Chapter–3

# Final Accounts

## (Financial Statements)

**LEARNING OBJECTIVES**

*In this chapter we will study*:

Introduction to Final Accounts

Preparation of Final Accounts—An Introduction

Preparation of Final Accounts for Sole Proprietorship Concern

Difference Between Trial Balance and Balance Sheet

Difference Between Trading Account and Manufacturing Account

Difference Between Trading Account and Profit & Loss Account

Difference Between Income Statement and Balance Sheet

Accounting Theory Framework

- Generally Accepted Accounting Principles (GAAP)
- Accounting Standards (AS)

Final Accounts for Partnership Firm

Final Accounts for Companies

## 3.1 INTRODUCTION TO FINAL ACCOUNTS

While the Trial Balance checks the accuracy of ledger balances, the final account reveals two facts:

1. Whether the business is in profit or loss during the period covered by the Trial Balance. A Trading and Profit & Loss account also known as income statement is prepared for this purpose.
2. What is the financial position (financial position means picture of assets and liabilities) of the business? This is judged by preparing a balance sheet for the business.

Thus, income statement represents the summary of all the expenses and incomes occurred during the financial year whereas balance sheet represents the financial position of the concerned organization at a particular point of time, usually at the end of financial year *i.e.*, $31^{st}$ March (in India, financial year starts from $1^{st}$ April to $31^{st}$ March).

**Final accounts are statutory requirements for all type of registered organizations. They are popularly known as Financial Statements.**

## 3.2 PREPARATION OF FINAL ACCOUNTS—AN INTRODUCTION

Preparation of final accounts is governed by different Acts, Laws, Standards and Principles like Income tax law, Company Act, Partnership Act, Accounting Standards (AS), Generally Accepted Accounting Principles (GAAP) etc., used for valuation of financial transactions/events to standardize accounting information, which in turn depends upon type of organization concerned. In other words, since different types of organizations operates under different legal framework, the methodology/procedure for preparation of final accounts will change accordingly.

Again, there are three main categories of organizations on the basis of incorporation (Registration) *viz*.

1. Sole proprietorship concern
2. Partnership firm
3. Joint stock companies
   (*a*) Private Limited Co.
   (*b*) Public Limited Co.

Thus preparation of final accounts should be dealt separately for all the above category of organizations and are chapterised as under:

| ***Particulars*** | ***Name of Chapter***[1] |
|---|---|
| 1. Accounting for Sole Proprietorship Concern | Final Account |
| 2. Accounting for Partnership Firm | Partnership Account |
| 3. Accounting for Joint Stock Companies | Company Account |
| 4. Accounting for Other Business Activity like Shipping, Leasing etc. | Miscellaneous Account |

## 3.3 PREPARATION OF FINAL ACCOUNTS FOR SOLE PROPRIETORSHIP CONCERN

Preparation of Final Accounts can be studied according to following cases:

***Case 1 :*** Preparation of Final Accounts when Transactions/Events are given.

***Case 2 :*** Preparation of Final Accounts when Ledger balances are given.

***Case 3 :*** Preparation of Final Accounts when Trial balance with additional information is given.

1. Preparation of Final Accounts for partnership firm, joint stock companies and miscellaneous activities are beyond the scope of this book. Only introduction is given here.

**Case 1: Preparation of Final Accounts when Transactions/Events are given:**

**Trading activity:**

Steps involved in preparation of Final Accounts when the organization concerned is engaged in trading activity are as follows:

**Step 1** Journal entry
↓
**Step 2** Ledger entry — **Book-keeping** (Steps 1–3)
↓
**Step 3** Trial balance
↓
**Step 4** Trading Account
↓ **(GP)** — **Income statement** (Steps 4–5)
**Step 5** P & L Account
↓ **(NP)**
**Step 6** **Balance Sheet**

**Manufacturing activity:**

Steps involved in preparation of final accounts when the organization concerned is engaged in manufacturing activity are as follows:

**Step 1** Journal entry
↓
**Step 2** Ledger entry — **Book-keeping** (Steps 1–3)
↓
**Step 3** Trial balance
↓
**Step 4** Manufacturing Account
↓ **(COP)**
**Step 5** Trading Account
↓ **(GP)** — **Income statement** (Steps 5–6)
**Step 6** P & L Account
↓ **(NP)**
**Step 7** **Balance Sheet**

***Note*:**
- **COP** represents cost of production, **GP** represents gross profit and **NP** represents net profit. These are balancing figure of manufacturing account, trading account and Profit & Loss A/c (P & L A/c) respectively.
- In case of trading concern, Income statement is subdivided into trading account and P & L A/c whereas in case of manufacturing concern income statement is subdivided into manufacturing account, trading account and P & L A/c.

**The Format for income statement in case of Trading concern is as follows:**

**Trading and P & L A/c for the year ------**

***Dr.*** ***Cr.***

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| To Opening stock | —— | By Sales (less return) | ——— |
| To Purchases (less return) | —— | ****By Gross loss b/d** | ——— |
| To Direct wages | —— | **(Balancing fig.)** | |
| To Direct expenses | —— | | |
| • Carriage inward | | | |
| • Duty and clearing charges | | | |
| • Fuel and energy | | | |
| • Octroi duty etc. | | | |
| **To Gross profit (GP) b/d** | ——— | | |
| **(Balancing fig.)** | | | |
| **Total** | = | **Total** | = |

| | | | |
|---|---|---|---|
| ****To Gross loss c/d** | —— | **By Gross profit (GP) c/d** | —— |
| **To General and administrative expenses** | ——- | **By Other income** | ——- |
| • Salaries | | | |
| • Rent, rates and taxes | | • Rent received | |
| • Stationary and printing | | • Discount received (Cr.) | |
| • Telephone bill | | • Sale of scrap material | |
| • General expenses | | • Commission received | |
| • Trade expenses | | • Interest received | |
| • Insurance premium | | • Dividend received | |
| • Loss by fire, theft, etc. | | • Bad debt recovered | |
| • Discount allowed | | | |
| • Office lighting | | ****By Net Loss b/d** | —— |
| • Depreciation | | | |

*Contd...*

| *Dr.* Particulars | Amount | Particulars | *Cr.* Amount |
|---|---|---|---|
| • Bad debt written off | | | |
| • Repairs | | | |
| • Audit fee | | | |
| • Preliminary expenses written off etc. | | ** This will happen when total of debit is more than total of credit. | |
| **To Selling and distribution expenses** | —— | | |
| • Carriage outward | | | |
| • Packaging material | | | |
| • Salesman commission | | | |
| • Conveyance | | | |
| • Advertisement | | | |
| • Export duty etc. | | | |
| **To Financial Expenses** | —— | | |
| • Interest paid | | | |
| • Tax paid etc. | | | |
| **To Net profit (NP) b/d** | —— | | |
| **(Balancing fig.)** | | | |
| **Total** | = | **Total** | = |

**The format for Income statement in case of manufacturing concern is as follows:**

**Manufacturing and Trading and P & L A/c for the year -------**

| *Dr.* Particulars | Amount | Particulars | *Cr.* Amount |
|---|---|---|---|
| To Opening stock WIP | —— | By Sale of scraps | —— |
| To Opening stock R/M | —— | By Closing stock WIP* | —— |
| To Purchases (R/M) | —— | **By Cost of production b/d** | —— |
| Less Purchases return | | **(balancing fig.)** | |
| Less Closing stock R/M* | | ↓ | |
| To Productive wages | —— | (or cost of manufacturing) | |
| To Manufacturing expenses | —— | | |
| • Coal, fuel and energy | | | |
| • Carriage inward | | | |
| • Import duty etc. | | | |

*Contd...*

***Dr.*** ***Cr.***

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| **To Factory Overhead (FOH)** | ——— | | |
| ● Factory lighting | | | |
| ● Factory insurance | | | |
| ● Repairs to plant and factory building | | | |
| ● Plant depreciation etc. | | | |
| **Total** | = | **Total** | = |

| | | | |
|---|---|---|---|
| **To Cost of production c/d** | —— | By Sales (less sales return) | —— |
| To Opening stock FG | —— | By Closing stock FG | —— |
| **To gross profit (GP) b/d** | —— | | |
| **(Balancing fig.)** | | | |
| **Total** | = | **Total** | = |

| | | | |
|---|---|---|---|
| **To general and administrative expenses** | ——- | **By gross profit (GP) c/d** | —— |
| ● Salaries | | By other income | ——- |
| ● Rent, Rates and Taxes | | ● Rent received | |
| ● Stationary and printing | | ● Discount received (Cr.) | |
| ● Telephone bill | | ● Sale of scrap material | |
| ● General expenses | | ● Commission received | |
| ● Trade/miscellaneous/ Sundry expenses | | ● Interest received | |
| | | ● Insurance premium | |
| ● Loss by fire, theft etc. | | ● Dividend received | |
| ● Discount allowed | | ● Bad debt recovered | |
| ● Office lighting | | | |
| ● Depreciation other than plant and machinery | | | |
| ● Bad debt written off | | | |
| ● Repairs and renewals excluding Factory | | | |
| ● Audit fee | | | |
| ● Preliminary expenses written off etc. | | | |
| **To selling and distribution expenses** | —— | | |
| ● Carriage outward | | | |

*Contd...*

***Dr.*** ***Cr.***

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| • Packaging material<br>• Salesman commission<br>• Conveyance<br>• Advertisement<br>• Export duty etc. | | | |
| **To Financial Expenses** | —— | | |
| • Interest paid<br>• Tax paid etc. | | | |
| **To Net Profit (NP) b/d** **(Balancing fig.)** | —— | | |
| **Total** | = | **Total** | = |

***Note***

1. WIP stands for work in progress *i.e.* semi-finished goods.
2. R/M stands for raw material.
3. FG stands for finished goods.
4. Closing stock of WIP, R/M and FG appear in income statement only when given in additional information.
5. Purchase return is also termed as return outward/return to supplier.
6. Sales return is also termed as return inward/return from customer.
7. Carriage inward is also known as freight inward.
8. Carriage outward is also known as freight outward/cartage outward.
9. For numerical purpose 'wages and salary' goes to Trading A/c whereas 'salary and wages' goes to P & L A/c.

**Vertical presentation of Income Statement in case of sole proprietorship concern**

**Income Statement for the year ------**

| | ***Particulars*** | ***Amount (Rs.)*** |
|---|---|---|
| | Sales | —— |
| Less | Cost of Goods Sold (COGS) | —— |
| | Gross Profit (GP)/(Gross Loss) } Trading A/c | ——@ |
| Less | Operating Expenses (OE) | —— |
| | Operating Profit (OP) | ——@ |
| Add | Non-operating income/less non-operating losses | —— |
| | Earning Before Interest and Tax (EBIT) | ——@ |
| Less | Interest | —— P & L A/c |
| | Earning Before Tax (EBT) | ——@ |
| Less | Tax | —— |
| | Earning After Tax/Profit After Tax (PAT)/Net Profit (NP) | ——@ |

↓ Goes to

**Balance Sheet (To Capital add Net Profit/less Net Loss, if there is)**

***Note***

- @ Stands for balancing figure.
- OE includes general and administrative expenses plus selling and distribution expenses plus depreciation.
- Interest is tax-deductible item means interest is charged before the tax is levied. Thus, debt capital provides tax shield and hence acts as cheaper source of finance.

