DIA-02
BLOCK-2

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ସମ୍ବଲପୁର, ଓଡ଼ିଶା

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ODISHA STATE OPEN UNIVERSITY, SAMBALPUR

Odisha State Open University
Sambalpur, Odisha

DIPLOMA IN ACCOUNTING (DIA)

FINANCIAL STATEMENT

ଓଡ଼ିଶା ରାଜ୍ୟ ମୁକ୍ତ ବିଶ୍ୱବିଦ୍ୟାଳୟ, ସମ୍ବଲପୁର, ଓଡ଼ିଶା
Odisha State Open University, Sambalpur, Odisha
Established by an Act of Government of Odisha.

Diploma in Accounting (DIA)

DIA-02
Financial Statement

Block

2

Unit-I : Depreciation, Provisions & Reserves

Unit-II : Preparation of Financial Statement Sole Traders and partnership firm

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Unit – I

Depreciation, Provisions & Reserves

Learning Objectives:

After studying this chapter, you should be able to understand :

- Meaning of Depreciation
- Causes of Depreciation
- Factors in computation of Depreciation
- Objectives for providing Depreciation
- Methods of Depreciation
- Straight Line Method
- Diminishing Balance Method
- Distinction between straight line & Diminishing Balance Method
- Provisions Meaning
- Reserves Meaning
- Capital Reserve & Revenue Reserve
- General Reserve & Specific Reserve
- Reserve Fund
- Secret Reserve
- Difference between Provisions & Reserves

1.1 Meaning of Depreciation:

Depreciation is the gradual decrease in the value of fixed assets due to wear and tear, effluxion of time, obsolescence or any other cause. It is a common knowledge that fixed assets are acquired primarily for use in the business so to generate revenue over its useful life. Since it will lose its value over its useful economic life, it is charged as an expense to the profit and loss account in order to determine the correct profit earned during an accounting period.

Depreciation is charged on all fixed assets excepting land whose useful life is considered to be unlimited. Normally, the value of land appreciates over the period of time.

Even though the terms depletion, amortisation and obsolescence convey the same purpose like that of depreciation, their use is context specific. The term depletion is used in case of wasting assets such as mines, quarries, oil well etc. The term amortistion is used in case of intangible assets such as goodwill, copyright, parents etc. Obsolescence is the decrease in the value of a fixed asset because of technological change or change in demand.

1.2 Causes of Depreciation:

When we acquire an asset, the service potential of the same decrease over a period of time because of use. Further, the fast changing technology may make the asset obsolete even though the asset has still service potential. Thus, we can say that the main causes of depreciation are physical deterioration and obsolescence.

The cause of depreciation can be explained as follows:

1. Wear and Tear: The use of the asset results in wear and tear and consequently the value of the asset decreases.

2. Obsolescence: The change in technology and change in demand makes the assets obsolete. For example, a new machine with modern technology may produce goods with much less cost in comparison to the old machine making the old machine obsolete.

3. Efflux of Time: Even if an asset is not put to use, the value decreases due to effects of weather wind or rain etc. Further, certain assets are used for a definite period of time (lease, patents) where the value of such asset decreases with the passage of time.

1.3 Factors in computation of Depreciation:

The computation of depreciation amount depends upon the following factors:

<u>1. Cost of Asset:</u> The cost of the asset includes the cost of acquisition and the expenses incurred till it is ready for use. For example, the cost of a machine will include the purchase price, freight incurred, insurance in transit, cost of installation etc. Similarly, the cost of land includes the purchase price, commission paid to broker, registration fees etc.

<u>2. Scrap Value:</u> The Scrap or residual value of an asset is the estimated value on its sale after the expiry of its useful life. For example, if a machine can be sold for ₹2,000 after its useful life, it is the scrap value.

<u>3. Useful life:</u> The useful life is the period during which the asset is expected to be used or the number of units expected to be produced by using the asset. The useful life may be expressed in number of years, working hours or units of output. The useful life of an asset is always less than that of its physical life.

1.4 Objectives for providing Depreciation:

The objectives of charging depreciation are as follows:

1. To ascertain the correct profit or loss: One of the basic objectives of accounting is to determine the profit earned or loss sustained during the accounting period. Unless charging depreciation to the profit and loss account, a correct profit or loss cannot be ascertained.

2. To ascertain the true and fair view of the financial position. A true and fair view of the financial position of the business can be ascertained only when fixed assets are shown at its proper value in the Balance sheet. Therefore, the written down value of the asset is shown in the Balance sheet which is the original cost of the asset less depreciation.

3. To provide funds for replacement: The depreciation charged to profit and loss account each year is accumulated and the funds generated are utilized for replacing the asset at the end of its useful life.

4. To comply with legal requirement: Under the companies Act, it is mandatory to charge depreciation before declaring dividend.

1.5. Methods of Recording Depreciation:

There are two method of recording depreciation in the books of accounts i.e. directly charging to asset account and creating provision for depreciation account.

Directly changing to Asset Account*:* Under this method, depreciation is directly charged to the concerned asset account by debiting depreciation account and crediting the concerned asset account. Asset is shown in the Balance Sheet at cost less depreciation (written down value). The following journal entries are passed:

Depreciation Account . . . Dr
To Asset Account
(Being depreciation charged)

Profit & loss Account …. Dr
To Depreciation Account
(Being transfer of depreciation to Profit & Loss account)

Creation of provision for Depreciation Account*:* Under this method, the amount of depreciation is not directly charged to asset account but credited to provision for depreciation account or accumulated depreciation account. In the Balance Sheet, the asset is shown at its cost and the provision for depreciation is shown as a deduction from the asset. The following entries are passed:

Depreciation Account . . . . Dr.
To provision for depreciation account
(Being depreciation charged)

Profit & Loss account . . . . Dr.
To depreciation account
(Being transfer of depreciation to
Profit & loss Account)

Sale of Asset: The Asset may be sold before the expiry of its useful life where the sale proceeds may be more or less than the written down value of the asset. If the asset is sold during the accounting period, the depreciation till the date of sale will be charged to the asset account. The difference between the sale proceeds of the asset and its written down value shall be profit or loss which is transferred to profit and loss account. The following entries are passed in the event of sale of asset.

1. Charging of depreciation till date of sale:
   Depreciation A/c…….Dr
   To Asset A/c
2. Sale proceeds of the Asset:
   Cash/Bank A/c …….Dr
   To Asset A/c
3. Profit on Sale
   Asset A/c …….Dr
   To profit & loss Account
4. Loss on Sale
   Profit & loss Account …….Dr
   To Asset A/c

1.6 Methods of Depreciation:

There are different methods of charging depreciation out of which straight line method and diminishing Balance method are the most commonly used methods.

1.6.1 Straight Line Method:

Under this method, a fixed amount of the original cost of the asset is written off every year. Thus, the depreciation charge is same in each year. The amount of depreciation is calculated by dividing the cost of the asset less its scrap value by the expected useful life.

Amount of depreciation = $\frac{\text{Cost of the asset – Scrap Value}}{\text{Expected Useful life}}$

For Example, if an asset costs ₹1,00,000 and its scrap value after it useful life is ₹10,000 and the machine has a useful life of 10 years the amount of depreciation shall be ₹ 9,000 per year.

$$\frac{(₹1,00,000 - ₹10,000)}{10}$$

Advantages of Straight Line Method: The important advantages of this method are as follows:

i. It is simple to calculate the amount of depreciation.
ii. It is easy to understand.
iii. The book value of the asset is reduced to zero or equal to its scrap value.

Disadvantages of Straight Line Method: The method has the following disadvantages:

i. While the charge of depreciation is uniform every year the amount of repairs and renewals of the asset charged to profit & loss account increases as the asset becomes older. Thus, the charge to profit and loss account increase over the years.
ii. The interest on capital invested in the asset is not taken into consideration under this method.
iii. The assumption to consider depreciation as a function of time rather than use (deprecation charge is same every year) is wrong.

This method is suitable for lease, patents, copyrights, trademark etc. where time is an important factor.

Illustration: 1 On 1st April 2013, X Ltd. Purchased a machine for ₹95,000 and spent ₹5,000 on its installation. It is expected that the useful life of the machine shall be four years and the scrap value at the end of its useful life is ₹20,000. On 30th September 2015, the machine is sold for ₹42,000. Depreciation is charged on straight line method.

Pass journal entries and prepare ledger accounts (Machinery Account and Depreciation Account) for three years. The accounts are closed on 31st march.

Solution.

Journal

Date	Particulars	LF	Dr. (₹)	Cr (₹)
01.04.2013	Machinery A/c …. Dr To Bank A/c (Being purchase of machinery)		95,000	 95,000
01.04.2013	Machinery A/c …. Dr To Bank A/c (Being installation charges incurred)		5,000	 5,000

31.03.2014	Depreciation A/c ………. Dr To machinery A/c (Being depreciation charged)		20,000	20,000
31.03.2014	Profit& Loss A/c ….. Dr To depreciation A/c (Being depreciation transferred to P&L A/c)		20,000	20,000
31.03.2015	Depreciation A/c ………… Dr To machinery A/c (Being depreciation charged)		20,000	20,000
31.03.2015	Profit & Loss A/c ….. Dr To Depreciation A/c (Being depreciation transferred to P&L A/c)		20,000	20,000
30.09.2015	Depreciation A/c …. Dr To machinery A/c (Being depreciation charged up to the date of sale)		10,000	10,000
30.09.2015	Bank A/c ……… Dr To Machinery A/c (Being sale of machinery)		42,000	42,000
30.09.2015	Profit & Loss A/c ….. Dr To machinery A/c (Being the transfer of loss on sale of machinery to P & L A/c)		8,000	8,000
31.03.2016	Profit & Loss A/c ……… Dr To Depreciation A/c (Being the transfer of depreciation to P & L A/c)		10,000	10,000

Machinery Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.2013	To Bank A/c To Bank A/c	95,000 95,000 1,00,000	31.3.2014	By Depreciation A/c By Balance c/d	20,000 80,000 1,00,000
1.4.2014	To Balance b/d	80,000 80,000	31.3.2015	By depreciation A/c By Balance c/d	20,000 60,000 80,000
1.4.2015	To Balance b/d	60,000 60,000	30.9.2015	By depreciation A/c By Bank A/c By profit & Loss A/c	10,000 42,000 8,000 60,000

Depreciation Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.3.2014	To machinery A/c	20,000	31.3.2014	By profit & Loss A/c	20,000
		20,000			20,000
31.3.2015	To machinery A/c	20,000	31.3.2015	By profit & Loss A/c	20,000
		20,000			20,000
30.9.2015	To machinery A/c	10,000	31.3.2016	By profit & Loss A/c	10,000
		10,000			10,000

1.6.2 Diminishing Balance Method:

Under this method, depreciation is charged at a given fixed percentage on the written down value (cost-depreciation) of the asset. However, the first year of acquisition of the asset it is on the original cost of the asset. Since the method is based on written down value of the asset, it is otherwise known as 'written down value method.' Even though the percentage rate is same throughout the useful life of the asset, the amount of depreciation goes on reducing year after year. For example, if the asset is purchased for ₹ 1,00,000 and the rate of depreciation is 10% the amount of depreciation in the first year shall be ₹10,000 and in the second year ₹9,000 (10% on 90,000) and third year ₹8,100 (10% on 81,000). Thus, in earlier years the depreciation charge is more.

