,000			5,02,000

Balance sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Capital	33,00,000		Land		21,50,000
Less: Net loss	4,49,000		Stock in trade		2,50,000
	28,51,000		Bank deposits		2,00,000
Less: Drawings	1,66,000	26,85,000	Cash in hand		97,000
Sundry creditors		12,000			
		26,97,000			26,97,000

Tutorial note

Trading account and profit and loss account are prepared together. The first part is trading account, whereas the second part is profit and loss account.

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Points to remember

- Trading and profit and loss account is a nominal account in nature. It means that while preparing this account, the rule of nominal account is followed.
- On the debit side of trading account, direct expenses and opening stock are shown.
- Direct expenses include the purchase price of goods purchased and all other expenses which are incurred to bring the goods to the business premises or godown and to make these ready for sale.
- On the credit side of trading account direct income, i.e. sales and closing stock are shown.
- On the debit side of profit and loss account, indirect expenses and losses are shown.
- On the credit side of this account, indirect incomes and gains are shown.
- Indirect expenses are those expenses incurred for office, administration and selling and distribution.
- Indirect incomes and gains are the incomes or gains which are not directly related to the operation of business enterprise. For example, interest received on the deposits in the bank.
- Balance sheet is a statement and not an account. On the left side liabilities including capital and on the right side the assets are shown in the balance sheet.
- Assets are the resources owned by a business entity. Liabilities are claims against the business or the amounts owed by business to outsiders and owners.

Self-examination questions

AKA2HT

I Multiple choice questions

Choose the correct answer

1. Closing stock is an item of __________.
   (a) Fixed asset (b) Current asset
   (c) Fictitious asset (d) Intangible asset
2. Balance sheet is __________
   (a) An account (b) A statement
   (c) Neither a statement nor an account (d) None of the above
3. Net profit of the business increases the __________
   (a) Drawings (b) Receivables
   (c) Debts (d) Capital
4. Carriage inwards will be shown
   (a) In the trading account (b) In the profit and loss account
   (c) On the liabilities side (d) On the assets side
5. Bank overdraft should be shown
   (a) In the trading account (b) Profit and loss account
   (c) On the liabilities side (d) On the assets side

6. Balance sheet shows the __________ of the business.
   (a) Profitability (b) Financial position
   (c) Sales (d) Purchases
7. Drawings appearing in the trial balance is
   (a) Added to the purchases (b) Subtracted from the purchases
   (c) Added to the capital (d) Subtracted from the capital
8. Salaries appearing in the trial balance is shown on the
   (a) Debit side of trading account (b) Debit side of profit and loss account
   (c) Liabilities side of the balance sheet (d) Assets side of the balance sheet
9. Current assets does not include
   (a) Cash (b) Stock
   (c) Furniture (d) Prepaid expenses
10. Goodwill is classified as
   (a) A current asset (b) A liquid asset
   (c) A tangible asset (d) An intangible asset

Answer

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

II Very short answer questions

1. Write a note on trading account.
2. What are wasting assets?
3. What are fixed assets?
4. What is meant by purchases returns?
5. Name any two direct expenses and indirect expenses.
6. Mention any two differences between trial balance and balance sheet.
7. What are the objectives of preparing trading account?
8. What is the need for preparing profit and loss account?

III Short answer questions

1. What are final accounts? What are its constituents?
2. What is meant by closing entries? Why are they passed?
3. What is meant by gross profit and net profit?
4. “Balance sheet is not an account”- Explain.
5. What are the advantages of preparing a balance sheet?
6. What is meant by grouping and marshalling of assets and liabilities?

IV Exercises

1. Prepare trading account in the books of Mr.Sanjay for the year ended 31st December 2017:

Particulars	₹	Particulars	₹
Opening stock	570	Purchases	15,800
Sales	26,200	Purchases returns	90
Sales returns	60	Closing stock	860

(**Answer**: Gross profit: ₹ 10,720)

2. From the following balances taken from the books of Saravanan, calculate gross profit for the year ended December 31, 2017

Particulars	₹	Particulars	₹
Opening stock	1,50,000	Net sales during the year	4,00,000
Direct expenses	8,000	Net purchases during the year	1,50,000
Closing Stock	25,000		

(**Answer**: Gross profit: ₹ 1,17,000)

3. From the following details for the year ended 31st March, 2018, prepare trading account.

Particulars	₹	Particulars	₹
Opening stock	2,500	Returns inwards	7,000
Purchases	27,000	Coal and gas	3,300
Sales	40,000	Carriage inwards	2,600
Wages	2,500	Closing stock	5,200
Returns outwards	5,200		

(**Answer**: Gross profit: ₹ 5,500)

4. From the following balances taken from the books of Victor, prepare trading account for the year ended December 31, 2017:

Particulars	₹	Particulars	₹
Adjusted purchases	80,000	Closing stock	7,000
Sales	90,000	Carriage inwards	3,000
Royalty on purchases of goods	4,000	Import duty on purchases of goods	6,000
Octroi on purchase of goods	2,000	Dock charges on purchases	5,000
Cost of goods manufactured	5,000		

(**Answer**: Gross loss: ₹ 15,000)

(**Hint**: Closing stock will not appear in trading account)

5. Compute cost of goods sold from the following information:

Particulars	₹	Particulars	₹
Opening stock	10,000	Indirect expenses	5,000
Purchases	80,000	Closing stock	15,000
Direct expenses	7,000		

(**Answer**: Cost of goods sold: ₹ 82,000)

(**Hint**: Indirect expenses do not form part of cost of goods sold)