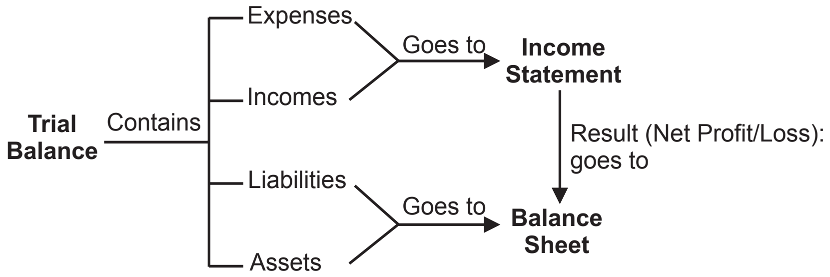
**The format for balance sheet is as follows:**

**Balance Sheet as on ————**

| ***Liabilities*** | | | ***Assets*** |
|---|---|---|---|
| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
| Capital | —— | Fixed Assets | ——— |
| **Add Net Profit or Less Net Loss** | | • Land and building | |
| **(as per P & L A/c)** | | • Plant and machinery | |
| Less drawings | | • Furniture | |
| Long-term loan | —— | • Fixture and fittings | |
| | | Investments | ——— |
| Current liability | —— | • Marketable securities | |
| • Trade creditors/sundry creditors (Crs) | | Current assets | ——— |
| • Bills Payable (B/P) | | • Cash in hand | |
| • Bank overdraft | | • Cash at bank | |
| • Outstanding expenses e.g. Outstanding Rent/Tax/Wages etc. | | • Trade debtors/sundry debtors (Drs) | |
| | | • Bills Receivable (B/R) | |
| | | • Prepaid expenses like Prepaid Rent/ Tax/Wages etc. | |
| **Total** | = | **Total** | = |

**Mechanism involved in preparation of Final Accounts from trial balance**

A clear scrutiny of the format for Income statement and balance sheet shown above results into following mechanism: -



**In summarized way:**

1. Trial balance contains four items *viz*. Expense, Income, Liability and Assets.
2. Expenses and Incomes go to Income Statement according to format shown above.
3. Liabilities and Assets go to Balance Sheet according to format shown above. Result of Income statement (Profit/Loss) also goes to balance sheet on liability side under reserves or adjusted to Capital A/c in case of sole proprietorship concern.

**Final Accounts for Illustration 3**

**(1) Income Statement for Illustration 3**

*Dr.* *Cr.*

| *Particulars* | | *Amount* | *Particulars* | | *Amount* |
|---|---|---|---|---|---|
| To Purchases | 27,100 | | By Sales | 27,000 | |
| Less Return | 1,100 | 26,000 | Less Return | 100 | 26,900 |
| **To Gross Profit b/d** | | **900** | | | |
| **Total** | | **26900** | **Total** | | **26900** |
| To Brokerage | | 40 | **By Gross Profit c/d** | | **900** |
| To Discount Allowed | | 100 | By P & L A/c | | 100 |
| To Rent | | 1,000 | **By Net Loss** | | **2,240** |
| To Salary | | 1,500 | | | |
| To Telephone Rent | | 500 | | | |
| To Travelling Expenses | | 100 | | | |
| **Total** | | **3,240** | **Total** | | **3,240** |

**(2) Balance Sheet for Illustration 3**

| *Liabilities* | | *Amount* | *Assets* | | *Amount* |
|---|---|---|---|---|---|
| Capital | 50,000 | | **Fixed Assets:** | | |
| Less Drawings | 1,500 | | Machinery and Furniture | | 1,500 |
| Less Net Loss | | | Typewriter | | 2,100 |
| (as per P & L A/c) | 2,240 | 46,260 | | | |
| | | | **Investment** | | **1,800** |
| S. Creditors: | | 4,100 | | | |
| Bhuwan | 2,000 | | | | |
| Universal Typewriter | | | | | |
| Co. | 2,100 | | **Current Assets:** | | |
| | | | S. Debtors: | | |
| | | | (Raghvendra) | 2,900 | |
| | | | Cash | 15,760 | 31,460 |
| | | | Bank | 12,800 | |
| **Total** | | **50,360** | **Total** | | **50,360** |

**Case 2: Steps in preparation of final accounts when ledger balances are given:**

Ledger balances

↓

**Step 1:** Prepare trial balance from given ledger balances as per rule given below.

↓

**Step 2:** Post the items of trial balance prepared under step 1 to income statement and balance sheet according to format shown above.

**Rule for preparation of Trial balance when ledger balances are given is as follows:**

| | |
|---|---|
| **Dr. Column** | All expenses/losses and assets |
| **Cr. Column** | All income/gains and liabilities |

**Illustration 4:** From the following ledger balance prepare final accounts: -

| ***Particulars*** | ***Amount*** |
|---|---|
| Sundry debtors (A) | 15,000 |
| Opening stock (E) | 50,000 |
| Land and building (A) | 10,0000 |
| Capital (L) | 25,0000 |
| Rent (Cr.) (I) | 6,000 |
| Cash in hand (A) | 16,000 |
| Cash at bank (A) | 40,000 |
| Wages (E) | 30,000 |
| Sundry creditors (L) | 70,000 |
| Bills receivable (A) | 20,000 |
| Interest given (E) | 2,000 |
| Bad debts (E) | 5,000 |
| Repairs (E) | 3,000 |
| Sales (I) | 17,0000 |
| Bills payable (L) | 40,000 |
| Furniture and fittings (A) | 15,000 |
| Depreciation (E) | 10,000 |
| Rates and taxes (E) | 8,000 |
| Salaries (E) | 20,000 |
| Drawings (A) | 20,000 |
| Purchases (E) | 10,0000 |
| Office expenses (E) | 25,000 |
| Plant and machinery (A) | 57,000 |

***Note:***
1. Bill receivables (B/R) are those receivables/debtors who has legal evidence (Promissory notes etc.) regarding their transactions.
2. 'A','E','L','I', stands for Asset, Expense, Liability, and Income respectively.

**Trial Balance**

| ***Particulars*** | ***Debit (A+E)*** | ***Credit (L+I)*** |
|---|---|---|
| Sundry debtors | 15,000 | — |
| Opening stock | 50,000 | — |
| Land and building | 10,0000 | — |
| Capital | — | 25,0000 |
| Rent received | — | 6,000 |
| Cash in hand | 16,000 | — |
| Cash at bank | 40,000 | — |
| Wages | 30,000 | — |
| Sundry creditor | — | 70,000 |
| B/R | 20,000 | — |
| Interest given | 2,000 | — |
| Bad debts | 5,000 | — |
| Repairs | 3,000 | — |
| Sales | — | 17,0000 |
| B/P | — | 40,000 |
| Furniture/Fixture | 15,000 | — |
| Depreciation | 10,000 | — |
| Rent and taxes | 8,000 | — |
| Salaries | 20,000 | — |
| Drawing | 20,000 | — |
| Purchase | 10,0000 | — |
| Office expenditure | 25,000 | — |
| Plant and machinery | 57,000 | — |
| **Total** | **53,6000** | **53,6000** |

**Trading and P & L A/c**

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| To Opening stock | 50,000 | By Sales | 17,0000 |
| To Wages | 30,000 | **By gross loss** | 10,000 |
| To Purchase | 10,0000 | | |
| **Total** | **18,0000** | **Total** | **18,0000** |
| **To gross loss** | 10,000 | By Other income | |
| By other exp | | • Rent given | 6,000 |
| Interest given | 2,000 | **By net loss** | **77,000** |
| Bad debts | 5,000 | | |
| Repairs | 3,000 | | |

*Contd...*

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| Depreciation | 10000 | | |
| Rent and tax | 8000 | | |
| Salaries | 20000 | | |
| Office Exp. | 25000 | | |
| **Total** | **83000** | **Total** | **83000** |

**Balance Sheet**

| ***Liability*** | | ***Amount*** | ***Assets*** | ***Amount*** |
|---|---|---|---|---|
| Capital | 250000 | | **Fixed Assets:** | |
| Less drawing | 20000 | | Land and Building | 100000 |
| Less net loss | 77000 | | Furniture and Fitting | 15000 |
| | | 153000 | Plant and Machinery | 57000 |
| **Current liability:** | | | **Current assets:** | |
| Sundry Creditor | | 70000 | Cash in Hand | 16000 |
| Bills payable | | 40000 | Cash at Bank | 40000 |
| | | | Sundry Debtor | 15000 |
| | | | Bills Receivable | 20000 |
| **Total** | | **263000** | **Total** | **263000** |

**Case 3: Preparation of final accounts when trial balance with additional information is given: - Adjustment entries (*i.e.,* additional information):**

According to going concern concept, an organization never dies, it runs endlessly and therefore it is necessary to evaluate the financial performance and financial position of organization after a fixed interval usually one year, so that the results of one interval can be compared with another. This will help to assess the trend regarding financial performance and position. Financial position means picture of assets and liabilities at given point of time.

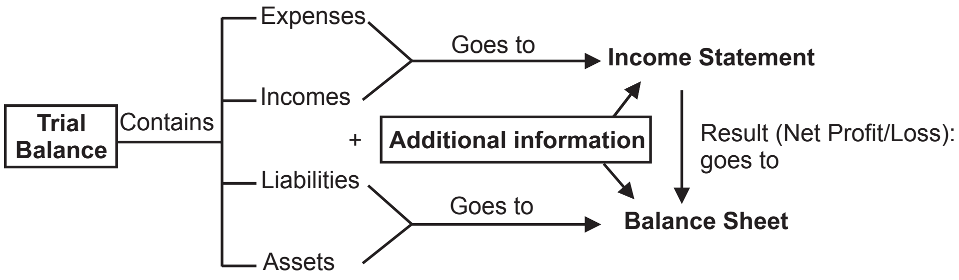
Furthermore, to bring the uniformity in process of estimating financial performance and position, it is necessary to match revenues with expenses related to concerned interval only. The revenues and expenses related to other interval must be separated from the interval under consideration. This requires adjustment in both the final accounts. Such items (information), which need to be separated and adjusted accordingly, are known as **'Additional Information'/'Adjustment entries'**. Since the Additional Information comes into the picture after the preparation of Trial Balance, they require double entry—first entry somewhere in income statement and second entry somewhere in Balance Sheet in such a way that Balance Sheet agrees. Similar treatment is given to **'Errors and Omissions'** detected after the preparation of Trial Balance.

**Steps in preparation of final accounts when trial balance with additional information is given:**

**Step1:** Post all the items of trial balance to income statement and Balance Sheet according to format shown above.

**Step 2:** Adjust each additional information one by one in both the final account as they require double entry, keeping in mind that the balance sheet agrees.

**Mechanism involved in preparation of final accounts when trial balance with additional information is given:**




**Some important additional information along with adjustment entries in final accounts are given below:**

1. Closing Stock
   - Trading A/c (Cr.)
   - B/S (Current Assets)
2. Outstanding Expenses
   - P & L A/c (Dr.- Added to concerned expenses)
   - B/S (Current Liabilities)
3. Prepaid Expenses
   - P & L A/c (Cr. or Expenses, less prepaid expenses)
   - B/S (Current Assets)
4. Outstanding or accrued income (Income due but not received)
   - P & L A/c (Cr.- Added to concerned income)
   - B/S (Current Assets)
5. Income received in advance or unearned income
   - P & L A/c (Dr. or deducted from concerned income on credit side)
   - B/S (Current Liabilities)
6. Depreciation
   - P & L A/c (Dr.)
   - B/S (Fixed Assets, Less Depreciation.)
7. Bad Debts
   - P & L A/c (Dr.)
   - B/S (Debtors, Less Bad debts)
8. Provision for bad debts
   - P & L A/c (Dr.)
   - B/S (Debtors, Less provision for bad debts)

9. Provision for discount on debtors
   - → P & L A/c (Dr.)
   - → B/S (Drs., Less provision for discount on debtors)
10. Provision for discount on creditors
    - → P & L A/c (Cr.)
    - → B/S (Crs., Less provision for discount on creditors)
11. Interest on capital
    - → P & L A/c (Dr.)
    - → B/S (Capital, add interest)
12. Interest on drawings
    - → P & L A/c (Cr.)
    - → B/S (Capital, less interest on drawings)
13. Interest on loan (Borrowed)
    - → P & L A/c (Dr.)
    - → B/S: Liability (Loan, add interest on loan)
14. Interest on loan (Advance)
    - → P & L A/c (Cr.)
    - → B/S: Asset (Loan, add interest on loan)
15. Accidental loss of Goods
    - → Trading A/c (Cr. side or deducted from Purchases A/c on Dr. side)
    - → P & L A/c (Dr.) as Loss of stock
16. Goods distributed as free sample
    - → Trading A/c (deducted from Purchases A/c on Dr. side)
    - → P & L A/c (Dr.) as Advertisement A/c
17. Goods given/taken as Charity/Personal use
    - → Trading A/c (deducted from Purchases A/c on Dr. side)
    - → B/S (Capital, less Charity A/c or Drawing A/c)

