Indira Gandhi
National Open University
School of Management Studies

# BCOC-131
## Financial Accounting

Block

# 3

## FINAL ACCOUNTS

## COURSE PREPARATION TEAM

**Accountancy-I: ECO-02**

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# BLOCK 3 FINAL ACCOUNTS

After recording and posting all business transactions in the appropriate books of account and testing the arithmetical accuracy of these records with the help of Trial Balance, we prepare a summary at the end of the accounting year. The purpose is to ascertain the profit or loss and the financial position of the business. The summary is prepared in the form of a Profit and Loss Account (also called Income Statement) and a Balance Sheet (also called Position Statement). These two financial statements are termed as Final Accounts. This block consists of 3 units (Unit 8 to 10) deals with the concepts to be observed for ascertaining the profit or loss and the financial position of the business, and the method of preparing the final accounts.

**Unit 8** discusses the causes and objectives of providing depreciation, the factors influencing the amount of depreciation to be charged and the two commonly used methods of providing depreciation.

**Unit 9** describes the method of preparing simple final accounts involving no adjustments. It also explains the preparation of a Manufacturing Account which may be prepared by manufacturing establishments.

**Unit 10** deals with the adjustments required in respects of certain expenses and incomes at the time of preparing the final accounts and explains how they are incorporated in the Profit and Loss Account and the Balance Sheet.

# UNIT 8 DEPRECIATON

## Structure



## 8.0 OBJECTIVES

After going through this unit you should be able to:

- define depreciation;
- distinguish depreciation from other related concepts;
- state the causes of depreciation;
- describe the objectives of providing depreciation;
- state the factors influencing the amount of depreciation;
- explain the methods of recording depreciation;
- list various methods of providing depreciation; and
- prepare accounts under fixed instalment and diminishing balance methods of providing depreciation.

## 8.1 INTRODUCTION

While preparing final accounts you have to provide for depreciation on all fixed assets so as to work out the correct amount of profit or loss for the accounting period. Adjustments usually contain an item asking you to charge depreciation on various fixed assets at some given rate and you know how to show it in final accounts In this unit we shall have a detailed discussion on depreciation and study the basic factors influencing the amount of depreciation and various methods of providing and accounting for the same.

## 8.2 WHAT IS DEPRECIATION ?

You are already familiar with the distinction between revenue expenditure and capital expenditure. You are aware that when the benefit of an expenditure is available beyond the accounting year (for one or more years) such an expenditure is treated as capital expenditure and it often results in acquisition of an asset. Since many accounting years are likely to receive benefits on account of the use of such an asset, the cost of investment must necessarily be allocated over the period of its useful life and charged to the Profit and Loss Account. **Allocation of the appropriate amount to each period is called depreciation which represents the expire portion of the cost of an asset.**

It would be useful to discuss different definitions given by various authorities in the subject for a proper appreciation of the meaning of depreciation.

Pickles defined depreciation as "the permanent and continuous diminution in the quality, quantity or value of an asset."

According to Spicer and Pegler, "Depreciation may be defined\as a measure of the exhaustion of the effective life of an asset from any cause during a given period."

These definitions refer to certain basic aspects like permanent and continuous diminution, exhaustion of effective life but they are not comprehensive. Let us see some more definitions.

According to ICMA (Institute of Cost and Management Accounts, London) terminology, "Depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time."

According to Walter B. Meigs and others, "The concept of depreciation is closely linked to the concept of business income. Since part of the service potential of the depreciable asset is exhausted in he revenue getting process each period, the cost of these services must be deducted from revenue in measuring periodic income; the expired cost must be recovered before a business Is considered as well off as at the beginning of the period. Depreciation is a measure of this cost."

According to the institute of Chartered Accountants in Austria, "Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the assets and is not dependent upon the amount of profit cleared."

From the above definitions it is clear that depreciation refers to that part of the cost of fixed asset which has expired on account of its usage and or the passage of time. It is thus the 'lost usefulness', 'expired utility', or 'reduction in the intrinsic value' of a fixed asset.

Depreciation is charged on almost all fixed assets, possible exceptions being land, antiques, etc. Usually the value of land and antiques appreciates over a period of time, because they do not have finite economic life as in the case of machinery or furniture,

## 8.3 DEPRECIATION AND OTHER RELATED CONCEPTS

Sometimes the terms depletion, amortisation etc., are used interchangeably with depreciation. These terms in fact are used in a different context. Let us understand the distinction between depreciation and such related concepts.