Advantages: The method has the following important advantages:

i. The charge to profit & loss account on account of depreciation and repairs comes uniform as in earlier years the depreciation amount is more and repair expenses is less and in subsequent years while the amount of depreciation goes on decreasing. The amount of repair expenses goes on increasing.
ii. This method is accepted under Income-Tax Act.
iii. Computation of depreciation amount is easily done even if new assets are added.

Disadvantages: The following are the disadvantages of this method:

i. The value of the asset after depreciation can never be zero.
ii. The calculation of the rate of depreciation is difficult.
iii. The interest on capital invested in the asset is not taken into consideration.

1.7 Distinction between straight Line Method & Diminishing Balance Method :

Straight Line Method	Diminishing Balance Method
1.Depreciation is calculated on the original cost	1.Depreciation is calculated on the written down value.
2. The amount of depreciation is the same for all the years.	2. The amount of depreciation goes on reducing year after year.
3. After the expiry of the useful life of the asset, the book value becomes zero.	3. The book value of the asset never reduces to zero.
4. The total charge as regards depreciation and repairs is less in earlier years and increases in subsequent years.	4. The total charge as regards depreciation and repairs comes almost equal through the life of the asset.
5. It is suitable for assets where benefit is derived from the asset within a fixed time period and repair charges are less.	5. It is suitable for assets where repair charges are more year after year and the possibility of obsolescence is more.

Illustration 2. On 1st April, 2012, S. Ltd purchased machinery for ₹2,00,000. On 1st July 14 a part of the machinery purchased on 1st April, 2012 for ₹50,000 was sold for ₹32,000 and a new machinery at a cost of ₹80,000 was purchased and installed on the same date. Depreciation is provided @10% on diminishing balance method. The accounts are closed on 31st march. Show machinery account and depreciation account.

Solution:

Machinery Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.2012	To Bank A/c	2,00,000	31.3.2013	By Depreciation A/c	20,000
					1,80,000
		2,00,000		By Balance c/d	2,00,000
1.4.2013	To Balance b/d	1,80,000	31.3.2014	By depreciation A/c	18,000
					1,62,000
		1,80,000		By Balance c/d	1,80,000
1.4.2014	To Balance b/d	1,62,000	1.07.2014	By depreciation	1,013
1.7.2014	To Bank A/c	80,000		A/c	32,000
				By Bank A/c	7,487
			31.3.2015	By profit & Loss	18,150
				A/c	1,83,000
		2,42,000		By depreciation	2,42,000
				A/c	
				By Balance c/d	

Depreciation Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.3.2013	To Machinery A/c	20,000 20,000	31.3.2013	By profit & Loss A/c	20,000 20,000
31.3.2014	To Machinery b/d	18,000 18,000	31.3.2014	By profit & Loss A/c	18,000 18,000
1.07.2014 31.3.2015	To Machinery b/d To Machinery A/c	1,013 18,150 19,163	31.3.2015	By profit & Loss A/c	1,013 18,150 19,163

Working Notes: Profit/Loss on sales of Machinery:

Original Cost	₹ 50,000
Less: Dep. For 2012-13	₹5,000
W.D.V	₹45,000
Less: Depreciation for 2013-14	₹4,500
W.D.V	₹40,500
Less: Dep. For 2014-15 (upto 1/7/14)	₹1,013
W.D.V	₹39,487
Less sales proceeds	₹32,000
Loss on sale	₹7,487

Calculation of depreciation on machinery excluding sale of machinery

WDV of machinery on 1.4.14	1, 62,000
Less, WDV of machinery sold	40,500
	121500
Depreciation @ 10% on WDV	12,150
Depreciation on new machinery Purchased for 9 months (1.7.14 to 31.3.2015)	6,000
Total Depreciation	18,150

1.8. PROVISIONS & RESERVES

1.8.1 PROVISIONS:

As we know, one of the objectives of accounting is to determine the profit earned or loss sustained by the business during the accounting period. In the process of determination of profit or loss, it is necessary to provide for all possible losses whether the amount of such loss is correctly ascertained or not. When a change is made to profit and loss account of the anticipated losses which is sure to be incurred, it is called provision. Losses may be anticipated while collecting amount due from customer, use of fixed assets or provisions are made to cover possible liabilities. The common examples of provisions are provision for doubtful debts, provision for depreciation, provision for discount on debtors, provision for taxation etc. while some provisions are deducted from concerned assets in the Balance Sheet, some provisions are shown on the liabilities side of the Balance Sheet.

1.8.2 RESERVES:

A reserve is an amount of money set aside to meet future contingency. It may arise from appropriation of profit or profit made on sale of fixed assets or issue of shares at a premium or revaluation of assets. The name of the reserve indicates its purpose. Examples of reserves are general reserve, dividend equalization reserve, investment fluctuation reserve etc.

Types of Reserve: Reserves can be of two types such as **Capital reserve** and **Revenue reserve**.

1.8.2.1 Capital Reserve:

Reserves created out of capital profits are capital reserves. Normally, such reserves are not distributed as dividend to shareholders. Capital profit may arise from:

i. Profits on sale of fixed assets
ii. Issue of shares or debentures at premium
iii. Redemption of debentures at discount
iv. Profits on forfeiture of shares
v. Profits prior to incorporation
vi. Profit on revaluation of fixed assets

1.8.2.2 Revenue reserve:

Reserves created out of revenue profits are revenue reserves. These reserves are available for distribution as dividend. Example of revenue reserves are general reserve, dividend equalization reserve, investment fluctuation reserve, credit balance of profit and loss account etc. Revenue reserves may be classified into General reserve and Specific reserve.

1.8.2.3 General Reserve:

Reserve not created for specific purpose is general reserve. It is created for meeting general contingencies and strengthening the financial position of the business.

1.8.2.4 Specific Reserve:

Reserve created for specific purpose is called specific reserve. For example, dividend equalization reserve, investment fluctuation reserve, capital redemption reserve etc.

1.8.2.5 Reserve Fund:

When the reserve created is invested outside the business in securities for a definite period, it is called reserve fund. After the expiry of the specified period, the investments in securities are sold and the amount realized are utilized for the purpose for which reserve was created.

1.8.2.6 Secret Reserve:

Such reserves are created and maintained secretly by understating the financial position of a business. The creation of such reserves strengthens the financial position which is not disclosed by the Balance Sheet. This is mostly done by banks and financial institutions. The reserve is created by any of the following method:

- i. By changing excessive depreciation
- ii. By undervaluing assets (Stock, debtors, etc.)
- iii. By overvaluing liabilities
- iv. By writing off good will
- v. By creating more provision for contingent liabilities
- vi. By treating capital expenditure as revenue expenditure
- vii. By creating more provision for bad and doubtful debts and provision for discount on debtors.

When secret reserve is created, neither the profit and loss account nor the Balance Sheet depicts the true and fair view of the financial position. The companies Act, 2013 prohibits the creation of such reserve excepting in case of banking and insurance companies.

1.8.3 Difference between Provision & Reserves:

The following are the differences between provisions and reserves:

i. A provision is a charge against profits (debited to profit & loss account) where as a reserve is an appropriation of profits (profit & loss appropriation account).
ii. A provision is created even if there is no profit but reserve is created only when there are profits.
iii. A provision is created to meet a known liability or contingency but reserve is created for unknown contingencies to strengthen the financial position the concern.
iv. Provisions are created and utilized for some specific purpose but reserves are mostly created for general purpose.
v. Provisions (balance amount) cannot be distributed as dividend but reserves other than capital reserves can be distributed as dividend.
vi. Provisions are not invested outside the business but reserves may be invested outside the business (reserve fund).
vii. Provisions may be shown on the liabilities side or asset side but reserves appear on the liabilities side.
viii.

Check your progress

1. What is depreciation? What are it causes? What are the factors to compute the amount of depreciation?
2. Explain the methods of depreciation with their merits, demerits and suitability.
3. How would you determine the profit or loss on sale of fixed assets? Explain with example.
4. Which method of depreciation is suitable for i) Short lease ii) Long lease iii) Machinery iv) Furniture v) Copyright
5. Distinguish between i) straight line & diminishing balance method ii) Capital reserve & Revenue reserve iii) General reserve & Specific reserve, iv) provisions and reserves
6. A Ltd. purchased a machine for ₹2,00,000 and spent ₹10,000 on its installation. The company follows straight line method of charging depreciation @10% p.a. the machine is sold for ₹1,20,000. Compute the profit or loss on sale of the machine in the following cases. The books of accounts are closed on 31st March.

	Date of purchase	Date of Sale
i.	01.04.2013	31.03.2016
ii.	01.04.2013	31.08.2016
iii.	01.09.2013	31.03.2016
iv.	01.09.2013	30.09.2016

7. A company purchased a machine for ₹3,00,000 and paid import duty of ₹ 60,000. The machine was installed on 1st April 2012 by incurring ₹20000 installation charges. The estimated life of the machine was 10 year and Scrap value ₹30000. The company charges depreciation @ 10%. The books are closed on 31st march. Pass journal entries for three years (2012-2014) when provision for depreciation account is maintained and not maintained.
8. A company which closes its books on 31st march, purchased a machine for ₹ 1,50,000 on 1st April 2012. New machineries were added on 30th September, 2013 at a cost of ₹ 40,000 and on 1st April, 2015 at a cost of ₹25,000/. The machine purchased on 30th September 2013 was sold for ₹ 32,000 on 30th September 2015. Show the machinery account. Depreciation was charged @ 10% on written down value method.