**Remark**

The journal entry for above adjustment are given below:

| ***S.No.*** | ***Particulars*** | ***L.F.*** | ***Debit (Rs.)*** | ***Credit (Rs.)*** |
|---|---|---|---|---|
| 1. | Closing stock A/c …Dr.<br>To Trading A/c | | | |
| 2. | Expenses A/c ...Dr.<br>To Outstanding expenses A/c | | | |
| 3. | Prepaid expenses A/c ...Dr.<br>To Expenses A/c | | | |
| 4. | Accrued income A/c ...Dr.<br>To Income A/c | | | |
| 5. | Income A/c ...Dr.<br>To Unearned income A/c | | | |
| 6. | Depreciation A/c ...Dr.<br>To Asset A/c | | | |
| 7. | Bad Debts A/c ...Dr.<br>To Debtors A/c | | | |
| 8. | P & L A/c ...Dr.<br>To Provision for bad debts A/c | | | |
| 9. | P & L A/c ...Dr.<br>To Provision for discount on debtors A/c | | | |
| 10. | Provision for discount on creditors A/c ...Dr.<br>To P & L A/c | | | |
| 11. | Interest on capital A/c ...Dr.<br>To Capital A/c | | | |
| 12. | Drawing A/c ...Dr.<br>To Interest on drawing A/c | | | |
| 13. | Interest on loans A/c ...Dr.<br>To Loan A/c | | | |
| 14. | Loans A/c ...Dr.<br>To Interest on loan A/c | | | |
| 15. | Loss of Stock A/c ...Dr.<br>To Trading A/c or To Purchase A/c | | | |
| 16. | Advertisement A/c ...Dr.<br>To Purchase A/c | | | |
| 17. | Charity A/c ...Dr.<br>To Purchase A/c | | | |

**Illustration 5:** Prepare a trading and P & L A/c for the year ending 31.03.2001 and a balance sheet as on that date from the following trial balance:

**Trial Balance**

| *Particulars* | *Dr. (Rs.)* | *Cr. (Rs.)* |
|---|---|---|
| Opening Stock | 16,000 | |
| Capital | | 45,000 |
| Salaries | 13,000 | |
| Drawings | 4,000 | |
| Carriage Inwards | 500 | |
| Carriage Outwards | 1,000 | |
| Sales Return | 1,000 | |
| Purchase Return | | 7,00 |
| Loan to Mr. X | 11,000 | |
| Loan from Mr. Y | | 7,000 |
| Rent | 1,300 | |
| Rent Outstanding | | 200 |
| Purchase | 40,000 | |
| Sales | | 73,100 |
| Debtors | 25,000 | |
| Creditors | | 8,000 |
| Bad Debt | 800 | |
| Reserve for Bad Debt | | 1,200 |
| Discount Allowed/Received | 600 | |
| Furniture | 11,700 | |
| Wages | 500 | |
| Insurance Premium | 1,200 | |
| Rent by Sub-letting | | 800 |
| Cash | 700 | |
| Bank | 8,000 | |
| **Total** | **1,36,300** | **1,36,300** |

**Adjustments**

1. Closing Stock Rs. 10,500, but the market value of closing stock was Rs. 9,500.
2. Insurance premium prepaid Rs. 200.
3. Loan to Mr. X, given at 10% interest p.a. and loan taken from Mr. Y carries 9% interest p.a.
4. Depreciation is to be provided at 5% on furniture.
5. Goods worth Rs. 500 have been taken by the proprietor for private use.
6. Bad and doubtful debts are to be provided at 10%.

**Solution**

**Trading Account for the Year ending March 31, 2001**

***Dr.*** ***Cr.***

| ***Particulars*** | | ***Amount*** | ***Particulars*** | | ***Amount*** |
|---|---|---|---|---|---|
| To Opening Stock | | 16,000 | By Sales: | 73,100 | |
| To Purchase: | 40,000 | | Less Return: | 1,000 | 72,100 |
| Less Return | 700 | 39,000 | By Proprietor [I] | | 500 |
| To Carriage Inward | | 500 | By Closing Stock [II] | | 9,500 |
| To Wages | | 500 | | | |
| **To Gross Profit b/d** | | **25,800** | | | |
| **Total** | | **82,100** | **Total** | | **82,100** |

**Profit and Loss Account for the Year ending March 31, 2001**

***Dr.*** ***Cr.***

| ***Particulars*** | | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|---|
| To Salary | | 13,000 | By Gross Profit c/d | 25,800 |
| To Carriage Outward | | 1,000 | (From Trading A/c) | |
| To Rent | | 1,300 | | |
| To Reserve for Bad Debts[III] | | 2,100 | By Discount Received | 300 |
| To Discount Allowed: | | 600 | By Rent by Sub-letting | 800 |
| To Insurance Premium: | 1,200 | | By Interest Receivable [VII] | 1,100 |
| Less pre-paid [IV] | 200 | 1,000 | | |
| To Interest Payable to Mr. Y[V] | | 630 | | |
| To Depreciation A/c: [VI] | | 585 | | |
| **To Net Profit** | | **7,785** | | |
| **Total** | | **28,000** | **Total** | **28,000** |

***Working notes***

Adjustment (*i*): [II] As per the rule of Conservatism.

Adjustment (*ii*): [IV] Insurance Premium Prepaid.

Adjustment (*iii*): [VII] Loan given to Mr. X is 11,000. Interest on loan is 10% of 11,000 *i.e.* 1,100.
[V] Loan from Mr. Y is Rs. 7,000. Interest payable on loan is 9% *i.e.* Rs. 630.

Adjustment (*iv*): [VI] Furniture is for Rs. 11,700. Depreciation is 5% on furniture *i.e.* Rs. 585.

Adjustment (*v*): [I] Drawing by the proprietor.

Adjustment (*vi*): [III] 10% of Debtor A/c is to be maintained in Reserve for Bad Debt *i.e.* 10% of 25,000 = 2,500. A bad debt of Rs. 800 has been incurred resulting in a balance of Rs. 400 (Rs. 1,200 – Rs. 800 = 400) in Reserve for Bad Debt A/c. In order to maintain Rs. 2,500 in reserve an amount of Rs. 2,100 is required.

***Note*:** Trading Account and Profit & Loss Accounts may be shown together as ‘Trading & P/L Account’.

**Balance Sheet as on March 31, 2001**

| ***Liabilities*** | | ***Amount*** | ***Assets*** | | ***Amount*** |
|---|---|---|---|---|---|
| Capital | 45,000 | | **Fixed Assets:** | | |
| Less Drawings [I] | 4,000 | | Furniture | 11,700 | |
| Less Goods taken | | | Less Depreciation [VI] | 585 | |
| by owner | 500 | | | | 11,115 |
| Add Profit during year | 7,785 | | **Current Assets:** | | |
| | | 48,285 | Loan to Mr. X | 11,000 | |
| Loan from Mr. Y [V] | 7,000 | | Add Outstanding | | |
| Add Interest | 630 | | Interest [VII] | 1,110 | |
| | | 7,630 | | | 12,100 |
| Rent Outstanding | | 200 | Debtors | 25,000 | |
| Creditors | | 8,000 | Less Provision for Bad | | |
| | | | Debt [III] | 2,500 | 22,500 |
| | | | Prepaid Insurance [IV] | | 200 |
| | | | Cash | | 700 |
| | | | Bank | | 8,000 |
| | | | Closing Stock [II] | | 9,500 |
| **Total** | | **64,115** | **Total** | | **64,115** |

***Note*:**

1. Provision for Doubtful Debts is deducted from Sundry Debtors A/c in the Balance Sheet.
2. Closing Stock (CS) appears in Trading A/c, only when given in Additional Information as well as in B/S (current asset)—Double entry, whereas CS appearing in trial balance, being an asset requires only one entry and hence goes to B/S under current asset. In this case CS do not appear in Trading A/c because it is already adjusted with Purchases A/c.

## 3.4 DIFFERENCE BETWEEN TRIAL BALANCE AND BALANCE SHEET

| ***Point of difference*** | ***Trial balance*** | ***Balance sheet*** |
|---|---|---|
| Objective | The objective of trial balance is to check the accuracy of ledger balances. | The objective of balance sheet is to present financial position at a given point of time. |
| Requirement | Trial balance is not a statutory requirement. | Balance sheet is a statutory requirement for every registered organization. |
| Coverage | It includes Expenses, Incomes, Liabilities and Assets. | It includes Liabilities and Assets only. |
| Time period | It is prepared whenever desired. | Normally it is prepared at the end of accounting period. |
| Closing stock | Normally Closing stock does not appear in trial balance. | Closing stock appear in balance sheet under Current asset group. |

## 3.5 DIFFERENCE BETWEEN TRADING ACCOUNT AND MANUFACTURING ACCOUNT

| ***Point of difference*** | ***Trading account*** | ***Manufacturing account*** |
|---|---|---|
| Objective | The objective is to know the Cost of Goods Sold (COGS). | The objective is to know the Cost of Production (COP)/Cost of Goods manufactured. |
| Balancing figure | The balancing figure is Gross Profit (GP) or Gross Loss. | The balancing figure is Cost of Production (COP)/Cost of Goods manufactured. |
| Sale of scrap | The sale of scrap does not appear in trading account. | The sale of scrap appears in manufacturing account on credit side. |
| Opening Stock (OS) and Closing Stock (CS) | It includes opening and closing stock of finished goods only. | It includes opening and closing stock of semi finished goods *i.e.* WIP and Raw Materials (R/M). |

## 3.6 DIFFERENCE BETWEEN TRADING ACCOUNT AND PROFIT & LOSS ACCOUNT (P & L A/C)

| ***Point of difference*** | ***Trading account*** | ***Profit and Loss account*** |
|---|---|---|
| Objective | The objective is to know the Cost of Goods Sold (COGS). | The objective is to know Operating Expenses (OE). |
| Balancing figure | The balancing figure is Gross Profit (GP) or Gross Loss. | The balancing figure is Net profit (NP) or Net loss. |
| Treatment of balancing figure | The balancing figure is transferred to P & L A/c. | The balancing figure is transferred to balance sheet on liability side adjusted to Capital A/c in case of Sole proprietorship concern. |

***Note*:**

1. Cost of Goods Sold (COGS) = OS + Net purchase + Direct wages + Direct expenses – CS (if given in additional information). Direct expenses are those expenses, which increases COGS.
2. Cost of Production (COP) = OS of WIP + R/M consumed – Sale of scrap – CS of WIP + Productive labour + Manufacturing expenses + Factory overhead.
3. R/M consumed = OS of R/M + Net purchase – CS of R/M.
4. Net purchases = Purchases, less purchases return.
5. Operating Expenses (OE) = General and administrative expenses + Selling and distribution expenses + Depreciation.

## 3.7 DIFFERENCE BETWEEN INCOME STATEMENT AND BALANCE SHEET

| ***Point of difference*** | ***Income Statement*** | ***Balance Sheet*** |
|---|---|---|
| Objective | The objective is to present the summary of expenses and incomes for the accounting period concerned. | The objective of balance sheet is to present financial position at the end of accounting period usually on 31st March. |
| Balancing figure | The balancing figure tells the result of business operation (Profit/Loss). | It always remains balanced *i.e.* there is no balancing figure. |
| Coverage | It includes only nominal accounts. | It includes Personal A/c, Real A/c and those Nominal accounts, which are capital in nature and need to be written off over a period of time. |
| Nature | It is dynamic in nature as it lists the expenses and incomes for the year concerned. | It is static in nature as it lists assets and liabilities at a given point of time usually at the end of year concerned. |

**Solved Problems**

**Problem 1. From the following ledger balances, prepare trial balance, income statement and balance sheet:**

| ***Particulars*** | ***Amount*** |
|---|---|
| Mr. X's capital | 5,00,000 |
| Drawing | 20,000 |
| Purchase | 2,00,000 |
| Loan | 1,00,000 |
| Machinery | 50,000 |
| Return to suppliers | 50,000 |
| Sales | 4,00,000 |
| Return inward | 6,00,000 |
| Carriage outward | 20,000 |
| Bad debts | 5,000 |
| Sundry Drs. | 1,00,000 |
| B/R | 20,000 |
| Sundry Crs. | 50,000 |
| Carriage inward | 10,000 |
| Salary and wages | 5,000 |
| Depreciation | 20,000 |
| Cash in hand | 1,00,000 |
| Sale of scrap | 5,000 |
| Closing stock | 50,000 |
| Prepaid tax | 10,000 |
| Outstanding wages | 5,000 |

Open Suspense A/c to balance trial balance if needed.