**Depreciation and Depletion :** The term 'depletion' is used in respect of the extraction of natural resources from wasting assets such as quarries, mines, etc. and refers to, the reduction in the available quantity of the material. As a matter of fact, depletion is regarded as a method of computing the depreciation on wasting assets. Thus, it has a limited application. Depreciation, on the other hand, Is a wider term and refers to a reduction in the value of all kinds of fixed assets arising from their wear and tear.

**Depreciation and Amortisation :** The terms 'amortisátion' refers to writing off the proportionate value of the intangible assets such as copyrights, patents, goodwill, etc., while depreciation refers to the writing off the expired cost of the tangible assets like machinery, furniture, building etc.

**Depreciation and Obsolescence:** Obsolescence refers to the decrease in usefulness arising on account of the external factors like change in technology, new inventions. change of style, etc. Thus, it is caused mainly on account of the asset becoming out of date, and old fashioned. Deprecation on the other hand, is a functional loss generally arising on account of wear and tear, Obsolescence, in fact, is regarded as one of the causes of depreciation.

Depreciation and Fluctuation : Fluctuation refers to an increase or decrease in the market price of an asset. Such a change is. usually temporary. Depreciation differs from fluctuation in the following respects.

i) Depreciation is concerned with book value of asset while fluctuation is related to the market value.

ii) Depreciation refers only to the decrease while fluctuation refers to either increase or decrease.

iii) Depreciation reflects a permanent decrease while fluctuation is only a temporary phenomenon.

## 8.4 CAUSES OF DEPRECIATION

The causes of depreciation can be stated as follows:

1. **Wear and Tear :** Wearing out of the asset on account of its constant use is called wear and tear. This causes a definite reduction in the value of the asset and is regarded as the major source of depreciation.

2. **Lapse of Time :** Normally, the passage of time also causes some reduction in the value of fixed assets because as they become old their value stands reduced. That is why the depreciation is usually charged on time basis. in case of certain assets like lease, patents, etc., the value decreases with passage of time as they generally have a fixed number of years of legal life. For example, a building is taken on lease for a period of 10 years costing **Rs.** 1,00,000. The yearly

depreciation of lease will amount to Rs. 10,000 (1/10 of Rs. 1,00,000) and charged as such to the Profit and Loss Account every year.

3. **Obsolescence:** The acquisition of an improved model may render the existing machine obsolete. As the new machine performs the same operation more quickly and/or more economically existing machine is said to have become out of date or obsolete. This causes a drastic reduction in the value of existing machinery and the amount of depreciation is bound to be heavy.

4. **Depletion:** Some assets are of a wasting character. For example mines, quarries, oil wells etc.. Due to continuous extraction of materials the natural resources get depleted. Depreciation, in case of such assets is often computed on the basis of actual depletion. For example, a coal mine has the coal deposits of 200 million tons. In the first year we extract 10 m. tons of coal. The depreciation in the first five years shall amount to 10/200 of the cost of mine.

**On the basis of the causes mentioned above, it can be said that depreciation is a permanent and continuous reduction in the value of an asset due to wear and tear, passage of time, obsolescence, depletion or any other cause.**

## 8.5 OBJECTIVES OF PROVIDING DEPRECIATION

You know depreciation is treated as a loss and is chargeable to the Profit and Loss Account every year. The justification for charging depreciation can be explained as follows

1. **Ascertaining the true profits:** Depreciation represents the expired cost of a fixed asset caused by its usage hi business, This cost is a part of the total expenses incurred in earning the revenue during an accounting period and must be taken into account for arriving at the correct amount of profit or loss for the period. If depreciation is not charged, the expenses and losses will understand and the Profit and Loss Account will show higher profits making the concern pay higher taxes.

2. **Ascertaining the true cost of production :** Depreciation on machinery and other fixed assets in the factory is an important component of the cost of production specially when the unit is not labour intensive. So if no provision is made for depreciation, the cost calculations will be incorrect.

3. **Presentation of true financial position:** The value of fixed assets reduces from year to year on account of their usage and passing of time. They must be shown in the Balance Sheet at their reduced values otherwise it will not reflect the true financial position of the business. Hence depreciation must be taken into account. It will enable the concern to show fixed assets at their proper values in the Balance Sheet.