KEY WORDS:

Depreciation: Gradual decrease in the value of fixed assets because of use, effluxion of time, obsolescence etc.

Depletion: Physical deterioration by extraction of natural resources (mines, quarries, oil wells, etc.)

Amortisation: Economic deterioration by the expiration of intangible assets (goodwill, patents, copyrights etc).

Obsolescence: Economic deterioration because of change in technology or demand.

Scrap value: Residual value after the expiry of useful life of the asset.

Written down value: Value of the asset after charging depreciation till date.

Straight line method: Method of charging depreciation where a fixed amount of the original cost of the asset is written off every year.

Diminishing Balance Method: Method of charging depreciation where depreciation is charged at a given fixed percentage on the written down value of the asset.

Provision: A charge against profit for all anticipate losses.

Reserve : Amount of money set aside to meet future contingency.

Capital Reserve : Reserve created out of capital profit.

Revenue Reserve: Reserve created out of revenue profit.

General Reserve: Reserve not created for specific purpose.

Specific reserve: Reserve created for specific purpose.

Reserve Fund: Investment of the created reserve outside the business in securities for a definite period.

Secret Reserve: Reserve created secretly understating the financial position of a business.

SUMMARY:

Depreciation is the gradual decrease in the value of fixed assets because of use passage of time or obsolescence. Since fixed assets are acquired to generate revenue, the loss in the value of such assets are charged to profit and loss account as an expense to determine the correct profit earned during an accounting period. The amount of depreciation depends upon factors such as cost of the asset, its scrap value and useful life. There are two methods, of recording depreciation in the books of accounts i.e. by directly charging to asset account and by creating provision for depreciation account. There are different methods of charging depreciation out of which straight line method and diminishing balance method are the most commonly used methods. While a fixed amount of depreciation is charged every year under straight line method, the amount of depreciation under diminishing balance method is a fixed percentage on the written down value of the asset.

Provision is a charge against profit for all anticipated losses. On the other hand, reserve is an appropriation of profit to meet future contingency. Reserves may be classified into capital reserve or revenue reserve, general reserve or specific reserve. When the amount of reserve is invested outside the business in securities it is called reserve fund. Secret reserve is secretly created. Mostly by banks and insurance companies by understating their financial position.

Situation / Answer:

Check your progress:

Q.6

i. Loss on sale ₹27,000.00
ii. Loss on sale ₹18,250.00
iii. Loss on sale ₹35,750.00
iv. Loss on sale ₹25,250.00

Q.8 Loss on sale transferred to profit & loss Account ₹ 490

UNIT – II

PREPARATION OF FINANCIAL STATEMENTS

Learning Objectives:

After studying this chapter, you should be able to understand:

- Meaning of Financial statements
- Classification of capital & Revenue
- Meaning, purpose, contents and preparation of Trading Account
- Meaning, purpose, contents and preparation of profit and loss Account
- Meaning, contents and preparation of Balance Sheet
- Difference between Trial Balance & Balance Sheet
- Meaning & purpose of adjustments
- Adjustment of different items

2.1 Meaning of Financial statements:

Financial statements are summaries of accounting information which conveys the financial position and the results of operations of an enterprise. Primarily financial statements comprise two statements i.e. position statement (Balance Sheet) and income statement (Profit And Loss Account). While the position statement gives information about assets, liabilities and capital, the income statement depicts the results of operations (profit or loss) during an accounting period. These statements are not only used by the management but by other stakeholders such as investor, creditors, lenders, customers, employees, government etc. to appraise the strengths and weaknesses of the enterprise.

Even though financial statements also include statement of retained earnings, cash flow statement, funds flow statement etc. We shall limit our discussion on preparation of only two financial statements, i.e. profit and loss account and balance sheet.

In Unit-II, you have already learnt how a Trial Balance is prepared. After preparing the Trial Balance, the next step in the accounting process is to prepare the financial statements. Before we go ahead with the procedure of preparing the Profit and Loss account and Balance Sheet. We must have an understanding of capital expenditure, revenue expenditure, capital receipts and revenue receipts etc. Because while preparing profit and loss account only revenue expenditure and revenue receipts are taken for matching so as to ascertain profit or loss. On the other hand, capital expenditures and capital receipts are capitalized.

2.2.1 Capital Expenditure:

Capital expenditure is that expenditure the benefit of which is available to the business over a number of years.

The following expenditure is capital in nature:

i. Expenditure incurred in acquiring permanent assets (Long-term Assets).
ii. Expenditure incurred in connection with purchase or putting an asset into working condition. Example wages paid for creation of a machine or installation of a machine, transporting charges of a machine, registration or stamp duty paid on purchase of a building overhauling of second hand machine etc.
iii. Expenditure on improvement of fixed asset or enhancement of the profit earning capacity of business. (for example, cost of shifting of a factory to have access to raw-material source)
iv. Expenditure before commencement of business (preliminary expenses)

2.2.2 Revenue Expenditure:

Expenditure incurred in the normal course of business or to maintain the fixed assets in good working condition is revenue expenditure. The benefit of such expenditure is consumed during the accounting period in which it is incurred. The following expenditures are revenue in nature:

i. Expenditure incurred for day-to-day running of the business (wages, salaries, rent, selling expenses, etc.)
ii. Expenditure on raw-material, finished goods or consumable stores to the extent these are use or sold during the accounting period.
iii. Expenditure incurred on maintenance of fixed assets (repairs, renewals etc.)
iv. Depreciation of fixed assets.

2.2.3 Distinction between Capital Expenditure & Revenue Expenditure:

Capital expenditure can be distinguished from revenue expenditure on the following points:

1. Capital expenditure is incurred on acquisition of fixed assets or improvement of fixed assets but revenue expenditure is incurred for day-to-day running of business of maintenance of fixed assets.

2. The benefit of capital expenditure is available over a period of time (more than one year) but the benefit of revenue expenditure is consumed during the year in which it is incurred.
3. Capital expenditure is non-recurring in nature but revenue expenditure is recurring in nature.
4. Capital expenditure enhances the profit earning capacity of the business but revenue expenditure aims at maintaining the existing earning capacity.
5. Capital expenditure may be incurred before of commencement of business but revenue expenditure is incurred only after the commencement of business.
6. Capital expenditure is not matched with capital receipts but revenue expenditure is matched with revenue receipts.
7. Capital expenditure is capitalized (taken to Balance sheet) but revenue expenditure is transferred to profit and loss account.

2.2.4 Deferred Revenue Expenditure:

Revenue expenditure is the benefit of which is available to the business for more than one year (say three to five years) is called deferred revenue expenditure. Therefore, it is not entirely charged during the year in which it is incurred and carried forward to be written off in future accounting periods. The portion which is carried forward is shown on the assets side of the Balance Sheet. For example, heavy advertisement to launch a new product development costs in mines and plantations, discounts on debentures, cost of experiments etc.

2.2.5 Capital Receipts and Revenue Receipts:

Capital receipts comprise of receipt of additional capital introduced by the proprietor, loan raised or sale of fixed assets. On the other hand, receipts arising from sale of goods and services or interest or commission received in the normal course of business are termed as revenue receipts. While capital receipts are taken to Balance Sheet, Revenue receipts are shown in credit side of profit and loss account.

Preparation of profit and loss account: Profit and Loss account has two parts. The first part is termed as trading account.

2.3 Trading Account:

The purpose of preparing trading account is to determine the gross profit or gross loss during an accounting period. Gross profit is the difference between sales (Net) and cost of goods sold. Net sales are calculated by deducting sales return (return inwards) from total sales. Cost of goods sold is calculated by the following equation.

Cost of goods sold = Opening stock of goods + Purchases (Net) + Direct Expenses – Closing stock of goods.

2.3.1 Format of Trading Accounting: Trading account can prepared in horizontal or vertical format.

The format of trading account with entries under both the formats are as follows:

Trading account for the year ended……….

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	....	By Sales	....
To purchases		....	....
Less, returns outwards	………..	Less, Return inwards ……..	
To direct Expenses :		By closing Stock	
Freight Inward/ carriage inward			
Custom duty			
Dock charges			
Motive power, Coal, Gas			
Fuel, Heating & Lighting			
Factory Rent & Insurance			
Royalties on production	………		
Wages / Wages & Salary			
To Gross Profit Transferred			
To P& L A/c	………		………

Trading account for the year ended

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)
Sales		……….
Less, returns inwards		……….
Opening stock		……….
Purchases		
Less, return outwards		
Direct expense		
Freight inward / carriage inward		
Custom duty		
Dock charges		
Motive power, Coal, Gas		
Fuel, Heating & Lighting	………	
Factory Rent & Insurance		
Royalties on production		
Wages / Wages & Salary	……….	
Less, closing stock	……….	………
Cost of goods sold		……….
Gross Profit		

2.3.2 Items in Trading Account: The Different items on the debit side of the trading account are as follows:

1. **Opening stock:** The closing stock of the previous accounting period is the opening stock of the current year. In case of trading business the opening stock consists of finished goods only. But in case of manufacturing business it will consist of raw-material, work- in-progress and finished goods.
2. **Purchases:** Purchases include both cash and credit purchases. Goods withdrawn by the proprietor for personal use, goods distributed by way of free samples or as charity shall be deducted from purchases. If goods purchased are in transit, the same shall be shown under goods-in-transit rather than debit to purchases account. Purchases should not include goods received on consignment or on approval or hire purchase.

If 'Adjusted Purchase' appears as an item in the Trial Balance, it implies that opening stock and closing stock have been adjusted in purchases account by debiting or crediting purchases account respectively. In this case opening stock or closing stock shall not appear as items inside the trading account.

3. **Purchase Returns:** Goods returned to the suppliers are deducted from purchases.

4. **Direct Expenses:** Direct expenses incurred are debited in Trading account and shown separately. The following expenses are treated as direct expenses :
   i. Carriage inward/Freight Inward: The expenses incurred on bringing the goods to the godown are termed as carriage inward or freight inward.
   ii. Custom duty, Book charge etc: The duty paid on import of goods or dock charges are debited in Trading Account.
   iii. Fuel, Power: Coal, gas, or electricity used in running of machines for the purpose of production are included under this category.
   iv. Factory Lighting: Lighting expenses, of the factory are debited to trading account.
   v. Factory rent & rates: The rent of the factory premises and the rates (municipal taxes) paid are direct expenses.
   vi. Wages: Wages are remuneration paid to workers engaged in production activities. It is treated as direct expense and debited to trading account. If wages are paid in connection with erection of an asset, the same shall be added to the cost of the concerned asset. The item wages & salary is also treated as direct expense.