**Solution**

**Trial Balance**

| *Particulars* | *Debit* | *Credit* |
|---|---|---|
| Mr. X's Capital | — | 5,00,000 |
| Drawing | 20,000 | — |
| Purchase | 2,00,000 | — |
| Loan | — | 1,00,000 |
| Machinery | 50,000 | — |
| Return to supplies | — | 50,000 |
| Sales | — | 4,00,000 |
| Return inward | 60,000 | — |
| Carriage outward | 20,000 | — |
| Bad debts | 5,000 | — |
| Sundry Debtors | 1,00,000 | — |
| Bills receivable | 20,000 | — |
| Sundry creditors | — | 50,000 |
| Carriage inward | 10,000 | — |
| Salary and wages | 5,000 | — |
| Depreciation | 2,000 | — |
| Cash in hand | 1,00,000 | — |
| Sale of scrap | — | 5,000 |
| Closing stock | 50,000 | — |
| Prepaid tax | 10,000 | — |
| Outstanding wages | — | 5,000 |
| Suspense A/c | 4,40,000 | — |
| **Total** | **11,10,000** | **11,10,000** |

**Trading and P & L A/c**

*Dr.* *Cr.*

| *Particulars* | | *Amount* | *Particulars* | | *Amount* |
|---|---|---|---|---|---|
| To Purchase | 2,00,000 | | By Sales | 4,00,000 | |
| Less: Returns | 50,000 | 1,50,000 | Less: Returns | 60,000 | 3,40,000 |
| To Direct Expense: | | | | | |
| Carriage inward | 10,000 | | | | |
| **To Gross profit** | | **1,80,000** | | | |
| **Total** | | **3,40,000** | **Total** | | **3,40,000** |

*Contd...*

| *Dr.* Particulars | Amount | Particulars | Amount *Cr.* |
|---|---|---|---|
| To Salaries and wages | 5,000 | **By Gross profit** | **1,80,000** |
| To Depreciation | 20,000 | By Sale of scrap | 5,000 |
| To Carriage outward | 20,000 | | |
| To Bad debts | 5,000 | | |
| **To Net profit** | **1,35,000** | | |
| **Total** | **1,85,000** | **Total** | **1,85,000** |

**Balance Sheet**

| Liabilities | | Amount | Assets | Amount |
|---|---|---|---|---|
| Capital | 5,00,000 | | Fixed Assets: | |
| Less: Drawing | 20,000 | | Machinery | 50,000 |
| | 4,80,000 | | | |
| Add: Net Profit | 1,35,000 | | **Current Assets**: | |
| | | 6,15,000 | B/R | 20,000 |
| | | | Sundry Debtors | 1,00,000 |
| Loan | | 1,00,000 | Cash in hand | 1,00,000 |
| Current liability | | | Closing stock | 50,000 |
| Sundry Creditor | | 50,000 | Prepaid tax | 10,000 |
| Outstanding wages | | 5,000 | Suspense A/c | 4,40,000 |
| **Total** | | **7,70,000** | **Total** | **7,70,000** |

**Problem 2. A book-keeper has submitted you the following trial balance. You are required to prepare income statement and balance sheet as on 31$^{st}$ March 2002.**

**Trial Balance as on 31$^{st}$ March 2002**

| Particulars | Debit | Credit |
|---|---|---|
| Cash in hand | 30 | |
| Purchases | 8990 | |
| Cash at bank | 885 | |
| Fixtures and fitting | 225 | |
| Freehold premises | 1500 | |
| Lighting and heating | 65 | |
| B/R | 825 | |
| Returns inward | 30 | |
| Salaries | 1075 | |
| Debtors | 5700 | |

*Contd...*

| ***Particulars*** | ***Debit*** | ***Credit*** |
|---|---|---|
| Opening stock | 3000 | |
| Printing | 225 | |
| Rates and taxes insurance | 190 | |
| Discount allowed | 200 | |
| Capital | | 7610 |
| Sales | | 11060 |
| Creditors | | 1950 |
| B/P | | 1875 |
| Discount received | | 445 |
| **Total** | **22940** | **22940** |

**Solution**

**Trading and Profit & Loss Account**
**(for the year ending March 31, 2002)**

***Dr.*** ***Cr.***

| ***Particulars*** | ***Amount*** | ***Particulars*** | | ***Amount*** |
|---|---|---|---|---|
| To Opening stock | 3000 | By Sales | 11060 | |
| To Purchase | 8990 | Less: Return | 30 | 11030 |
| | | By Gross loss | | 960 |
| | **11990** | | | **11990** |
| To Gross loss | 960 | By Discount received | | 445 |
| To Salaries | 1075 | By Net loss | | 2270 |
| To Rent and tax | 190 | | | |
| To Printing | 225 | | | |
| To Lighting and heating | 65 | | | |
| To Discount allowed | 200 | | | |
| | **2715** | | | **2715** |

**Balance Sheet**
**(as on 31st March 2002)**

| ***Liabilities*** | | ***Amount*** | ***Assets*** | ***Amount*** |
|---|---|---|---|---|
| *Current Liability:* | | | *Current assets:* | |
| Creditor | | 1950 | Cash in hand | 30 |
| Bills payable | | 1875 | Cash at bank | 885 |
| *Proprietorship:* | | | Debtor | 5700 |
| Capital | 7610 | | Bills receivable | 825 |
| Loss | 2270 | 5340 | *Fixed assets:* | |
| | | | Fixture and fitting | 225 |
| | | | Freehold premise | 1500 |
| **Total** | | **9165** | **Total** | **9165** |

**Problem 3. Prepare final accounts from the trial balance given below:**

**Trial Balance as on 31$^{st}$ March 2002**

| *Particulars* | *Debit* | *Credit* |
|---|---|---|
| Cash in hand | 30 | |
| Purchases | 8990 | |
| Cash at bank | 885 | |
| Fixtures and fitting | 225 | |
| Freehold premises | 1500 | |
| Lighting and heating | 65 | |
| B/R | 825 | |
| Returns inward | 30 | |
| Salaries | 1075 | |
| Debtors | 5700 | |
| Opening stock | 3000 | |
| Printing | 225 | |
| Rents and taxes insurance | 190 | |
| Discount allowed | 200 | |
| Capital | | 7610 |
| Sales | | 11060 |
| Creditors | | 1950 |
| B/P | | 1875 |
| Discount received | | 445 |
| **Total** | **22940** | **22940** |

**Additional Information**

- Closing stock at the end of year amount Rs. 5000.
- Outstanding wages was Rs. 1000.
- Dep. charges at the rate of 10% on furniture and fixture.

**Solution**

**Trading and P & L A/c**

| *Particulars* | *Amount* | *Particulars* | *Amount* |
|---|---|---|---|
| To Opening stock | 3000 | Sales (less return) | 11030 |
| To Purchase | 8990 | | |
| To Out. wages | 1000 | Closing stock | 5000 |
| To Gross profit | 3040 | | |
| | 16030 | | 16030 |
| To Salary | 1075 | By Gross profit | 3040 |

*Contd...*

| *Particulars* | *Amount* | *Particulars* | *Amount* |
|---|---|---|---|
| To Printing | 225 | By Discount received | 445 |
| To Rents and tax insurance | 190 | | |
| To Discount allowed | 200 | | |
| To Lighting and heating | 65 | | |
| To Depreciation | 23 | | |
| To Net profit | 1708 | | |
| | **3485** | | **3485** |

**Balance Sheet**

| *Liabilities* | *Amount* | *Assets* | *Amount* |
|---|---|---|---|
| Capital | 7610 | Furniture and fitting | 202 |
| Net profit | 9318 | Freehold Premises | 1500 |
| Creditors | 1950 | *Current assets:* | |
| Bills payable | 1875 | Cash in hand | 30 |
| Out. wages | 1000 | Cash at bank | 885 |
| | | B/R | 825 |
| | | Drs. | 5700 |
| | | Current liabilities | 5000 |
| **Total** | **14142** | **Total** | **14142** |

**Problem 4. Following is the trial balance as on 30th June 2001.**

**Trial Balance**

| *Particulars* | *Debit* | *Credit* |
|---|---|---|
| Land and building | 20000 | |
| Machinery | 50000 | |
| Furniture and fixtures | 4000 | |
| Opening stock | 16300 | |
| Purchases | 80000 | |
| Salaries | 6000 | |
| Carriage on sales | 1500 | |
| Freight on purchases | 2000 | |
| Custom duty on purchases | 8000 | |
| Advertising | 5400 | |
| Wages | 15000 | |
| Rent | 3000 | |
| Postage and stationary | 1500 | |
| General expenses | 3200 | |

*Contd...*

| ***Particulars*** | ***Debit*** | ***Credit*** |
|---|---|---|
| Repairs to Machinery | 2000 | |
| Loan to Kumar @ 9% | 5000 | |
| Prepaid insurance | 200 | |
| Sundry debtors | 20000 | |
| Cash in hand | 250 | |
| Cash at bank | 3100 | |
| Capital | | 80000 |
| Sundry creditors | | 8000 |
| Discount received | | 400 |
| Outstanding expenses | | 1550 |
| Sales | | 150500 |
| Repairs and rewards (provision) | | 6000 |
| **Total** | **246450** | **246450** |

*The additional information is as follows:*

1. Closing stock was worth Rs. 14900.
2. Dep. is to be written of @ 3% on land and building, 10% on machinery and 5% on furniture and fixture.
3. Provision for repairs and renewals are credited with Rs. 1500 every year.
4. Provision for bad debts is 5% on Sundry debtors.

**Prepare income statement and balance sheet**.

**Solution**

**Trading and P & L A/c**
**(for the year ending $30^{th}$ June 2001)**

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| To Opening stock | 16300 | By Sales | 150500 |
| To Purchase | 80000 | By Closing stock | 14900 |
| To Freight on purchase | 2000 | | |
| To Custom duty | 8000 | | |
| To Wages | 15000 | | |
| To Gross profit | 44100 | | |
| | 165400 | | 165400 |
| To Provision for R and R | 1500 | By Gross profit | 44100 |
| To Depreciation | 5800 | By Discount received | 400 |
| To Carriage on sales | 1500 | | |
| To Pro. for bad debts | 1000 | | |
| To Advertisement | 5400 | | |
| To Salaries | 6000 | | |

*Contd...*

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| To Rent | 3000 | | |
| To Postage and stationary | 1500 | | |
| To General expenses | 3200 | | |
| To Repair of machinery | 2000 | | |
| To Net profit | 13600 | | |
| **Total** | **44500** | **Total** | **44500** |

**Balance Sheet**
**(as on 30th June 2001)**

| ***Liabilities*** | | ***Amount*** | ***Assets*** | ***Amount*** |
|---|---|---|---|---|
| Capital | 8000 | | Land & Building (less–dep) | 19400 |
| Add N.P. | 13600 | 93600 | Machinery (less–dep) | 45000 |
| Creditors | | 8000 | For Furniture (less–dep) | 3800 |
| Outstanding expenses | | 1550 | Prepaid insurance | 200 |
| Prov. for Repairs & Rewards | | 6000 | Sundry debtors | |
| Add: Provision every year | | 1500 | Less: Prov. for bad debts | 19000 |
| | | | Cash in hand | 250 |
| | | | Cash at bank | 3100 |
| | | | Loan to Kumar | 5000 |
| | | | Closing stock | 14900 |
| **Total** | | **110650** | **Total** | **110650** |

## 3.8 ACCOUNTING THEORY FRAMEWORK

To bring uniformity in accounting information, accountants all over the world follow certain common practices known as concepts, conventions and postulates while recording financial transactions. These practices come under preview of accounting theory framework.

Accounting theory framework can be studied in two parts:

**3.8.1 Part I:** Generally Accepted Accounting Principles (GAAP) *i.e.* concepts, conventions and postulates etc.

**3.8.2 Part II:** Accounting Standards (AS)

**Part I**
**[Accounting principles]**
(Accounting principles are first practicalized then theorized)

### *3.8.1.1 Concepts*

A concept is a general notion or thought.