6. Find out the amount of sales from the following information:

Particulars	₹	Particulars	₹
Opening stock	30,000	Closing stock	20,000
Purchases less returns	2,00,000	Gross profit margin (on sales)	30%

(**Answer**: Sales ₹ 3,00,000)

7. From the following details, prepare profit and loss account.

Particulars	₹	Particulars	₹
Gross profit	50,000	Interest received	2,000
Office rent	10,000	Discount received	3,000
Depreciation on office assets	8,000	Carriage outwards	2,500
Discount allowed	12,000	Insurance on office building	3,500
Advertisement	4,000	General expenses	3,000
Audit fees	1,000	Freight inwards	1,000

(**Answer**: Net profit ₹ 11,000)

(**Hint**: Freight inwards will not appear in profit and loss account as it is a direct expense)

8. From the following information, prepare profit and loss account for the year ending 31st December, 2016.

Particulars	₹	Particulars	₹
Gross loss	60,000	Printing and stationery (office)	2,000
Promotional expenses	5,000	Legal charges	5,000
Distribution expenses	15,000	Bad debts	1,000
Commission paid	7,000	Depreciation	2,000
Interest on loan paid	5,000	Rent received	4,000
Packing charges (on sales)	4,000	Loss by fire not covered by insurance	3,000
Dividend received	3,000		

(**Answer**: Net loss: ₹ 1,02,000)

9. From the following balances obtained from the books of Mr. Ganesh, prepare trading and profit and loss account.

Particulars	₹	Particulars	₹
Stock on 01.01.2017	8,000	Bad debts	1,200
Purchases for the year	22,000	Trade expenses	1,200
Sales for the year	42,000	Discount allowed	600
Expenses on purchases	2,500	Commission allowed	1,100
Financial charges paid	3,500	Selling expenses	600
Expenses on sale	1,000	Repairs on office vehicles	600

Closing stock on December 31.12.2017 was ₹ 4,500

(**Answer**: Gross profit: ₹ 14,000; Net profit: ₹ 4,200)

10. From the following particulars, prepare balance sheet in the books of Bragathish as on 31st December, 2017:

Particulars	₹	Particulars	₹
Capital	80,000	Cash in hand	20,000
Debtors	12,800	Net profit	4,800
Drawings	8,800	Plant	43,200

(**Answer**: Balance sheet total: ₹ 76,000)

11. Prepare trading and profit and loss account in the books of Ramasundari for the year ended 31st December, 2017 and balance sheet as on that date from the following information:

Particulars	₹	Particulars	₹
Opening stock	2,500	Sales	7,000
Wages	2,700	Purchases	3,300
Closing Stock	4,000	Salary	2,600
Discount received	2,500	Capital	52,000
Machinery	52,000	Cash at Bank	6,400
Creditors	8,000		

(**Answer**: Gross profit: ₹ 2,500; Net profit: ₹ 2,400; Balance sheet total: ₹ 62,400)

12. Prepare trading and profit and loss account and balance sheet in the books of Deri, a trader, from the following balances as on March 31, 2018.

Debit Balances	₹	Credit Balances	₹
Stock	10,000	Sales	1,22,500
Cash	2,500	Creditors	5,000
Bank	5,000	Bills payable	2,000
Freight inwards	750	Capital	1,00,000
Purchases	95,000		
Drawings	4,500		
Wages	27,500		
Machinery	50,000		
Debtors	13,500		
Postage (office)	150		
Sundry expenses	850		
Rent paid	2,500		
Furniture	17,250		
	2,29,500		**2,29,500**

Closing stock (31st March, 2018) ₹ 8,000

(**Answer**: Gross loss: ₹ 2,750; Net loss: ₹ 6,250; Balance sheet total: ₹ 96,250)

DO YOU KNOW?

Operating profit is the profit earned from the normal operating activities of a business entity. Operating profit is the difference between operating revenue and operating cost.

Operating profit = Operating revenue – Operating Cost
= Net sales – (Cost of goods sold + other operating expenses)
= Net sales – (Cost of goods sold + office and administration expenses + selling and distribution expenses)

Operating profit is also called Earning Before Interest and Tax, ie., EBIT

Operating activities mean the activities relating to normal or main business of an enterprise. Operating revenues are the revenues earned in the normal course of business and operating cost is the cost incurred in the normal course of business of an enterprise.

Operating cost includes cost of goods sold and other indirect operating expenses such as office and administration and selling and distribution expenses. Purely financial expenses interest on loan and incomes such as dividend received are not included in operating expenses.

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CASE STUDY

Mr. Abhinav started a small shop of selling dairy products. He wanted to maintain proper books of accounts. But, he had very little knowledge of accounting. He maintained only three books – purchases, sales and cash book by himself. He bought some dairy products and a refrigerator to store the milk products for which the payment was made by cheque but recorded the same in the purchases book. He also spent for the transportation charges and paid some money to the person who unloaded the stock. He recorded the same in the cash book.

He made both cash and credit sale for the next few weeks. He entered the entire sales in the sales book. In the middle of the month, he was in need of some money for his personal use. So he took some money, but did not record in the books.

Now, discuss on the following points:

- Do you think Mr. Abhinav needs an accountant? Why do you think so?
- Does he maintain enough books of accounts?
- What other books do you think that he needs to maintain?
- What will be the impact on the profit, if he records the purchase of refrigerator in the purchases book?
- Is it important to record the money taken for personal use? Will it affect the final accounts?
- Identify some of the accounting principles relevant to this situation.

To explore further

Do you think the presentation of final accounts is the same for all forms of business?

Reference

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