The items on the credit side of the trading account are as follows: -

1. Sales: Sales include both cash and credit sales and appears in the credit side of trading account. Goods sold on approval basis or on consignment or on hire purchase shall be deducted from sales it included.
2. Sales Return: Goods returned by the customers are termed as sales return or return inward. This is deducted from sales to calculate net sales.
3. Closing stock: Goods remaining unsold as the end of the accounting period is termed as closing stock. In case of trading business, closing stock consists of finished goods. But in case of manufacturing business, the same will consist of raw-materials, work-in-progress and finished goods.

closing stock normally appears outside the Trial Balance, but when it appears inside the Trial Balance, it is implied that the purchases account has been adjusted. In such a case, closing stock will not appear inside the trading account.

It must be remembered that closing stock is valued at cost price or market price whichever is less in accordance with the principle of conversations.

2.3.3 Closing Entries:

When we prepare trading account, the balances of accounts which shall appear as items in trading account are transferred by way of passing entries, known as closing entries. For item appearing on the debit side of trading account, the closing entry shall be...

Trading account …. Dr.

To Opening Stock Account

To Purchases Account

To Direct Expenses Account (individual items)

For items appearing on the credit side of trading account, the closing entry shall be

Sales account ………. Dr

Closing Stock account … Dr

To Trading Account

For gross profit

Trading account ……….. Dr

To Profit & loss account

For gross loss

Profit and Loss Account ………. Dr

To Trading account

2.4 PROFIT AND LOSS ACCOUNT:

Profit and Loss Account is prepared to ascertain the net profit or net loss during an accounting period. It is prepared only after preparing the Trading Account which reveals the gross profits or gross loss. While the gross profit in trading account is transferred to the credit side of profit and loss account, the gross loss is transferred to the debit side. Profit and loss account is debited with all indirect expenses and losses occurring during the accounting period. The expenses may relate to management expenses, maintenance expenses, selling and distribution expenses or financial expenses. On the other hand, incomes received such as discount or commission received, interest or dividend received etc. and profit on sale of assets are credited to the profit and loss account. It must be remembered that expenses and incomes pertaining to the concerned accounting period are taken into consideration. The difference between the credit and debit side represents net profit or net loss which is transferred to capital account. It must be kept in mind that cash or goods drawn by the proprietor or insurance premium on the life policy of the proprietor or income-tax payment made by the proprietor and treated as drawings. Like that of the trading account, profit and loss account can be prepared in horizontal or vertical format. Both of the formats with the list of indirect expenses, losses, incomes and gains are as follows:

Profit and Loss Account of ……….. for the year ending ……………..

Particulars	Dr. Amount ₹	Particulars	Cr. Amount ₹
To Gross Loss transferred from trading account	……………	By Gross Profit transferred from trading account	……………
Management expenses		By discount received	……………..
To salaries	……………..	By commission received	……………..
To Rent, Rates & Taxes	……………..	By Interest (Bank)	……………..
To Printing and stationery	……………..	By Rent received	……………..
To Postage	……………..	By Dividend received	……………..
To Telephone Expense	……………..	By Income from investment	……………..
To Insurance	……………..	By profit on sales of fixed assets	
To Legal Charges			
To Audit fees			
To office lighting			
To other expenses			
Maintenance expenses			
To repairs and renewals			
To depreciation			
Selling & Distribution expenses			
To salaries (Sales Staff)			
To advertisement			
To carriage outward			
To commission to salesmen			
To Godown rent			
To Bad debts			
To provision for Bad Debts			
To Financial Expenses			
To Bank charges			
To interest on loan			
To Discount allowed			
Losses:			
To loss on sales of assets		By Net Loss transferred to capital account	……………..
To Loss by fire	____________		____________
To net profit transferred to capital account	……………..		…………….

Profit and loss account of …………. For the year ending ………………

Particulars	Amount ₹	Amount ₹
Gross profit		…………….
Add, incomes & Gains (item-wise)	…………….	…………….
	…………….	
Less, management Expenses (item-wise)	…………….	
Less, maintenance Expenses (item-wise)	…………….	
Less, Selling & Distribution Expenses (item-wise)		
Less, Financial Expenses, (item-wise)	…………….	
Less, Losses (item-wise)	…………….	
		.
Net Profit / Loss Transferred to capital Account		……………….

2.4.1 Items in profit & loss Account:

The items appearing on the debit and credit side of the profit and loss account under different heading are as follows:

Management Expenses *:* The expenses on day to day administration of the business such as salaries, rent, rates and taxes, printing and stationary, telephone charges, postages, insurance, legal charges, audit fees, office lighting etc. are treated as management expenses.

Maintenance Expenses*:* The expenses incurred on maintenance of fixed assets such as repairs and renewals, depreciation etc. are included under this category.

Selling and Distribution Expenses : The expenses incurred on selling and distributing goods, such as salaries of sales staff, advertisement, carriage outward, commission to salesmen, godown rent, bad debts, provision for bad debts etc. are included under this category.

Financial Expenses*:* Bank charges, interest on loan, discount allowed etc. are the financial expenses.

Losses*:* Losses arising in connection with sale of fixed assets, loss by fire etc are debited in profit and loss account.

Other incomes and Gains: During the accounting period the business may earn certain other incomes or there may be abnormal gains such as discount received, commission received, rent received, dividend received, interest on bank deposits, income from investment, profit on sale of fixed assets etc. which are credited in profit and loss account.

2.4.2Closing Entries:

All the accounts representing revenue expenses (indirect), losses, income and gains which are not transferred to trading account are closed by transferring to profit and loss account. The journal entry for the purpose shall be:

Profit and loss account ………Dr
To expenses /Losses Account (Individual items)

Incomes/ Gains Account (individual items)
To profit and loss Account

The profit and loss account shall show net profit or net loss which is transferred to capital account by passing the following journal entry.

Profit and Loss Account …………. Dr.
To capital account
(In case of net profit)
Or
Capital Account …………..Dr
To Profit and Loss Account
(In case of ne loss)

2.5 BALANCE SHEET:

Balance Sheet or position statement is the next most important financial statement after profit and loss account. It is a statement wherein the assets and liabilities of the enterprise on a given date are shown. Balance sheet is a summary of balances of ledger accounts (Personal and Real Account) which are not transferred to trading and profit and loss account. The basic purpose of preparing Balance Sheet is to ascertain the financial position of the enterprise (what is owns and what is owes).

2.5.1 Preparation of Balance Sheet:

Balance Sheet can be prepared either in horizontal format or vertical format. When it is prepared in horizontal format (traditional format), the different assets are reflected in the right hand side (asset side) and liabilities and capital are shown in the left hand side (liabilities side). But he American practice of reflecting assets and liabilities is just the opposite of our system.

2.5.2 Arrangement of Assets and Liabilities: The assets and liabilities are shown in the Balance sheet in a particular order called 'marshalling'. It may be either in order of liquidity or permanence.

Order liquidity: The assets are shown in the order of their liquidity (the order in which they can be converted into cash). Cash in hand and cash at bank which are the most liquid assets are shown first and the least liquid assets (building, land, goodwill) are shown last. The liabilities are shown in the order of their payment (the short-term liabilities such as bank overdraft, bills payable, trade creditors etc. are shown first and the long-term liabilities and capital are shown at the bottom). The Balance sheet in order of liquidity shall appear as follows:

Balance Sheet as at ……….

Liabilities	Amount ₹	Assets	Amount ₹
Bank Overdraft Bills Payable Sundry creditors Outstanding expenses Loans Capital Add, Net Profit/ Less, Net less Less, Drawings		Cash in Hand Cash at Bank Bills receivable Sundry Debtors Investments Prepaid Expenses Stock Furniture & Fixtures Plant & Machinery Building Land Goodwill	

Order of Permanence : According to this order, assets are shown in order of their permanence (the most permanent asset or least liquid assets such as goodwill, land, building, are shown first and the most liquid assets such as cash at bank and cash in hand are shown last. Liabilities are also shown in order of their permanence (capital is shown first and the short-term liabilities such as bills payable and bank overdraft are shown last). The form of Balance Sheet as contained under schedule. VI of Indian companies Act is based on arrangement of assets and liabilities in order of permanence. The format of Balance Sheet is order of permanence shall be as follows.

Balance Sheet as at ……….

Liabilities	Amount ₹	Assets	Amount ₹
Capital Add, Net Profit/ Less, Net Loss		Goodwill Land Building	

Less Drawings		Plant and Machinery	
Loan		Furniture & Fixtures	
Outstanding expenses		Stock	
Sundry Creditors		Prepaid expenses	
Bills payable		Investments	
Bank overdraft		Sundry Debtors	
		Bills Receivable	
		Cash at Bank	
		Cash in hand	

Vertical Form of Balance Sheet: The vertical form of Balance Sheet shows additional information such as working capital (difference between current assets and current liabilities) and net assets employed apart from information about fixed assets, current assets, capital and loan funds. The Balance sheet under vertical form shall appear as follows:

Balance Sheet as at ……….

Liabilities	Amount ₹	Amount ₹	Amount ₹
Fixed Assets:		………...	
Goodwill		………...	
Land		………...	
Building		………...	
Plant & Machinery		………...	
Furniture & Fixtures		.	
Current Assets:	………...		
Stock	………...		
Prepaid expenses	………...		
Investments	………...		
Sundry Debtors	………...		
Bills Receivable	.		
Cash at Bank	………...		
Cash in hand	………...	………...	
Current Liabilities:	………...	………...	………...
Outstanding expenses	………...	………...	………...
Sundry Creditors	………...	………...	………...
Bills Payable	.	………...	………...
Bank overdraft		.	………...
			.
Working Capital			
Net Assets Employed			
Financed by:		………...	
Capital			………...
Add, Net Profit/Less, Net Loss			
Loan Capital			

2.5.3 Classification of Assets and Liabilities:

The assets and liabilities as reflected in Balance Sheet can be classified into different groups. Accordingly, the assets are classified into three distinct groups such as fixed assets, current assets and fictitious assets.

Fixed Assets: Assets which are acquired for use in the production of goods or services and not meant for resale are called fixed assets. Fixed assets may be classified as tangible fixed assets or intangible fixed assets. Tangible fixed assets are assets which can be seen and felt such as land & building, plant & machinery, furniture and fixtures, motor vehicles etc. The examples of intangible fixed assets are goodwill, trade mark, patents etc. fixed asset are shown at cost less depreciation.