Accounting is based on a few basic concepts, they are:

### *1. Money Measurement Concept*

According to this concept, in the books of account, only those business transactions are recorded which can be expressed in terms of money. The advantages of expressing facts in monetary terms is that money provides a common denominator by means of which heterogeneous facts about a business can be expressed in terms of numbers that can be added and subtracted.

This concept can better be illustrated by taking the following example.

**Example:** A business owns the following assets:

| | |
|---|---|
| Land | 5 acres |
| Building Space | 2500 sq. metres |
| Machines | 5 |
| Stock of Raw Material | 1,500 kgs. |
| Trucks | 5 |
| Motor Cars | 2 |
| Trade Debtors | Rs. 1,20,000 |
| Bank Balance | Rs. 5,000 |

These different units of measurement cannot be added together to produce meaningful information. If these assets can be expressed in terms of money they will reveal the total property and assets of the business.

| | |
|---|---|
| Land | Rs. 2,00,000 |
| Buildings | 15,00,000 |
| Machines | 50,00,000 |
| Stock of Material | 60,000 |
| Trucks | 1,50,000 |
| Motor Cars | 50,000 |
| Trade Debtors | 1,20,000 |
| Bank Balance as on 31st March 2001 | 5,000 |
| **Total** | Rs. 70,85,000 |

**Remark**

Money provides a common denominator for measuring value and implies a basic similarity between one rupee and another, but it may not be a fact particularly in a period of inflation. In the assets shown above, the bank balance is expressed in the rupee value of 2001, but the amounts for land, buildings, machines etc. are in terms of rupee value of ten years back when they were purchased. The rupee of ten years back was worth more than a rupee of today, because the purchasing power of the present rupee has gone down due to high degree of inflation in the economy.

### *2. Business Entity Concept*

According to this concept, for accounting purposes, an organization is taken as a separate legal entity and it is distinct from owner itself. In other words, irrespective of the form of organization a business has got its own individuality as distinguished from those persons who own, control or otherwise are associated with the business.

If the business transactions and personal transactions of the owner of the business are mixed up then the twin financial statements *i.e.* the balance sheet and profit and loss account will not correctly disclose the true financial position and profitability of the business. Management is entrusted with the funds of a business and it is expected of them to make the best use of these resources. Through the medium of financial accounting and reporting of the business transactions the owners will judge how well this responsibility has been discharged. For these reasons the business must have its own personality.

### *3. Going Concern Concept*

According to this concept, accounting assumes that the business is a going concern and not a gone concern. In other words, an organization never dies. It will continue to operate in the future. Its success is judged by the surplus, which it generates from the sale of goods and services over the cost of the resources used.

Production resources such as plant and machinery, land and building which have been acquired and whose period of usefulness has not expired *i.e.* which could not be consumed in creating output are shown in books of account at their book-value and not at their current market value. They are acquired to remain in the business; so long it is a going concern, for earning revenues and are not meant for resale. But when it is a gone concern and is about to be liquidated or sold, accounting would attempt to measure what the business is currently worth. Under this arrangement the current resale value of the assets becomes relevant.

### *4. Cost Concept*

This fundamental concept of accounting is closely related to the going concern concept. According to this concept, an asset is ordinarily recorded in the books of account at its acquisition cost. This cost then becomes the basis for all subsequent accounting for the asset. The market value of an asset may change with the passage of time, but for accounting purpose it continues to be shown in the books at its book-value *i.e.* the cost at which it was acquired minus the provision for depreciation.

There is therefore a wide difference between the accounting concept of cost and the economic concept of value, which means what the asset is currently worth.

**Example:** A business purchased a piece of land for Rs. 100,000/-. It was recorded in the books of account for Rs. 100,000/-. In course of time its economic value has shot up, with the result that its current market value is Rs. 500,000/-. No change would ordinarily be made in accounting record to reflect this fact.

### *5. Dual-Aspect Concept*

According to this concept, at least two parties are involved in every transaction, one for receiving aspect and another for giving aspect and therefore to record a single transaction simultaneously two books of account are required. In other words, every transaction has dual aspect (a) the yielding of a benefit, and (b) the receiving of that benefit. It is impossible to think of one without the other; a giver necessarily implies a receiver and a receiver necessarily implies a giver.

**Example:** Suppose Gopal starts a business with a capital of Rs. 50,000/-. Then the business now has an asset cash of Rs. 50,000/- and Gopal, the proprietor has a claim against this asset also of Rs. 50,000.

**Balance sheet**

| | | | |
|---|---|---|---|
| Gopal's Capital | Rs. 50,000 | Cash | Rs. 50,000 |

If the business later on purchased furniture on credit from Krishna Kumar for Rs. 5,000/-, the Furniture Account receives the benefit and Krishna Kumar gives the benefit. The accounting record would now show the following position.

**Balance sheet**

| | | | |
|---|---|---|---|
| Gopal's Capital | Rs. 50,000 | Cash | Rs. 50,000 |
| Krishna Kumar | 5,000 | Furniture | 5,000 |
| | **55,000** | | **55,000** |

It follows that in order to have a complete record of each transaction, there must be a double entry.

Thus to record a single transaction at least two book of accounts are needed simultaneously, one for receiving aspect (*i.e.* debit entry) and another for giving aspect (*i.e.* credit entry). This is also known as "**double entry book-keeping system".**

### *6. Accrual Concept*

According to this concept, income/profit arises from the operations of a business when the sales revenue exceeds the cost of sale. Cost of sale includes manufacturing cost plus non-cash charges like depreciation. The income so accrued will increase the owners equity.

**Remark: (Difference between income *i.e.* profit and cash)**

It is important to remember that income and cash are not synonyms. They are not interchangeable, because their nature is different. If a business has made a profit of Rs. 50,000/-, it does not mean that it has the same amount of cash. Income is added to the capital of the business and is shown on the liabilities side. The income shown on the liability side increases owner's equity and is absorbed in the assets shown on the assets side of the balance sheet. It is not necessary that it may be in the form of cash. It is important to recognize that income is associated with changes in owner's equity and has no necessary relation to changes in cash. Income connotes prosperity of the business. The higher the income the better off is the business and therefore the owners. An increase in cash does not necessarily mean that the business is doing well and the owners are better off. The increase in cash may have been due to the sale of machine or decrease in some other asset or an increase in liability, with no effect on owner's equity at all.

**Example:** Suppose in the manufacture of 5000 units of X product the following expenses are incurred and revenues earned.

| | | |
|---|---|---|
| (a) Cash expenses— | | |
| Process material @ Rs. 5/- per unit | Rs. | 25,000 |
| Process wages @ Rs. 3/- per unit | | 15,000 |
| Overheads, paid in cash | | 10,000 |
| Total | | 50,000 |
| (b) Non-cash expenses— | | |
| Depreciation etc. | | 5,000 |
| **Cost of 5000 units of finished stock** [(a)+(b)] | | **55,000** |
| Selling Price @ Rs. 15/- per unit | | 75,000 |
| **Income** | Rs. | **20,000** |

In understanding how this income came about we will have to consider the two aspects of this event separately. The sum of Rs. 75,000/- received from sales revenue and the decrease in finished stock of goods of Rs. 55,000/-. Rs. 75,000/- will result in the increase in owner's equity and a corresponding increase in the asset of the business. Rs. 55,000/- will cause a decrease in assets *i.e.* of the finished stock of goods and corresponding decrease in owner's equity. These two aspects show the only two ways in which the business operations can affect owner's equity. They can increase or decrease it.

**Conclusions**

- Any increase in the owner's capital resulting from the operations of the business is called revenue.
- Any decrease in the owner's capital resulting from the operations of the business is called an expense.

- Income is thus the excess of revenues over expenses.
- Income is tied to owner's equity and has no direct link to changes in cash.

*7. Realization Concept*

According to this concept, revenue is considered as being earned on the date when the goods are delivered to the customer whereas profit is not recognized to have been earned till it is realized in cash or a third party has legally become liable to pay the amount. In fact cash is received from the customer when the customary period of credit allowed, has expired.

**Example:** JK company manufacturers sewing machines at Lucknow. During the month of December 2001 it manufactured 12 dozen machines and booked 5 dozen by rail to its customer at Agra. The invoice for Rs. 25,000/- was sent on 1$^{st}$ January 2002. The period of credit allowed by the company was 2 months after delivery. The revenue from this transaction was realized not in the month of December 2001, the month of manufacture, not in March 2002 in which cash was received but in January, the month in which they were delivered *i.e.* when the exchange took place. The accounting practice is to show the date of realizing revenue, the date the product was booked, shipped or the date shown as the invoice to the customer, whichever is later.

*8. Matching Concept* (Match Expenses against Revenue)

At the end of the financial year, all costs (expenses) of the organization are to be matched against the revenue of the organization. Income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue.

**Surplus ⇒ Profit or excess of revenue over expenses**.

**Deficit ⇒ Loss or excess of expenditure over revenue or income**.

### 3.8.1.2 Accounting Conventions

Accounting convention means established usage.

The three essential elements of convention are:

(1) Consistency
(2) Conservatism
(3) Materiality

*1. Consistency*

The element of consistency requires that once a business has decided to adopt a particular method, it will consistently follow the same in years to come. For example, a company has adopted the straight-line method of charging depreciation on its plant and machinery, then it will continue charging depreciation on this asset under the same method. If the company later on switches over to diminishing balance method of charging depreciation, then comparison of its accounting figure from one year to another would become difficult. Another example is the valuation of inventory. There are different methods of valuing the assets *viz.*

- Actual cost based on LIFO and FIFO methods.
- Average cost.
- Standard cost.
- Market price.

If the company has adopted actual cost based on LIFO method, it should adhere to it. Suppose it changes over to market price subsequently for valuation of inventory, it will distort the figure of profit and comparison of profit form one year to another will be misleading. The essence of the element of consistency in accounting is very well made out in this case.

### *2. Conservatism*

The element of conservatism in relation to accounting conventions may be stated as follows. "Anticipate no profit, and provide for all possible (conceivable) losses." On the basis of conservatism the value of closing stock for preparing final accounts is shown at cost or market price whichever is lower.

**Example:** The following example will show how conservatism pays in the long run. A company has taken a contract of Rs. 10,00,000/- for the construction of a building in one year. The work commenced on 1st April 2001 and is to be completed by 31st March 2002. The company closes its books of account on 31st December every year. There is a penalty clause for late completion of the work @ Rs. 5,000/- per month. On 31st December 2001 only half of the work could be completed and was certified by the architect. Due to labour trouble and difficulty in procuring cement, bricks and iron, it was estimated that the work would take six months more for completion and will not be finished by 31st March 2002 as provided in the contract.

According to the agreement the company will have to pay a penalty of Rs. 15,000/- @ Rs. 5,000/- per month for the late completion of the work. Conservatism demands that the company should make provision for the conceivable loss of Rs. 15,000/-. A worker has also sued the company for claiming compensation of Rs. 5,000/- under the Workmen's Compensation Act. The case has not been so far decided by the court, but the company must also make provision for this liability. In case if the work is completed earlier and the claim of the worker has not been so far decided by the court, the company must also make provision for this liability. In case if the work is completed earlier and the claim of the worker is not upheld by the court, which will naturally reduce the estimated loss to the company, it will not lose anything by providing for all liabilities, which have not occurred, to that extent.

The cost of half of the work completed as on 31st December 2001 as revealed by the books came to Rs. 4,50,000/- and the amount received for half of the work certified was Rs. 5,00,000/-. Thus the estimated earnings of the company would be Rs. 50,000/-.

Conservatism demands that the company should not show this amount as profit on this contract for the year ending 31st December 2001. This profit may not result due to the following reasons:

(1) Increase in wages due to the frequent labour trouble which disrupts the work,

(2) Increase in the cost of other inputs,

(3) Provision for penalty arising out of late completion of the work, and lastly

(4) Compensation claimed by a worker.

If for the above reasons the estimated profit of Rs. 50,000/- is not taken into consideration in preparing final accounts of 2001, and if these contingencies do not take place or their impact is lesser, the company will not lose anything, but will surely gain by way of its improved financial position.

### *3. Materiality*

According to this convention it is expected that accounting information should disclose all the material information. By the term material information, we mean that information which would have changed the result of business operation, in case it would have been disclosed. This does not mean that accounting should be over-burdened with information. This can better be explained by taking an example. A new lead pencil is an asset to the business. Every time the pencil is used its value decreases. In theory the business can ascertain everyday the number of partly-used pencils. But the labour and time involved for this insignificant matter will be huge and no sensible accountant would think of doing this exercise.

There is no line of demarcation between significant and insignificant events. Much will depend on the common sense of the accountant and the policy, which is followed by the business concern.

Under materiality convention, accountants furnish certain information in footnotes. Most common information given in footnotes are:

(1) Information regarding contingent liabilities.

(2) Information regarding market price of investments.

The accountant should always keep in mind that materiality does not mean leaking business secrets. It stresses not to reveal vital information, which are of strategic importance.

### *3.8.1.3 Postulates*

Accountants make various assumptions that implement the principles/conventions they have adopted. Such assumptions are:

(1) The enterprise for which the accounting is performed will remain in business. The rupee amounts shown in the balance sheet are, therefore, going concern values.

(2) The value of money, that is, its purchasing power is constant.

(3) The entire income from sales is earned at the moment the sales take place even though a considerable amount of time may have been required to produce the item sold.

Thus, the rupee amount of assets in the balance sheet and the amount of net profit or loss in the profit and loss account is produced by certain conventional method, implemented by various postulates, which have been developed in course of time. These stated rupee amounts do not provide precise measurement of the financial statement items and do not necessarily bear any relation to the market value of the assets of the business or the price at which they could be replaced.

**Role of Personal Judgement of Accountant in Book-keeping System**

Although the procedure for stating how much of a particular expenditure is to be assigned to revenue and how much is to be carried forward as an asset is governed by conventions and postulates. The application of these conventions and postulates depends on the personal judgement of the accountant. Even though the intentions of accountants are of the best, the human quality of judgement plays an unconscious part. Perfectly honest and capable individuals on the basis of physical facts frequently reach very different conclusions. Let us see how judgement enters into the estimation of three items—the valuation of inventory, the determination of a reserve for doubtful debts and the determination of the rate of depreciation to be charged on the various classes of the fixed assets.

**Valuation of Inventory**

The inventory could be carried at cost or market, whichever is lower and still have widely different valuations depending upon the method of computations: first in first out, last in first out, average cost, standard cost, and so on. In every case someone must decide which method of valuation will be used. That particular method will affect the valuation of the inventory in the balance sheet, the cost of goods sold, and hence the net profit in the profit and loss account.

**Reserve for Doubtful Debts**

The amount of reserve to be set aside for doubtful debts is likewise an exercise of judgement alone, based perhaps on past experience.

**Depreciation**

When it comes to depreciation, judgement enters into two necessary decisions. First, the rates of depreciation to be used for various types of fixed assets, and second, the method of depreciation to be adopted. The rate of depreciation, which is based upon the useful life expectancy of an asset, is engineering rather than an accounting problem. Useful life expectancy in itself is a generality. The method of depreciation selected will give different values to assets over the years and different charges to profit and loss account affecting net profit, even though the same life expectancy is used.

**Remark**

"One might question the usefulness of accounting statements whose fairness rests so heavily upon judgement rather than upon demonstrated facts. But as against such doubts it should be borne in mind that the judgement employed is an informed one. It is concerned with actualities and is not mere imagination. The accounting statements reflect the summary of all relevant information relating to the transactions involved."

### *3.8.1.4 Accounting systems*

The two systems of accounting are as follows:

*1. Cash System of Accounting*

Accounting entries are made only when cash is received or paid, *i.e.* when actual cash exchange takes place.

No entry is made when a payment or receipt is merely due, *e.g.* government system of accounting and small business enterprise.

*2. Mercantile or Accrual System of Accounting*

Accounting entries are made on the basis of amounts having become due for payment or receipt. In this system, the sale is recognized soon after delivery, *e.g.* corporate accounting *i.e.* accounting for corporate.

**Part II**
**[Accounting Standards (AS)]**

### *3.8.2.1 Meaning of Accounting Standard*

The uniform, definite and universally accepted accounting rules developed by International Accounting Standards Committee (IASC) are known as accounting standard.

### *3.8.2.2 Need for Accounting Standard*

It was felt that there were different accounting concepts, conventions, customs, traditions and rules prevailing in different nations leading to misunderstanding, uncertainty and often resulting in scandal. Confusion prevailed at the national level also. This created need to develop universally accepted and internationally standardized accounting terminology, commonly known as accounting standard.

### *3.8.2.3 Development of International Accounting Standard*

In 1973, an International Accounting Standards Committee was formed with 16 accounting bodies from 9 nations as founder members. The committee agreed to formulate and publish in public interest standards to be observed in the presentation of audited financial statements and to promote their worldwide acceptance and observance.

### *3.8.2.4 International Accounting Standard (IAS) issued by IASC*

IAS –1: Disclosure of Accounting Policies
IAS –2: Valuation and Presentation of Inventories
IAS –3: Consolidated Financial Statements
IAS –4: Depreciation accounting

IAS –5: Information to be disclosed in financial statements
IAS –6: Accounting responses to changing prices.
IAS –7: Statement of changes in financial position and so on …

### 3.8.2.5 Development of Accounting Standard in India

In India, Institute of Chartered Accountants of India works as the counterpart of International Accounting Standards Committee. The institute has formulated and issued accounting standards of recommendatory nature. These standards are known as Accounting Standards (AS).

### 3.8.2.6 Accounting Standards (AS) issued by Institute of Chartered Accountants of India (ICAI) on February 8, 2002

AS – 1: Disclosure of accounting policies. (Effective from 1-4-1991)
AS – 2: Valuation of inventories. (Effective from 1-4-1999)
AS – 3: Cash flow statement. (1-4-1997)
AS – 4: Contingencies and events occurring after balance sheet date. (1-4-1995)
AS – 5: Prior period and extraordinary items and changes in accounting policies. (1-4-1996)
AS – 6: Depreciation accounting. (1-4-1995)
AS – 7: Accounting for construction contracts. (1-4-1999)
AS – 8: Accounting for research and development. (1-4-1991)
AS – 9: Revenue recognition. (1-4-1991)
AS – 10: Accounting for fixed assets. (1-4-1991)
AS – 11: Accounting for the effects of changes in foreign exchange rates. (1-4-1995)
AS – 12: Accounting for government grants. (1-4-1994)
AS – 13: Accounting for investments. (1-4-1995)
AS – 14: Accounting for amalgamations. (1-4-1995)
AS – 15: Accounting for retirement benefits in the final statements of employers. (1-4-1995)
AS – 16: Borrowings cost. (1-4-2000)
AS – 17: Segment reporting. (1-4-2001)
AS – 18: Related party disclosure. (1-4-2001)
AS – 19: Leases (1-4-2001)
AS – 20: Earning per share. (1-4-2000)
AS – 21: Consolidated financial statements. (1-4-2001)
AS – 22: Accounting for taxes on income (1-4-2001)
AS – 23: Accounting for investments associates in consolidated financial statements. (1-4-2002)
AS – 24: Discontinued operations. (8-02-2002)

### 3.8.2.7 Objectives of the Accounting Standards (AS)

(*i*) To bring out uniformity in financial reporting and to ensure consistency and comparability in the data published by the organization.
(*ii*) Standard must provide a generally understood and accepted measure of the phenomena of concern.
(*iii*) Standard should significantly reduce the amount of manipulation of the reported numbers that is likely to occur in the absence of the standards.

### *3.8.2.8 Is Accounting Theory Framework Good or Bad?*

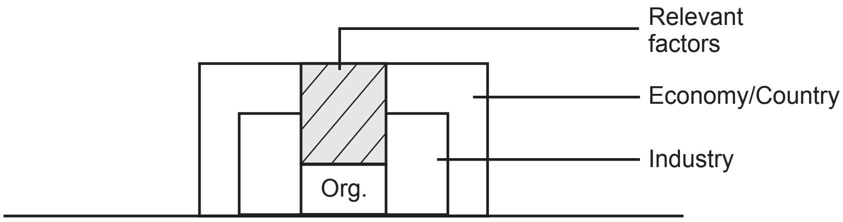
Though accounting theory framework imposes constraints during book-keeping process, it has positive aspects too. Following are the benefits of accounting theory framework.

1. Accounting theory framework discussed above brings uniformity in accounting information from one year to another and from one company to another company, making comparison/inter-firm comparison possible.
2. Strict implementation of accounting theory framework reduces the chances of window dressing and standardizes the accounting information.
3. Accounting information produced under accounting theory framework soon after incorporating relevant factors, becomes valuable information for decision-making purposes.

***Note***

By relevant factors we mean:

"All those micro factors (industry level) and macro factors (economy level), which affects the organization concerned, constitute relevant factors."




## 3.9 FINAL ACCOUNTS FOR PARTNERSHIP FIRM

### 3.9.1 Introduction

Any organization registered under Partnership Act 1932 is defined as partnership firm. Partnership Act defines partnership as follows:

"Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

Partners carry business according to partnership deed.

### 3.9.2 Partnership Deed

Partnership deed is the written/oral agreement between partners for the conduct of the business. It includes –

- Share of profit/loss
- Interest on capital drawing
- Salary, rent, commission etc.
- Nature of business
- Provisions regarding admission, retirement of partners, etc.

However, in those situations where partnership deed remains silent, the general provisions of Partnership Act will apply e.g.

1. No interest is to be allowed on Capital in case such provision is not given in partnership deed.
2. No interest is to be charged on Drawings made by the partners.

3. If any partner apart from his share capital, advances loan to the firm, he is entitled to receive interest at 6% per annum.
4. In the absence of partnership deed, profits and losses are to be shared equally by partners irrespective of their capitals contributed to the firm.

### 3.9.3 Final Accounts of Partnership

(*a*) The method of preparing final accounts of a partnership firm is not different from the one followed for the preparation of final accounts for a sole proprietorship concern.

(*b*) There will be a separate capital account for each partner. The amount of profit or loss, drawings etc. will be all credited or debited to that accounts.

(*c*) Steps involved in preparation of final accounts from trial balance are given below.

### 3.9.4 Preparation of Final Accounts from Trial Balance

Steps involved in preparation of final accounts from trial balance in case of partnership business is as follows:

**Step 1:** Prepare Trading and P & L A/c as in case of sole proprietorship concern excluding expenses and incomes related to partners only. Transfer the balancing figure to partner's Capital A/c in profit/loss sharing ratio.

**Step 2:** Prepare partner's Capital A/c by posting all the expenses and incomes related to partners and also transfer the balancing figure of Trading and P & L A/c to partner's Capital A/c in profit/loss sharing ratio. The rule and format for posting in partner's Capital A/c is as follows:

**Rule:**

Partner's Capital A/c → Dr. (Decrease)
Partner's Capital A/c → Cr. (Increase)

**Format:**

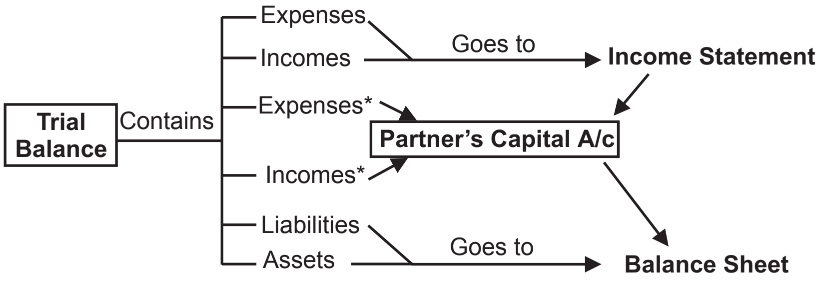
Let 'A' and 'B' be two partners.

***Dr.*** ***Cr.***

| *Date* | *Particulars* | *A* | *B* | *Date* | *Particulars* | *A* | *B* |
|---|---|---|---|---|---|---|---|
| | **To Balance b/d:** | | | | | | |
| | **A's Capital A/c** | ------- | | | | | |
| | **B's Capital A/c** | | -------- | | | | |
| | **Total** | = | = | | **Total** | = | = |

**Step 3:** Prepare a Balance Sheet as in case of sole proprietorship concern by posting balancing figure of partner's Capital A/c (under step 2) on liability side under head partner's Capital A/c *e.g.* A's Capital A/c and B's Capital A/c in above case.