Current Assets : Assets which are either in cash form (cash in hand or at Bank) or meant to be converted into cash or consumed in the normal course of business (stock of raw-material , work-in-progress or finished goods, Bills receivable, debtors, current investments etc. These assets are valued at cost or market price whichever is lesser.

Fictitious Assets: These assets are not represented by anything concrete (preliminary expenses, accumulated losses, advertising expenses not written off (deferred revenue expenditure) etc.

Liabilities & their classification: Liabilities are obligations of an enterprise to outsiders. It may be classified as long term or fixed liabilities current liabilities and contingent liabilities.

Long Term Liabilities: Liabilities which are repaid after a long period of time are fixed or long term liabilities. For example, debentures long term loans etc.

Current Liabilities: Liabilities which are due for payment within one year are called current liabilities. For example: bills payable, sundry creditors, bank overdraft, outstanding expenses etc.

Contingent Liabilities: Contingent liabilities are liabilities the occurrence of which depends upon happening of a future contingency. For example, penalties or fines expected to be paid claims against the enterprise etc. Since this is not an actual liability. It is not shown inside the Balance Sheet as an item. Rather, it appears as a footnote below the Balance Sheet.

Capital: Amount contributed by the owner in to the business is called capital. The contribution of the owner may be in cash or in kind. Capital is the excess of assets over liabilities. It is the obligation of the enterprise towards the owner. Capital is increased by further investment made by the owner and net profit earned and is reduced by the amount of loss sustained or drawing made.

2.5.4 Difference between Trial Balance and Balance Sheet:

A Trial Balance can be differentiation from a Balance Sheet as follows:

Basis	Trial Balance	Balance Sheet
1. Purpose of preparation	It is prepared to check the arithmetical accuracy of the accounting.	It is prepared to know the financial position of an enterprise.
2.Coverage	All ledger accounts are shown.	Only personal and real accounts (which are not closed by transferring to P&L A/c) are shown.
3.Headings	Trial Balance has two columns i.e. Debit and Credit.	Balance Sheet (Horizontal format) has two sides i.e. assets and liabilities.
4.Closing Stock	Normally, closing stock does not appear in Trial Balance	Closing stock appears as an item on the assets side of the Balance Sheet.
5.Periodically of preparation	It is prepared at the end of every month or quarter etc.	It is prepared at the end of every accounting period.
6.Information about Net Profit / Loss	Information about net profit / loss cannot be obtained from Trial Balance	Balance Sheet contains information about net profit / net loss
7.Adjustments	Trial Balance is prepared without adjustments for outstanding or prepaid items etc.	Balance sheet cannot be prepared without adjustments.
8.Compulsion of preparation	Preparation of Trial Balance can be dispensed with.	Preparation of Balance Sheet is compulsory and cannot be dispensed with.

Illustration: 1 From the following Trail Balance of Mr. Ashok Patnaik prepare profit and loss account and the balance sheet as at 31st March, 2016.

Particular	Debit ₹	Credit ₹
Plant and machinery	65,000	
Fixtures & Fittings	3,720	
Capital account / Drawings Account	6,820	1,05,230
Factory Fund and Power	542	
Salaries	8,745	
Bills payable		10,422
Factory Lighting	392	
Manufacturing expenses	1,680	
Travelling Expenses	925	
Carriage on sales	960	

Cash at bank	12,245	
Cash in hand	3,068	
Purchases / Sales	83,290	1,26,177
Sundry Debtors / Sundry Creditors	47,800	35,680
Wages	9,915	
Rent and taxes	1,765	
Office Expenses	2,778	
Carriage inward	897	
Discount	422	
Stock (opening)	21,725	
Returns	5,422	1,172
Insurance	570	
	2,78,681	2,78,681

Stock as on 31st March, 2016 ₹ 16,580

Solution: Trading and profit & Loss Account of Mr. Ashok Patnaik for the year ended 31st March, 2016.

Particulars	Dr. ₹	Particulars	Cr. ₹
To Opening Stock	21,725	By Sales 1,26,177	
To purchases 83,290		Less, Returns 5,422	1,20,755
Less, Returns 1,172	82,118	By closing Stock	16,580
To Carriage inward	897		
To Wages	9,915		
To Manufacturing expenses	1,680		
To Factory lighting	392		
To factory fuel and power	542		
To Gross profit transferred to	20,066		
P&L Account	1,37,355		1,37,355
To Salaries	8,745	By Gross profit	20,066
To Travelling Expenses	925		
To carriage on sales	960		
To Rent and taxes	1,765		
To Office Expenses	2,778		
To Discount	422		
To Insurance	570		
To net profit			
Transferred to capital	3,901		
account	20,066		20,066

Balance Sheet of Mr. Ashok Patnaik as on 31st March, 2016

Liabilities		₹	Assets	₹
Capital	1,05,230		Plant and Machinery	65,000
Add, Net Profit	3,901		Fixtures and fittings	3,720
	1,09,131		Sundry Debtors	47,800
Less, Drawings	6,820	1,02,311	Closing Stock	16,580
Bills, Payable		10,422	Cash at Bank	12,245
Sundry creditors		35,680	Cash in Hand	3,068
		1,48,413		1,48,413

2.6 Adjustments:

While preparing the profit and loss account we have seen that revenue is matched with expenditure incurred to earn that revenue. The revenue or income pertains to the concerned accounting year whether received in cash or not but excludes incomes received in advance. Similarly, the expenditure of the concerned accounting year is taken into consideration whether it is paid or outstanding. The expenditure paid in advance is excluded while computing the expenditure of the concerned accounting period. Thus, a number of items of expenses and incomes are to be adjusted at the time of preparation of financial statements. This is nothing but adjustment. Unless these adjustments are made, the financial statements shall not depict the true picture of results of operations or financial position of an enterprise.

The items which are adjusted at the time of preparation of financial statements are explained as follows:

1. ***Closing stock:*** The stock of unsold goods at the end of the accounting period normally appears as an additional information. This is taken to the credit side of trading account and also shown as an item in the Balance Sheet in the asset side under current assets. The adjusting entry to be passed shall be :

Closing stock Account ……… Dr

To Trading Account

When closing stock appears as an item inside the Trial Balance, this means that it has already been adjusted (adjusted purchase appears as an item in the Trial Balance). Closing stock in such a case is shown in the Balance Sheet only.

2. ***Outstanding Expenses:*** Expenses which has been incurred during the current accounting period but not paid are called outstanding expenses. The amount of outstanding expenses is added to the concerned expenses in the debit side of trading or

profit and loss account and shown in the liabilities side of the Balance Sheet as current liability. The adjusting entry passed in the books shall be :

Expenses account ………. Dr

To outstanding Expenses Account

But when outstanding expenses appear as an item inside the Trial Balance, there is no need to pass the adjusting entry as the same has already been adjusted. In such a case it will appear in the Balance Sheet only.

3. ***Prepaid Expenses:*** Expenses which have been paid during the current accounting period but the benefit of which shall accrue in subsequent accounting period are called prepaid expenses. While preparing trading or profit and loss account such prepaid expenses are deducted from concerned expenses. Further, it appears as an item in the asset side of the Balance sheet under current assets.

   The adjusting entry shall be:

   Prepaid expenses account ………. Dr

   To expenses Account

When prepaid expenses appear as an item inside the Trial Balance, no adjustment entry is passed because; such amount has already been adjusted in the concerned expenses. In such a case, it is not taken to income statement but shown in the Balance Sheet as an item.

4. ***Accrued income:*** Income which has been earned during the current accounting period but not received in cash is called accrued income or outstanding income. Accrued income is added to the concerned income in the credit side of profit and loss account and also shown in the asset side of the balance sheet as current asset. The following adjusting entry is passed:

   Accrued income Account……… Dr

   To income Account

Accrued income, it appears as an item inside the Trial Balance, it is implied that the same has already been adjusted. Instead of taking it to profit and loss account it is taken to Balance Sheet only.

5. ***Income received in advance:*** Income which has not been earned but received during the current accounting period is termed as income received in advance. It is deducted from the concerned income in profit and loss account and at the same time shown as an

item in the liabilities side of the Balance Sheet as a current liability. The adjusting entry passed in such case shall be :

Income Account ………. Dr
To Income Received in advance Account

If income received in advance appears as an item inside the Trial Balance, then it is only taken to Balance sheet and shown as current liability because the same has already been adjusted.

6. ***Depreciation:*** Depreciation is the loss in the value of fixed assets because of use, passage of time or obsolescence. A fair portion of the cost of fixed asset is charged to profit and loss account so as to ascertain the true profit earned during an accounting period and also to find out the correct value of the asset as reflected in the Balance Sheet. While calculating the amount of depreciation, the period for which the fixed asset has been used during the accounting period need to be considered. The depreciation is calculated on different fixed assets and shown on the debit side of profit and loss account separately and at the same time shown on the asset side of the Balance sheet by way of deduction from the value of concerned fixed asset. The adjusting entry for depreciation shall be:

Depreciation account ……………. Dr
To asset account / Provision for depreciation account

When depreciation appears in the Trial Balance as an item, the above adjusting entry is not passed. In such cases, depreciation is debited to profit and loss account only and not shown in balance sheet because the value of the fixed asset has already been reduced to the extent of such depreciation amount.

7. ***Interest on capital:*** Capital is invested by the proprietor or partners in the business. Sometimes a provision may be made towards interest on the capital contribution of the proprietor or partners. Interest is calculated as a percentage of the capital introduced in the business and shown on the debit side of profit and loss account as well as liabilities side of Balance Sheet by way of addition to capital.

The following adjusting entry is passed:

Interest on capital account ………. Dr
To Capital Account

8. ***Interest on Drawings:*** When provision is made to allow interest on capital, it is prudent to charge interest on drawings made by the owner either in the form of cash or goods. In the absence of information regarding dates of drawings, it is assumed that the

drawings were made evenly throughout the year. Accordingly, interest is calculated at a specified rate for six months on the full amount of drawings made by the proprietor. However, if drawings were made at the beginning of each month, interest is calculated for six and half months. On the other hand, interest is calculated for five and half months if drawings were made at the end of every month.