### 3.9.5 Mechanism Involved in Preparation of Final Accounts for Partnership Firm




* **denotes expenses and incomes related to partners only e.g. interest on capital, interest on drawings, salaries to partners are some incomes/expenses related to partners.**

**Illustration 6**

Following is the trial balance of a partnership firm as on 31$^{st}$ March 2001 where 'A' and 'B' are partners. Interest on capitals and drawings are allowed @ 6% per annum. 'B' is also entitled to salary of Rs. 6000 per annum. The profit sharing ratio is 3:1.

**Additional Information**

- Closing stock amounting to Rs. 5000 — R/M (Raw Material)
  Rs. 10000 — FG (Finished Goods)
- Goods taken by 'B' for personal use amounting to Rs. 2000.
- Provide additional provision of Bad Debts @ 3% per annum.
- Material not recorded amount to Rs. 2000.
- Provision for depreciation:
  Land and Building (L & B) — @ 3% per annum
  Plant and Machinery and Furniture (P & M & F) — @ 10% per annum

**Prepare Final Accounts**

**Trial Balance**

| ***Particulars*** | ***Dr.*** | ***Cr.*** |
|---|---|---|
| A's Capital A/c | | 50000 |
| B's Capital A/c | | 20000 |
| Opening stock—R/M | 4000 | |
| Opening stock—FG | 9000 | |
| Purchases | 74000 | |
| Sales | | 174080 |
| Purchases return | | 200 |
| Sales return | 400 | |
| Wages | 42400 | |
| Salaries | 12000 | |

*Contd...*

| ***Particulars*** | ***Dr.*** | ***Cr.*** |
|---|---|---|
| Insurance | 400 | |
| Postage | 400 | |
| Travelling | 2100 | |
| Advertising | 6100 | |
| Bad debts | 300 | |
| Reserve funds | | 20000 |
| Bills payable | | 16200 |
| Discount allowed | 580 | |
| Discount received | | 340 |
| Land and building | 16000 | |
| Plant and machinery | 59000 | |
| Furniture | 600 | |
| Debtors | 42000 | |
| Creditors | | 15820 |
| Cash | 1600 | |
| Bank | 6000 | |
| Power | 3000 | |
| Lighting | 500 | |
| Provision for bad debts | | 500 |
| Carriage | 760 | |
| Office expenses | 4000 | |
| A's Drawing | 9000 | |
| B's Drawing | 3000 | |
| **Total** | **297140** | **297140** |

**Solution**

**Income Statement**
**Manufacturing A/c and Trading and P & L and P & L (Appr.) A/c**

| ***Particulars*** | | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|---|
| To Opening Stock—R/M | | 4000 | By Cost of production | 116960 |
| To Purchases | 74000 | | | |
| Less Return | 200 | | | |
| Less Closing stock | 5000 | | | |
| Less Material not recorded | 2000 | 66800 | | |
| To Power | | 3000 | | |
| To Carriage | | 760 | | |
| **Total** | | **116960** | **Total** | **116960** |

*Contd...*

| ***Particulars*** | | ***Amount*** | ***Particulars*** | | ***Amount*** |
|---|---|---|---|---|---|
| **To cost of production** | | **116960** | By Sales | 174080 | |
| To Finished goods | 9000 | | Less Return | 400 | 173680 |
| Less Goods taken by B | 2000 | 7000 | | | |
| | | | By Closing stock - FG | | 10000 |
| **To Gross Profit (GP)** | | **59720** | | | |
| **Total** | | **183680** | **Total** | | **183680** |
| To Salary | | 12000 | **By GP** | | **59720** |
| To Insurance | | 400 | By Discount received | | 340 |
| To Postage | | 400 | | | |
| To Travelling expenses | | 2100 | | | |
| To Discount allowed | | 580 | | | |
| To Advertising | | 6100 | | | |
| To Lighting | | 500 | | | |
| To Office expenses | | 4000 | | | |
| To Bad debts | | 300 | | | |
| To Depreciation | | | | | |
| — P and M and F | | 5960 | | | |
| — Building | | 480 | | | |
| To Provision for bad debts | | 1260 | | | |
| **To Net Profit (NP)** | | **25980** | | | |
| **Total** | | **60060** | **Total** | | **60060** |
| To Interest on capital: | | 8400 | By NP | | 25980 |
| A : | 6300 | | | | |
| B : | 2100 | | By Interest on drawings: | | 720 |
| To Salary to B | | 6000 | A's Capital A/c | 540 | |
| **To Balance b/d:** | | 12300 | B's Capital A/c | 180 | |
| A's Capital A/c | 9225 | | | | |
| B's Capital A/c | 3075 | | | | |
| **Total** | | **26700** | **Total** | | **26700** |

**Partner's Capital Account**

***Dr. (decrease)*** ***Cr. (increase)***

| ***Particulars*** | ***A*** | ***B*** | ***Particulars*** | ***A*** | ***B*** |
|---|---|---|---|---|---|
| To Drawings | 9000 | 3000 | By Balance | 50000 | 20000 |
| To Interest on drawings | 540 | 180 | By Interest on capital | 6300 | 2100 |
| To Goods taken by B | | 2000 | By P & L (App.) A/c | 9225 | 3075 |
| To Balance b/d | 55985 | 25995 | By Salary to B | | 6000 |
| **Total** | **65525** | **31175** | **Total** | **65525** | **31175** |

**Balance Sheet**

| *Liabilities* | *Amount* | *Assets* | | *Amount* |
|---|---|---|---|---|
| A's Capital A/c | 25995 | Land and building | 16000 | |
| B's Capital A/c | 55985 | Less Depreciation | 480 | 15520 |
| Reserve fund | 20000 | P and M and F | 59600 | |
| Bill payable | 16200 | Less dep. | 5960 | 53640 |
| Creditors | 15820 | Debtors | 42000 | |
| | | Less Provision for bad debt | 1760 | 40240 |
| | | Cash | | 1600 |
| | | Bank | | 6000 |
| | | Closing stock—R/M | 5000 | |
| | | Add Material not recorded | 2000 | 7000 |
| | | Closing stock—FG | | 10000 |
| **Total** | **134000** | **Total** | | **134000** |

## 3.10 FINAL ACCOUNTS FOR COMPANIES

- The monetary transactions of a limited company are recorded in the same manner as those of a sole trading concern or partnership firm. The special transactions related to formation of company are governed by provisions of Companies Act 1956 amended up to date. The general principles applicable to preparation of trading and profit and loss account as well as balance sheet of sole proprietorship concern also hold good in respect of final accounts of a limited company. However, the preparation and presentation of final accounts of company are governed strictly by the provisions of Companies Act 1956 amended up to date.
- There is a range of provisions contained in Companies Act 1956 which regulate the accounting for, and the record of, business transactions of a company but only certain salient points profoundly affect the preparation of final accounts. They are,
  1. The balance sheet and profit and loss account of a company are to be drawn up in strict conformity with the provisions of section 211 and schedule VI of Companies Act 1956.
  2. Annual accounts of a company which are statutorily required to be filed with the registrar of companies, comprises of balance sheet, profit & loss account, and every other documents annexed or attached to balance sheet and profit & loss account. The auditor's report on annual accounts is attached to balance sheet of the company. This annual accounts of a company must give a 'true and fair view, of the state of affairs of a company at the end of financial year including the profit or loss position under Section 211 of the Company Act. Truly speaking, the provisions of Companies Act regulates every aspect of not only the preparation of final accounts but also the accounting for business transactions.

### Balance Sheet of Companies

- **Distinction between a Company's Balance Sheet and Firm's Balance Sheet**

A Company's Balance Sheet is different from a Firm's Balance Sheet in the following respects:

1. A company's Balance Sheet is prepared in the order of permanence whereas a partnership firm's Balance Sheet is usually prepared in the order of liquidity.

2. For a company's Balance Sheet, there are two standard forms prescribed under the Companies Act 1956 whereas, there is no standard form prescribed under the Indian Partnership Act 1932 for a partnership firm's Balance Sheet.
3. In case of a company's Balance Sheet, previous year's figures are required to be given whereas, it is not so in the case of a partnership firm's Balance Sheet.
   - **Form of Balance Sheet:**

**Balance Sheet**
**(Main Headings only)**
**(As per Section 211, Schedule VI, Part I)**

| ***LIABILITIES*** | ***Previous Yr.*** | ***Current Yr.*** | ***ASSETS*** | ***Previous Yr.*** | ***Current Yr.*** |
|---|---|---|---|---|---|
| **Share Capital** | | | **Fixed Assets** | | |
| **Authorized:** | | | (1) Goodwill | | |
| ————Shares of Rs.—— each | | | (2) Land | | |
| **Issued:** | | | (3) Buildings | | |
| ————Shares of Rs. —— each | | | (4) Leaseholds | | |
| **Subscribed:** | | | (5) Railway sidings | | |
| ————Shares of Rs.—— each | | | (6) Plant and machinery | | |
| **Paid-up capital:** | | | (7) Furniture and fittings | | |
| Rs. —— per share called up | | | (8) Development of property | | |
| Less: Unpaid calls | | | (9) Patent, trade marks and designs | | |
| Add: Forfeited shares | | | (10) Livestock and | | |
| (Amount originally paid-up) | | | (11) Vehicles, etc. | | |
| **Reserves and Surplus** | | | **Investments** | | |
| (1) Capital reserves | | | (1) Investment in government or trust or trust securities | | |
| (2) Capital redemption reserve | | | (2) Investment in shares, debentures or bonds | | |
| (3) Share premium account | | | (3) Immovable properties | | |
| (4) Other reserves, specifying the nature of each reserve | | | (4) Capital of partnership firms | | |
| (5) Profit & Loss account or surplus *i.e.* balancing figure carried over as per Profit & Loss (appropriation) account | | | **Current Assets, Loans and Advances** | | |
| (6) Proposed additions to reserves | | | **A. Current Assets:** | | |
| (7) Sinking funds | | | (1) Interest accrued on investment | | |

*Contd...*

| ***LIABILITIES*** | ***Previous Yr.*** | ***Current Yr.*** | ***ASSETS*** | ***Previous Yr.*** | ***Current Yr.*** |
|---|---|---|---|---|---|
| **Secured loans**<br>(1) Debentures<br>(2) Loans and advances from banks<br>(3) Loans and advances from subsidiaries<br>(4) Other loans and advances<br><br>**Unsecured loans**<br>(1) Fixed deposits<br>(2) Loans and advances from subsidiaries<br>(3) Short-term loans and advances<br>(4) Other loans and advances<br><br>**Current Liabilities and Provisions**<br>**A. Current Liabilities**<br>(1) Acceptances<br>(2) Sundry creditors<br>(3) Subsidiary companies<br>(4) Advance payment and unexpired discounts<br>(5) Unclaimed dividends<br>(6) Other liabilities<br>(7) Interest accrued but not due on loans<br><br>**B. Provisions**<br>(8) Provision for taxation<br>(9) Proposed dividends<br>(10) Provision for contingencies<br>(11) Provision for provident fund schemes<br>(12) Provision for insurance, pension and similar staff benefit schemes<br>(13) Other provisions | | | (2) Stores and spare parts<br>(3) Loose tools<br>(4) Stock-in-trade<br>(5) Work-in-progress<br>(6) Sundry debtors<br>(7) Cash balance in hand<br>(8) Bank balance<br><br>**B. Loans and Advances:**<br>(9) Loans and advances to subsidiaries<br>(10) Loans and advances to partnership firm in which company or any of its subsidiaries is a partner<br>(11) Bill of exchange<br>(12) Advances recoverable in cash or kind or value to be received, e.g. rates, taxes, insurances, etc.<br>(13) Balances with custom, port trust, etc.<br><br>**Miscellaneous Expenditure**<br>(to the extent not written off or adjusted)<br>(1) Preliminary expenses<br>(2) Expenses including | | |

*Contd...*

| ***LIABILITIES*** | ***Previous Yr.*** | ***Current Yr.*** | ***ASSETS*** | ***Previous Yr.*** | ***Current Yr.*** |
|---|---|---|---|---|---|
| | | | commission or brokerage or underwriting of subscription of shares or debentures<br>(3) Interest paid out of capital during construction<br>(4) Development expenditure not adjusted<br>(5) Other sums, specifying nature | | |
| **Total** | | | **Total** | | |
| **Footnote may be added as the following:**<br>(1) Claims against the company not acknowledged as debts<br>(2) Uncalled liability on shares partly paid-up<br>(3) Arrears of fixed cumulative dividends<br>(4) Estimated amount of contracts remaining to be executed on capital account and not provided for<br>(5) Other sums for which the company is contingently liable | | | | | |

***Note*:** Amounts shown above dotted line (———) are excluded from total of Balance Sheet.

## Profit & Loss Account of Companies

No standard form has been prescribed by law for the profit & loss account of a company as has been done for the balance sheet. This is due to the reason that there are many different types of companies and industries, with their own peculiar characteristics, for which one set form cannot be suitable. However, the part II of schedule VI of the Companies Act has specified presentation and disclosure requirements in respect of items of income and expenditure.

## Vertical presentation of Final Accounts for Joint Stock Companies (condensed form)

**Income Statement for the year ———**

| | *Particulars* | | Amount (Rs.) | |
|---|---|---|---|---|
| | Sales | Trading A/c | —— | |
| Less | Cost of Goods Sold (COGS) | | —— | |
| | Gross Profit (GP)/(Gross Loss) | | ——@ | |
| Less | Operating Expenses (OE) | | —— | P & L A/c |
| | Operating Profit (OP) | | ——@ | |
| Add | Non operating income/Less non operating losses | | —— | |
| | Earning Before Interest and Tax (EBIT) | | ——@ | |
| Less | Interest | | —— | |
| | Earning Before Tax (EBT) | | ——@ | |
| Less | Tax | | —— | |
| | Profit After Tax (PAT)/Net Profit (NP) | | ——@ | |
| Less | Provision for dividend | P & L (appropr.) A/c | —— | |
| Less | Transfer to general reserve | | —— | |
| Less | Transfer to other reserves | | —— | |
| | Profit & Loss A/c | | ——@ | |

↓ Goes to

**Balance Sheet liability side (under the head Reserves and Surplus as Profit & Loss A/c or Retained Earnings (RE)**

***Note*:**

- @ Stands for balancing figure.
- OE includes general and administrative expenses plus selling and distribution expenses plus depreciation.
- Interest is tax-deductible item means interest is charged before the tax is levied. Whereas dividend is not tax-deductible item means dividend is paid after tax is paid. This is the reason why debt is cheaper source of finance as compared to equity.

**Balance Sheet as on ———**

| *Particulars* | | Amount (Rs.) |
|---|---|---|
| Fixed Assets (FA) | | — |
| Investment | | — |
| Current Asset (CA) | — | — |
| Less Current Liability (CL) | — | — |
| Net Working Capital (NWC) | | — |
| **Total** | | == |

*Contd...*

| ***Particulars*** | ***Amount (Rs.)*** |
|---|---|
| Financed by: | |
| Equity capital | — |
| Reserves and surplus (R and S) | — |
| Long-term debt: | |
| Debentures/bonds | — |
| Term loans | — |
| **Total** | == |

**Remark**

In case of sole proprietorship concern Net Profit (NP)/Net Loss goes to balance sheet and is adjusted with capital account as follows:

**Capital Account**

**Add Net Profit/Less Net Loss**

**Illustration**

From the following information prepare financial statements of ABC Ltd. for the year ending 31, March 2005.

**Trial Balance**
**(As on 31$^{st}$ March 2005)**

| ***Particulars*** | ***Dr. (Rs.)*** | ***Cr. (Rs.)*** |
|---|---|---|
| Stock | 6,80,000 | |
| Furniture and fixture | 5,00,000 | |
| Discount allowed | 40,000 | |
| Loan to directors | 80,000 | |
| Bad debts | 35,000 | |
| Advertisement | 20,000 | |
| Purchases | 23,19,000 | |
| Commission | 1,20,000 | |
| Plant and machinery | 8,60,000 | |
| Rent | 25,000 | |
| Current account with bank | 45,000 | |
| Cash in hand | 8,000 | |
| Interest on bank loan | 1,16,000 | |
| Preliminary expenses | 10,000 | |
| Wages | 9,00,000 | |
| Consumables | 84,000 | |
| Freehold land | 15,46,000 | |

| ***Particulars*** | ***Dr. (Rs.)*** | ***Cr. (Rs.)*** |
|---|---|---|
| Tools and equipment | 2,45,000 | |
| Goodwill | 2,65,000 | |
| Debtors | 2,87,000 | |
| Bills receivable | 1,53,000 | |
| Dealer aids | 21,000 | |
| Insurance premium (Marine) | 30,000 | |
| Trade expenses | 72,000 | |
| Distribution freight | 54,000 | |
| Debenture interest | 20,000 | |
| Equity Capital (Shares of Rs. 10 each) | | 25,00,000 |
| 11% Debentures | | 5,00,000 |
| Bank loan | | 6,45,000 |
| Bills payable | | 1,25,000 |
| Creditors | | 1,56,000 |
| Sales | | 42,68,000 |
| Rent received | | 46,000 |
| Transfer fees | | 10,000 |
| Profit & loss account | | 1,39,000 |
| Accumulated depreciation—machinery | | 1,46,000 |
| **Total** | **85,35,000** | **85,35,000** |

The Closing Stock valued as on 31, March 2005 is Rs. 8,23,000.

**Solution**

**ABC Limited**
**Profit & Loss Account for the Year ending March 31, 2005**

***Dr.*** ***Cr.***

| ***Particulars*** | ***Amount*** | ***Particulars*** | ***Amount*** |
|---|---|---|---|
| To Stock | 6,80,000 | By Sales | 42,68,000 |
| To Purchases | 23,19,000 | By Rent received | 46,000 |
| To Consumables | 84,000 | By Transfer fees | 10,000 |
| To Wages | 9,00,000 | By Closing stock | 8,23,000 |
| To Bad debt written off | 35,000 | | |
| To Discount allowed | 40,000 | | |
| To Rent paid | 25,000 | | |
| To Commission paid | 1,20,000 | | |
| To Interest on bank loan | 1,16,000 | | |
| To Advertisement | 20,000 | | |

*Contd...*

| ***Dr.*** Particulars | Amount | Particulars | Amount ***Cr.*** |
|---|---|---|---|
| To Dealer aids | 21,000 | | |
| To Insurance (Marine) | 30,000 | | |
| To Trade expenses | 72,000 | | |
| To Distribution freight | 54,000 | | |
| To Debenture interest | 20,000 | | |
| To Net profit | 6,11,000 | | |
| **Total** | **51,47,000** | **Total** | **51,47,000** |

**ABC Limited**
**Balance Sheet as at March 31, 2005**

| *Liabilities* | | *Amount* | *Assets* | *Amount* |
|---|---|---|---|---|
| **Equity Share Capital** | | 25,00,000 | **Fixed Assets** | |
| (2,50,000 shares of Rs. 10 each) | | | Goodwill | 2,65,000 |
| | | | Freehold land | 15,46,000 |
| | | | Furniture and fixture | 5,00,000 |
| **Reserves and Surplus** | | | Plant and machinery | 7,14,000 |
| Profit & Loss Account | 1,39,000 | 7,50,000 | Tools and equipment | 2,45,000 |
| Add: Current year's net profit | 6,11,000 | | **Investments** | |
| | | | **Current Assets, Loans and** | |
| **Secured Loan** | | | **Advances** | |
| 11% Debentures | | 5,00,000 | **Current Assets:** | |
| Bank loan | | 6,45,000 | Stock | 8,23,000 |
| | | | Debtors | 2,87,000 |
| **Unsecured Loans** | | | Current account | 45,000 |
| | | | Cash in hand | 8,000 |
| **Current Liabilities and** | | | **Loans and Advances:** | |
| **Provisions** | | | Loans to Director | 80,000 |
| Bills payable | | 1,25,000 | Bills payable | 1,53,000 |
| Sundry creditors | | 1,56,000 | | |
| | | | **Miscellaneous Expenses** | |
| | | | Preliminary expenses | 10,000 |
| **Total** | | **46,76,000** | **Total** | **46,76,000** |

## Exercises

Q. 1. What are Final Accounts? What purpose do they serve?

Q. 2. Distinguish between Profit & Loss Account and Balance Sheet, also give their format.

Q. 3. Differentiate between Trading Account and Profit & Loss Account. What is the purpose of preparing trading and profit & loss account?

Q. 4. Distinguish between Trial Balance and Balance Sheet.

Q. 5. Explain the format of trading account. Illustrate your answer with suitable example.

Q. 6. What adjustments are necessary at the time of preparing Final Accounts? Give two examples.

Q. 7. What do you understand by Manufacturing Account? What items are found in a Manufacturing Account?

Q. 8. Distinguish between:
(*i*) Current Assets and Fixed Assets.
(*ii*) Current Liabilities and Long-term Liabilities.

Q. 9. What do you understand by financial statements? Discuss the significance of financial statements to various parties interested in business concern.

Q. 10. Define Profit & Loss account or Income Statement. Explain the format of profit & loss account.

Q. 11. Briefly describe the following:
(*i*) Gross Profit
(*ii*) Net Profit
(*iii*) Operating Profit

Q. 12. What do you understand by
(*a*) Cost of Goods sold
(*b*) Direct expenses
(*c*) Indirect expenses

Q. 13. Briefly describe the steps involved in preparation of final accounts in case of (*a*) Manufacturing business (*b*) Trading business of sole proprietorship concern.

Q. 14. Write short note on
(*a*) Final Accounts for Partnership firm
(*b*) Final accounts for Companies

Q. 15. Briefly describe meaning, need and objective of Accounting standards in India and explain in what context they differ from International Accounting Standard (IAS).

Q. 16. Describe Generally Accepted Accounting Principles (GAAP) with the help of suitable examples.

Q. 17. From the following balances draw up a Trading and Profit & Loss Account and Balance Sheet.

| ***Particulars*** | ***Amount (Rs.)*** |
|---|---|
| Prakash's Capital | 20,000 |
| Bank Overdraft | 5,000 |
| Machinery | 13,400 |
| Cash in hand | 1,000 |
| Fixtures & Fittings | 5,500 |
| Opening Stock | 45,000 |
| Bills Payable | 7,000 |

*Contd...*

| ***Particulars*** | ***Amount (Rs.)*** |
|---|---|
| Creditors | 40,000 |
| Debtors | 63,000 |
| Bills Receivable | 5,000 |
| Purchases | 50,000 |
| Sales | 1,29,000 |
| Return from customers | 1,000 |
| Return to creditors | 1,100 |
| Salaries | 9,000 |
| Manufacturing wages | 4,000 |
| Commission and T.A. | 5,500 |
| Trade Expenses | 1,500 |
| Discount (Cr.) | 4,000 |
| Rent | 2,200 |

The closing stock amounted to Rs. 52,000.

Q. 18. From the understated Trial balance of M/s Rashu Brothers prepare (*a*) Manufacturing Account (*b*) Trading and Profit & Loss Account and (*c*) Balance Sheet.

**Trial Balance as on 31st December 2004**

| ***Debit balances*** | ***Amount (Rs.)*** | ***Credit balances*** | ***Amount (Rs.)*** |
|---|---|---|---|
| Wages | 20,000 | Sales | 1,74,000 |
| Stock (Raw Materials) 1.1.2004 | 5,710 | Profit and Loss Balance 1.1.2004 | 12,000 |
| Purchases | 88,274 | | |
| Carriage Inward | 3,686 | Capital | 1,30,000 |
| Repairs | 6,000 | | |
| Salaries (factory) | 2,100 | | |
| Salaries General | 1,000 | | |
| Rates and Taxes | 2,240 | | |
| Travelling Expenses | 3,550 | | |
| Insurance (Factory) | 700 | | |
| Insurance General | 80 | | |
| Bad debts | 410 | | |
| General Expenses | 2,942 | | |
| Carriage Outward | 9,424 | | |
| Various Assets | 1,13,884 | | |
| Stock (Finished goods) 1.1.2004 | 56,000 | | |
| **Total** | **3,16,000** | **Total** | **3,16,000** |

The Closing Stocks are as follows:

| | |
|---|---|
| Raw materials | Rs. 40,000 |
| Work-in-progress | 12,000 |
| Finished goods | 6,000 |