Interest on drawings is shown on the credit side of profit and loss account and at the same time deducted from capital in the Balance Sheet. The adjusting entry shall be:

Capital Account …………..Dr
To interest on Drawings account

9. ***Interest on Loan***: Interest paid on amount borrowed by the business appears on the debit side of profit and loss account. But the amount of interest on loans not paid need to be adjusted and shown in the profit and loss account by way of addition to the interest paid. At the same time it is shown in Balance Sheet by way of addition to loan on the liabilities side. While calculating the interest, the date on which loan is taken during an accounting period is considered. The following adjusting entry is passed

Interest Account ………… Dr
To outstanding Interest Account

10. ***Bad Debts:*** The debt which could not be recovered from credit customers is called bad debt. It is a loss of the business and shown on the debit side of profit and loss account. In the balance sheet it is shown as a deduction from sundry debtors. In this connection. Adjusting entry is passed as follows:

Bad Debts Account ……… Dr
To Debtors Account

If bad debt appears as an item in the Trial Balance, adjustment is not required and the same is debited to profit & loss account only.

11. ***Provision for Bad Debts:*** When we ascertain the profit or loss during an accounting period, the anticipated losses in connection with collection of amount from credit customers need to be provided for. Thus, a provision is created to cover the anticipated losses on account of bad debt. It is calculated as a percentage of sundry debtors (after deduction of bed debts). The adjusting entry passed in such a case shall be :

Profit & Loss account …….. Dr
To provision for bad debts account

Profit & loss account is debited with the amount of provision created and in the Balance Sheet it is shown as a deduction from sundry debtors. When provision for bad debts appears in the Trial Balance, the new provision created is compared with the existing provision and accordingly profit and loss account is debited or credited. The following example will make the point clear:

Suppose, the Trial Balance shows sundry debtors at ₹10,000, bad debts at ₹700 and provision for bad debts at ₹900. If it is required to create a provision for bad debts at 10% on sundry debtors, the treatment shall be as follows:

** The Actual amount of bad debt will be transferred to provision for bad debts account instead of profit and loss account**

Dr. Profit & Loss Account Cr.

To provision for Bad Debts required (10% on sundry debtors) 1,000 Add, Bad Debt <u>700</u> 1700 Less, provision For debts <u>900</u>	800		

Balance Sheet

		Sundry Debtors 10,000 Less, provision For Bad Debts <u>1,000</u>	9,000

Taking the above example, suppose the provision for bad debts in the Trial Balance is ₹1900 instead of ₹ 900, the treatment shall be as follows:

Profit and loss account

		By provision for bad debts 1,900 Less, bad debt 700 Provision for bad debts required <u>1,000</u>	200

		1,700	
Balance Sheet			
		Sundry Debtors 10,000 Less, Provision For bad debts 1,000	9,000

When bad debt appears in the adjustment, first it is to be deducted from sundry debtors and then provision is created at the specified percentage on sundry debtors. Such bad debt is shown in the balance sheet by way of deduction from Sundry debtors.

12. ***Provision for discount on debtors:*** The anticipated loss of allowing cash discount to debtors on their prompt payment is provided for by creating provision for discount on debtors. The provision amount is calculated as a percentage on debtors after deducting bad debts (further bad debt appearing in adjustment) and provision for bad debts. The provision for discount on debtors is shown on the debit side of profit and loss account and at the same time shown in the balance sheet by way of deduction form Sundry Debtors. The adjusting entry passed for the purpose shall be;

Profit and loss account ………. Dr

To provision for discount on debtors account

When provision for discount appears in the Trial Balance, the discount allowed to debtors is transferred to provision for discount on debtors account rather that to profit and loss account.

Illustration: 2

The extract the Trial Balance is as follows:

Name of Account	**Dr. ₹**	**Cr. ₹**
Sundry Debtors	1,50,900	
Bad Debts	2,000	
Discount	1,000	
Provision for bad debts		4,000
Provision for Discount		2,000

Additional information

i. Create a provision for bad debts @5% on sundry debtors
ii. Create a provision for discount on debtors @2% on sundry debtors
iii. While off further bad debt of 700
iv. Additional discount of ₹200 is allowed to debtors.

Pass journal entries and shown relevant ledger account, also show how these are treated in profit and loss account and Balance Sheet.

Solution:

Particulars	LF	Dr. ₹	Cr. ₹
Bad Debts account ………Dr Discount account ……..Dr To Sundry Debtors account (Being further bad debt written off and discount allowed)		700 200	 900
Provision for Bad Debts Account …….. Dr To Bad Debts Account (Being transfer of bad debts provision for bad debt A/c)		2700	 2700
Provision for discount A/c………… Dr To discount Account (Being transfer of discount to provision for discount A/c)		1200	 1200
Profit and loss account ………. Dr To provision for Bad Debts A/c (Being provision for bad debts created @ 5% on sundry debtors i.e. 150900-900)		6200	 6200
Profit and loss account ………. Dr To provision for discount A/c (Being provision for discount created @ 2% on sundry debtors i.e. 142500) [1,50,900 - (900+7500)]		2050	 2050

Dr. Sundry Debtors Account Cr.

To Balance b/d	1,50,900	By bad debts A/c By discount A/c By Balance c/d	700 200 1,50,000
	1,50,900		1,50,900

Dr. Bad Debt Account Cr.

To Balance b/d To Sundry Debtors A/c	2,000 700	By Provision for bad debts A/c	2,700
	2,700		2,700

Dr. Provision for Bad Debts Account Cr.

To Bad Debts Account	2,700	By Balance b/d	4,000
To Balance c/d	7,500	By profit and loss A/c	6,200
	10,200		10,200

Dr. Discount Account Cr.

To Balance b/d	1,000	By provision for discount A/c	1,200
To sundry debtors A/c	200		
	1,200		1,200

Dr. Provision for Discount Account Cr.

To Discount Account b/d	1,200	By Balance b/d	2,000
To Balance c/d	2,850	By profit and loss A/c	2,050
	4,050		4,050

Dr. Profit and loss Account Cr.

Particulars	₹		
To provision for bad debts required …….. 7,500 Add, Bad Debt. ……….2,700 10,200 Less, provision for bad debts ... 4,000	6,200		
To provision for discount on Debtors …… 2,850 Add, Discount …..1,200 4,050 Less, provision for discount ……. 2,000	2,050		

Dr. Balance Sheet Cr.

Liabilities	₹	Assets	₹
		Sundry Debtors 1,50,900 Less, further Bad debt 700 1,50,200 Less, further discount 200 1,50,000 Less provision for Bad debts 7,500 1,42,500 Less provision for discount 2850	1,39,650

13. ***Reserve for discount on creditors:*** Like that of discount allowed to debtors, the business may receive discount when payment is made to creditors. The expected discount to be received from creditors when payment is made them provided for in the financial statement is nothing but reserve for discount on creditors. It is calculated as a percentage on sundry creditors. The adjusting entry shall be:

Reserve for discount on creditors account ……. Dr
To profit and loss account

The reserve for discount on creditors is shown on the credit side of profit and loss account and at the same time deducted from sundry creditors in the balance sheet. When reserve for discount on creditors has already been created, any amount received as discount shall be credited to this account and not to profit and loss account. The reserve new to be created for the current year is compared with the reserve already created (shown in Trial Balance) and accordingly the difference is shown in the profit and loss account.

However in normal practice this reserve is not created as it goes against the principle of conservatism which provides that 'anticipate no profit but provide for all possible losses.

14. ***Managers' commission:*** The manager may be entitled to a commission on profits which is calculated as a percentage of profit earned by the business. The commission either is paid as a percentage of profit before charging such commission or after charging such commission. The commission is calculated in the above case by the following formulae.

Commission before charging commission:

$$\text{Net profit before commission} \times \frac{\text{percentage of commission}}{100}$$

Commission after charging such commission :

$$\text{Net profit before commission} \times \frac{\text{percentage of commission}}{100 + \text{percentage of commission}}$$

The adjusting entry for commission payable to the manager shall be:

Profit and loss account ……… Dr
To commission payable account

The commission payable is debited to profit and loss account and also shown in the liabilities side of the balance sheet.

15. ***Drawings of Goods by the proprietor:*** Goods withdrawn by the proprietor from the business for personal use or need to be adjusted by debiting drawings account and crediting purchase account. Thus, the entry shall be:

Drawing account ……….. Dr.
To purchases account

The value of the goods withdrawn is deducted from purchases in trading account and added to drawing which is ultimately deducted from capital in the balance sheet.

16. ***Accidental Losses of Stock:*** The value of goods lost by accident (by fire or other calamities) is debited to abnormal loss account and credited to trading account. The reason behind crediting to trading account is that the true gross profit new to be ascertained. Further, such abnormal loss is debited to profit and loss account. The following adjusting entries are passed.

Abnormal Loss Account …….. Dr
To Trading Account
Profit and loss account ……. Dr
To abnormal loss account.

If the stock of goods are insured and the insurance company has admitted the claim, then the following entry is passed .

Insurance company account ……….. Dr
(Extent of claim admitted)
Profit & loss account …….. Dr
(claim not admitted)
To abnormal loss account

17. ***Goods distributed as free samples:*** Goods distributed as free samples is nothing but advertisement expenses incurred by the business. The following entry is passed :

Advertisement account ………. Dr
To purchases account

The value of the goods distributed as free samples is deducted from purchases in trading account and added to adjustment expenses which is ultimately debited to profit and loss account.

18. ***Goods sent on Approval:*** Sometimes goods are sent to customers on sales or return or on approval basis. Unless it is approved by the customers or agreed time period expires. It is not treated as sale. At the end of the year if the goods are still lying with the customers awaiting approval, the original entry made for sale is cancelled and such goods are valued at cost and treated as stock lying with customers. The following entries are passed :

i) Sales account ………. Dr
To Sundry Debtors Account
ii) Stock with customers Account …….. Dr
To Trading account

In the trading account, the goods at selling price is deducted from sales and the cost of such goods is added to the value of closing stock. In the Balance sheet the sales value of such goods is deducted from sundry debtors and the value of closing stock as adjusted in trading account is reflected in the Balance Sheet.

19. ***Goods in Transit:*** Goods which have been purchased but in transit at the end of the accounting period are treated as part of closing stock. It is added to the value of closing stock in trading account and accordingly shown in Balance Sheet. The entry passed shall be as follows:

Goods-in-Transit Account ………. Dr
To Trading Account

Illustration: 3 The following Trial Balance has been extracted from the books of Mrs. Raja laxmi Singh on 31st March, 2016.

Particulars	Dr. (₹)	Cr. (₹)
Drawings Account	5,000	
Capital Account		35,000
Sundry Debtors	20,100	
Cash in Hand	5,050	
Sundry creditors		8,401
Stock (1.04.2015)	6,394	
Interest on loan	200	
Motor vehicles	15,000	
Cash at bank	2,000	
5% mortgage loan (1.4.15)		12,500
Bills Receivable	6,882	
Carriage inward	3,929	
Salaries	8,097	
Rates, Taxes & Insurance	3,891	
Bad Debts provision		710
Sales		1,11,589
Purchase Return		1000
Discount		440
Land & Building	20,000	
Bad Debts	625	
Purchase	68,279	
Sales Return	2,000	
Carriage outward	1,404	
Advertisement	2,264	
General Expenses	1,489	
Bills payable		2714
Rent received		250
	1,72,604	1,72,604

Prepare Trading and profit & loss account for the year ending 31st March, 2016 and a Balance Sheet as on that date after taking into consideration the following adjustments:

i. Depreciate land building at 5% p.a. and motor vehicle at 15% p.a.
ii. Salaries and Rates & Taxes outstanding ₹700 and ₹400 respectively.
iii. The provision for Bad Debts is to be brought up to 5% on sundry debtors.
iv. Goods costing ₹600 were sent to a customer on sale or return basis (selling price ₹700) on 31st March, 2016 which has been shown as actual sales.
v. The value of stock in hand on 31st March, 2016 was ₹ 6250.
vi. Goods costing ₹500 were withdrawn by the proprietor for personal use for which no entry has been made in the books.
vii. Insurance is prepaid to the extent of ₹175.

viii. Manager is entitled to a commission at 5% on net profits after charging such commission.

Solution : Trading and profit & loss account for the year ending 31st March, 2016

Particulars	₹	Particulars	₹
To opening stock	6,394	By Sales	
To purchases		1,11,589	
68,279		Less, Sales Return	
Less, Returns		2,000	
1,000	66,779		
	3,929	1,09,589	1,08,889
67,279	38,637	Less, Goods on Sale	
Less, Goods withdrawn		Or return	
500		700	6,850
To carriage inward			
To Gross profit	1,15,739	By closing stock	1,15,739
		6,250	
		Add, Goods on sales	
		or return (cost price)	
		600	
To Salaries		By Gross profit	38,637
8,097		By Rent received	250
Add, outstanding	8,797	By Discount Received	440
700			
To interest on loan	625		
200			
Add, outstanding			
425			
To Rates, Taxes &	4,116		
Insurance			
	2,264		
3,891	1,404		
Add, outstanding	1,489		
400			
4,291			
Less prepaid insurance	3,250		
175			
To Advertisement			
To carriage outward			

To general expenses			
To depreciation	885		
To land & building	786		
1,000	15,711		
Motor vehicles			
2,250			
To provision for Bad Debts required			
970			
Add, Bad Debts			
625			
1,595			
Less:- Existing provision			
710			
To Manager's commission			
To Net profit			
	39,327		39,327

Balance Sheet as at 31st March, 2016

Liabilities	₹	Assets	₹
Capital		Land & Building	
35,000		20,000	19,000
Add, Net profit		Less, Depreciation	
15,711	45,211	1,000	12,750
Less, Drawings		Motor vehicles	
50,711	12,925	15,000	
(5000+500)	8,401	Less, Depreciation	
5,500	2,714	2,250	18,430
5% mortgage loan	700	Sundry Debtors	
12,500	400	20,100	6,850
Add, interest due	786	Less, Goods on sale or return	6,882
425		700	175
Sundry creditors			2,000
Bills Payable		19,400	5,050
Salaries outstanding		Less, provision for bad debts	
Rates & Taxes outstanding		970	
Manager's commission		Closing Stock	
		6,250	
		Add, Goods Sale or return	

		600	
		Bills receivable	
		Prepaid insurance	
		Cash at Bank	
		Cash in hand	
	71,137		71,137

Note: provision for bad debts @ 5% on sundry Debtors is calculated after deducting sales value of goods sent to customers on sale or return basis amounting to ₹700.

Illustration : 4 From the following Balances taken from the books of Mr. Lingaraj Satapathy on 31st March,2016 prepare Trading and profit and loss account for the year ending on 31st March,2016 and the Balance Sheet as the on 31st March,2016. In vertical format:

Particulars	(₹)
Building	20,000
Sundry creditors	14,000
Cash at bank	10,000
Purchases	1,63,200
Loose Tools	1,000
Income-tax	1,025
Cash in hand	835
Sales	1,85,000
Motor vehicle	12,000
Carriage inwards	1,120
Wages	10,590
Sundry expenses	1,400
Bank interest (cr.)	75
Bad debts	300
Loan from Patnaik	2,500
Sundry debtors	9,300
Investments	6,500
Provision for Bad Debts	1,600
Rent and Rates	1,000
Furniture	3,500
Stock (1.4.2015)	27,000
Capital	57,300
Dividend received	925
Discount allowed	630
Drawings	2,000
Bills payable	10,000

Adjustments:

i. Write off further bad debt ₹ 300 and create a provision for bad debts at 20% on Sundry Debtors.
ii. Dividend accrued on investment ₹ 135.
iii. Rates paid in advance ₹ 100 and wages owing ₹ 450.
iv. On 31st March, 2016 stock was valued at ₹ 15,000 and loss tools were valued at ₹800.
v. Write off 5% depreciation on building and 40% on motor vehicle.
vi. Provide for interest at 12% p.a. due on loan taken on 1.6.2015.
vii. Income-tax paid has to be treated as drawings.

Solution:

Trading and Profit & Loss Account of Mr. Ligaraj Satapathy for the year ended 31st March, 2016.

Particulars	(₹)	(₹)
Sales		1,85,000
Opening Stock	27,000	
Purchases	1,63,200	
Carriage inward	1,120	
Wages 10,590		
Add, outstanding 450	11,040	
Less, closing stock	2,02,360	
Cost of goods sold	15,000	1,87,360
Gross Loss		(-)2,360
Bank interest		75
Dividend received	925	
Add, Accrued	135	1,060
Less, Rent & Rates 1,000		(-) 1,225
Less, prepaid 100	900	
Sundry Expenses	1,400	
Interest on Loan	250	
Discount allowed	630	
Provision for Bad Debts 1,800		
Add, Bad Debts (300+300) 600		
2,400		
Less, provision for Bad Debts 1,600	800	
Depreciation		
On Building (5%) 1,000		
On Motor vehicle (40%) 4800		
On Loose Tools 200		
Net Loss Transferred to capital	6,000	
		9,980
		11,205

Balance Sheet of Mr. Ligaraj Satapathy as at 31st March, 2016.

Particulars		(₹)	(₹)
A. Fixed Asset:			
Building	20,000		
Less, Depreciation	1,000		
		19,000	
Motor vehicle	12,000		
Less, Depreciation	4,800		
Furniture		7,200	
Investments		3,500	
Loose Tools	1,000	6,500	
Less, Depreciation	200		
		800	
			37,000
Current Assets :			
Sundry Debtors	9,300		
Less, Bad Debts	300		
	9,000		
Less, provision for bad debt	1,800	7,200	
Closing Stock		15,000	
Cash at Bank		10,000	
Cash in Hand		835	
Prepaid Rates		100	
Dividend Accrued		135	
		33,270	
Current Liabilities :			
Sundry Creditors	14,000		
Bills Payable	10,000		
Outstanding Wages	450		
Interest on Loan Due	250		
		24,700	
B. Working Capital :			8,570
Net Assets Employed (A+B)			45,570
Financed by			
Capital	57,300		
Less, Net Loss	11,205		
	46,095		
Less, Drawings (2,000+1,025)	3,025	43,070	
Loan from Patnaik		2,500	45,570

2.7 Check your Progress:

1. State where the following are Capital or Revenue :

i. A second-hand truck purchased for ₹2,00,000 and ₹1,00,000 Spent on overhauling and painting it.
ii. ₹30,000 spent on white washing of factory building
iii. ₹20,000 paid to obtain license for starting the factory.
iv. ₹9,000 spent on removal of stock to a new site.
v. A factory shed was constructed at a cost of ₹100000. A sum of ₹5000 had been incurred for construction of temporary huts for storing building materials.
vi. Amount realised on sale of a discarded machine.
vii. Expenses on a foreign tour to purchase a new machine.
viii. Interest on term loan for purchase of a machine. The commercial production has not begun

1. From the following balances of Anil& Ankit Associates, a partnership firm as on 31st December, 2016, prepare trading & profit and loss account for the year ended 31st December, 2016 and the Balance Sheet as at that date.

	₹
Opening Stock	30,000
Purchases	1,10,000
Sales	2,50,000
Building	55,000
Wages	23,000
Carriage inward	3,000
Bills Payable	10,000
Furniture	9,000
Salaries	42,000
Advertisement	24,000
Coal & coke	2,000
Cash at Bank	14,000
Prepaid wages	1000
Machinery (including ₹10000 new)	60,000
Sundry Debtors	20,000
Bad Debts	3,000
Sundry Creditors	24,000
Rent, Rates & Taxes	4,000
Trade Expenses	4,000
Capital : Anil	50,000
Ankit	40,000

Petty Expenses	4,000
Provision for Bad Debts	1,000
Gas and Water	1,200
Cash in Hand	800
Outstanding Rent	400
Bank Loan	34,600

The following additional information is supplied:

i. The partners share profits and losses as Anil 2/5 and Ankit 3/5.
ii. Value of closing stock ₹15,000.
iii. Stock valued at ₹10,000 was destroyed by fire but the insurance company admitted a claim of ₹8,500 only, and the claim is not yet paid.
iv. Wages include 2,000 for installation of new machinery on 1.7.2015.
v. Depreciation on machinery at 10% p.a.
vi. Create a provision for bad debts @ 10% of sundry Debtors.

2. The following balances are available from the books of Mr. Aswini Sharma as on 31st December 2014 and 31st December 2015.

	31.12.2014 (Rs.	31.12.2015 (Rs.)
Building	60,000	60,000
Equipment's	1,20,000	1,34,000
Furniture	10,000	10,000
Debtors	?	48000
Creditors	32,000	?
Stock	?	34000
Bank Loan	20,000	16,000
Cash	32,000	22,000

The transactions of Mr. Aswini Sharma during the year ended 31.12.2015 were the following:

Collection from Debtors ₹ 1,86,000
Payment to creditors ₹ 1,22,000
Cash purchases ₹ 32,000
Expenses ₹ 20,000
Sales of an equipment on 1.1.15 ₹ 6,000
(book value ₹ 10,000)
on January 1, 2015)
Drawings ₹ 20,000
Purchase of new equipment

On July 1, 2015

Cash sales amounted to 10% of total sales. Credit sales amounted to ₹ 1,80,000. Credit purchases were 80% of total purchases. Mr. Aswini Sharma sells goods at cost plus $33^1/_3$ %. His suppliers allowed him discount Rs. 2,000.

Equipment's and furniture are to be depreciated by 10% p.a. and building by 2% p.a.

Prepare Trading and profit & Loss account for the year ended 31st December, 2015 and a Balance Sheet as at that date.

2.8 KEY WORDS:

Financial Statements: Summaries of accounting information conveying the results of operation and financial position of an enterprise. Primarily consists of Profits & Loss Account and Balance Sheet.

Capital Expenditure: Expenditure the benefit of which is derived by the business over a number of years.

Revenue Expenditure: Expenditure incurred in the normal course of business the benefit of which is consumed during the accounting period.

Deferred Revenue Expenditure: Expenditure, the benefit of which is available for more than one year.

Capital Receipt: Receipts arising out of additional capital introduced, loan raised or sales of fixed assets.

Revenue receipts: Receipts arising out of sale of goods or services in the normal course of business or other incomes received.

Trading Account: The first part of profit and loss account which reveals the gross profit.

Cost of Goods sold: Total of opening stock of goods, net purchases, direct expenses less closing stock of goods.

Gross Profit : The difference between sales and cost of goods sold.

Profit & Loss Account: Account prepared to ascertain the net profit or loss through matching of indirect expenses and losses to the gross profit and other incomes and gains.

Closing Entries: All the accounts representing revenue expenses, losses, incomes and gains are transferred to trading and profit & loss account by passing journal entries.

Balance Sheet : Statement which reveals the financial position by showing the assets and liabilities on a given date.

Order of liquidity: Assets and liabilities are shown in the balance sheet in order of their liquidity (order of conversion in to cash) or order of their payment.

Oder of permanence: Assets and liabilities are shown in the Balance sheet in order of their permanence.

Fixed Assets: Assets acquired for use in the business and not meant for resale.

Current Assets: Assets in cash form or meant to be converted into cash in the normal course of business.

Fictitious Assets: Assets not represented by anything concrete (mostly expenses and losses).

Long-term Liabilities: Liabilities repaid after a long period of time.

Current liabilities: Liabilities due for payment within one year.

Contingent liabilities: Liabilities, the occurrence of which depends upon happening of a future contingency.

Capital: contribution of the owner in cash or in kind to the business.

Marshalling: Order of showing assets and liabilities in the Balance sheet (either in the order of liquidity or permanence)

2.9 SUMMARY :

Financial statements are summaries of accounting information conveying the results of operations and financial position of an enterprise. Mostly it refers to income statement (Profit & Loss Account) and position statement (Balance Sheet). While revenue expenditure and revenue receipts are taken to profit and loss account to ascertain profit or loss, the capital expenditure and capital receipts are capitalized and taken to balance sheet. Trading account, which is the first part of profit and loss account reveals the gross profit through matching of sales and cost of goods sold. All indirect expenses, losses and incomes are shown in profit & loss account to determine the net profit or loss. Balance sheet may be prepared in order of liquidity or permanence. While preparing the financial statements, a number of items of expenses and incomes are adjusted so that a proper matching of revenue is done with the expenditure incurred to earn that revenue.

2.10 SOLUTION :

1.

i. Capital expenditure ₹ 3,00,000
ii. Revenue expenditure
iii. Capital expenditure
iv. Revenue Expenditure
v. Capital Expenditure ₹ 1,05,000
vi. Capital Receipt
vii. Capital expenditure
viii. Capital expenditure

2. Trading and profit & loss Account of Anil & Ankit Associates for the year ended 31st December, 2016.

Particulars	₹	Particulars	₹
To opening stock	30,000	By Sales	2,50,000
To purchases	1,10,000	By Abnormal loss	10,000
To wages		By Closing Stock	15,000
23,000			
Less, wages for installation	21,000		
of machinery	3,000		
2,000	2,000		
To carriage inward	1,200		
To coal & coke	1,07,800		
To gas & Water	2,75,500		2,75,500
To Gross profit			

To Salaries	42,000	By Gross profit	1,07,800
To Advertisement	24,000		
To Rent, Rates & Taxes	4,000		
To Trade Expenses	4,000		
To Petty Expenses	4,000		
To Depreciation on	5,400		
machinery	1,500		
To abnormal loss			
To provision for Bad Debts			
required			
2,000			
Add, Bad Debt			
3,000			
5,000	4,000		
Less, provision for			
Bad Debts			
	18,900		
1,000	1,07,800		1,07,800
To Net profit transferred to			
To Anil's Capital			
7,560			
Ankit's Capital			
11,340			

Balance Sheet of Anil & Ankit Associates as at 31st March, 2016

Liabilities	₹	Assets	₹
Capital		Building	55,000
Anil		Furniture	9,000
50,000	57,560	Machinery	
Add, Net profit		60,000	
7,560	51,340	Add, Wages for installation of	
Ankit	34,600	machinery	
40,000	10,000	2,000	
Add, Net profit	24,000		56,600
11,340	400	62,000	
Bank Loan		Less, Depreciation	18,000
Bills payable		5,400	15,000
Sundry creditors			14,000
Outstanding Rent		Sundry Debtors	800
		20,000	1,000
		Less, provision for bad debts	8,500
		2,000	
		Stock	
		Cash at Bank	

		Cash in hand Prepaid wages Insurance company (claim due)	
	1,77,900		1,77,900

Note :

1. Depreciation on machinery @10 on ₹50,000 +10% on ₹12,000 (10,000 newly purchased +2,000 wages on installation) for 4 months.
2. Since the insurance claim has not been received, it is shown as asset.
   Before preparation of Trading and profit & loss account and Balance Sheet the missing figures are to be found out. Refer to working notes for the missing figure.

Trading and profit & loss account of Mr.Aswini Sharma for the year ended 31st December 2015

Particulars	₹	Particulars	₹
To opening stock	24,000	By Sales	
To purchases		Cash Sales	
Cash 32,000		20,000	2,00,000
Credit 1,28,000	1,60,000	Credit Sales	34,000
To Gross profit	50,000	1,80,000	
		By closing Stock	
	2,34,000		2,34,000
To Expenses	20,000	By Gross profit	50,000
To loss on sales of		By Discount	
equipment	4,000	received from	2,000
To Depreciation		suppliers	
Building 1,200			
Furniture 1,000			
Equipment 12,200	14,400		
To Net profit	13,600		
	52,000		52,000

Balance Sheet of Mr. Aswini Sharma as at 31st December, 2015

Liabilities	₹	Assets	₹
Capital		Building	
2,48,000		60,000	58,800
Add, Net profit		Less, Depreciation	
13,600	2,41,600	1,200	1,21,800
	36,000	Equipment’s	
2,61,600	16,000	1,34,000	9,000
Less, Drawings		Less, Depreciation	48,000
20,000		12,200	34,000
Creditors		Furniture	22,000

Bank Loan		10,000 Less, Depreciation 1,000 Debtors Stock Cash	
	2,93,600		2,93,600

WORKING NOTES :

1. Credit Purchase : Credit purchases were 80% of total purchases. Thus, cash purchases are 20% of total purchases. Cash purchases amounted to ₹ 32,000 (given). Thus, total purchase = 32,000 /20 x100=1,60,000
   Credit purchases = ₹1, 60,000-₹32,000=₹1, 28,000

2. Cash Sales : Cash sales amounted to 10% of Total Sales. Therefore, Credit sales are 90% of Total sales. Credit sales amounted to ₹ 1, 80,000.
   Thus, total sales = ₹1, 80,000/90 x 100=₹2, 00,000
   Cash Sales = Total Sales – Credit Sales=₹ 2, 00,000 - 1, 80,000= ₹20,000

3. Cost of goods sold: Goods are sold at cost plus 33 $^{1}/_{3}$ %
   Let the cost be ₹100
   Then profit =₹33 $^{1}/_{3}$ % and sales 133 $^{1}/_{3}$ % or 400/3
   When sales = 2,00,000, cost shall be ₹2,00,000 x 3/400 x100= ₹1,50,000.
   Thus, cost of goods sold = 1,50,000.

4. Opening Stock : Cost of goods sold = opening stock + purchases – closing stock
   Thus, ₹ 1,50,000 = opening stock+₹1,60,000-₹34,000
   ₹1,50,000=₹1,26,000+opening stock
   Opening stock =₹ 1,50,000-₹ 1,26,000=₹ 24,000

5. Loss on Sale of Equipment:
   Book value of the equipment on 01.01.2015 ₹ 10,000
   Selling price of the equipment on 01.01.2015 ₹ 6,000
   Thus, loss on sales of equipment₹ 4,000

6. Depreciation on Equipment :
   Book value of the equipment on 01.01.2015 ₹ 1,20,000
   Sale of equipment on 01.01.2015₹ 10,000
   Balance of equipment on 01.01.2015 ₹ 1,10,000
   Book value of equipment on 31.12.2015 ₹ 1,34,000

Equipment purchased on 1.07.2015₹ 24,000
(₹1, 34,000 - ₹1,10,000)

Depreciation of ₹ 110000 for 12 months = ₹1,10,000 x 10/100 =11,000
Depreciation on ₹ 24000 for 6 month = ₹ 24,000x 10/100x 6/12=1200
Total Depreciation = ₹ 11,000+₹1200= ₹12,200

7. Capital at the beginning

Balance Sheet as at 31st December, 2014

Creditors	32,000	Building	60,000
Bank Loan	20,000	Equipment	1,20,000
Capital (Balancing figure)	2,48,000	Furniture	10,000
		Debtors	54,000
		Stock	24,000
		Cash	32,000
	3,00,000		3,00,000

8. Debtors as on 31.12.2014

Balance b/d (Balancing figure)	54,000	By Cash A/c (Cash Collected form Debtors)	1,86,000
To Sales A/c (credit Sales)	1,80,000	By Balance c/d (closing balance)	48,000
	2,34,000		2,34,000

9. Creditors as on 31.12.2015

To Cash A/c (payment made)	1,22,000	By Balance b/d	32,000
To Discount A/c	2,000	By purchases A/c (Credit purchase)	1,28,000
To Balance c/d (Balancing figure)	36,000		
	1,60,000		1,60,000

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