4. **Funds for replacement of assets :** Charging depreciation reduces the profits available for distribution It enables the. concern to retain a part of its profit and thus accumulate funds for the replacement of the assets as and when necessary.

**Check Your Progress A**

1. What is depreciation?

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

2. How is depreciation different from amortisation ?

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..........................................................................................................

3. State whether the following statements are **True** or **False.**

   i) Depreciation is charged also on current assets.

   ii) Profits will be overstated if depreciation is not charged.

   iii) Expenses will be understated if depreciation is not charged

   iv) If adequate maintenance expenditure is incurred, depreciation need not be charged.

   v) Depreciation is charged to reduce the value of asset to its market value,

   vi) Depreciation is charged only on the original purchase price of the asset.

   vii) When market value of an asset is higher than book value, depreciation is not charged.

   viii) The main cause of depreciation is wear and tear caused by its usage.

## 8.6 FACTORS INFLUENCING DEPRECIATION

The amount of depreciation to be charged to the Profit and Loss Account in respect of a particular fixed asset is affected by following factors:

1. **Cost of the asset :** Cost of the asset should include purchase price and all other costs incurred to bring the asset to usable condition like transportation costs, erection charges, etc. It is to be noted that financial charges, such as interest on loan taken for the purchase of the asset is not to be included in the original cost of an 'asset.

2. **Estimated working life of the asset:** The useful or economic life of the asset can be stated in terms of time i.e., years, months, hours or in terms of quantity, i.e., number of units of output or any other operating measure such as kilometres in the case of lorries, motor vans, etc.

3. **Estimated Scrap value :** Scrap Value (also called salvage value, residual value) refers to the estimated amount expected to be realized when the asset is sold to the end of its useful life. While the original cost of an asset can be correctly determined, useful life and salvage value can only be estimated, based on certain assumptions.

The total amounts of depreciation to be written off during the life time of an asset is calculated as follows

| | Rs. |
|---|---|
| Total Cost of Asset | ….. |
| Less Estimated Scrap Value | ….. |
| Total amount of Depreciation to be written off during its useful life | ….. |

For example, a machine was bought for Rs. 1,00,000 and a sum of Rs. 24,000 was spent towards its transportation and erection charges. It was estimated that the machine has a useful life of 10 years and that the residual value expected to realise at the end of its useful life is Rs. 14,000. The total amount of depreciation to be written off during the economic life of an asset can be calculated as shown below:

| | Rs. |
|---|---|
| Original cost of the asset | 1,00,000 |
| Add Transportation and erection charges | 24,000 |
| | 1,24,000 |
| Less Estimated residual value | 14,000 |
| Total amount of depreciation to be written off during its useful life | 1,10,000 |

After determining the total amount of depreciation to be written off during the life time of an asset the next step is to decide the amount of depreciation to be charged every year. In the above situation the annual amount of depreciation to be written off may be considered s 1/10 of the total amount of depreciation because its estimated life is 10 years.

However, there are various methods of calculating the amount of depreciation to be charged from year to year.

## 8.7 METHODS OF RECORDING DEPRECIATION

There are essentially two methods of recording depreciation in the books of account:

(1) when Provision for Depreciation Account is maintained, and (2) when Provision for Depreciation Account is not maintained. Under the first method, the amount of depreciation is credited to the 'Provision for Depreciation Account' every year and the concerned asset account continues to appear at its original cost. Of course, while preparing the Balance Sheet, the accumulated balance of the Provision for Depreciation Account is shown by way of deduction from the cost of the asset. Under the second method, no Provision for Depreciation Account is opened. The amount of depreciation is directly credited to the concerned asset account every year. The asset account would thus appear in books at the depreciated value (written down value). Of course, it will be shown in the Balance Sheet giving the details of the opening balance, purchase and sale of the asset, and the depreciation provided during the year.

The following are the journal entries passed for the related transactions under the two methods.

1. **When Provision for Depreciation Account is maintained**

   **a) For charging depreciation:**

   Depreciation Account Dr.

   To Provision for Depreciation Account

   (Being depreciation provided)

   **b) For transferring depreciation to Profit and Loss Account:**

   Profit and Loss Account Dr.

   To Depreciation Account

   (Being transfer of depreciation)

**c) When the asset is sold:**

i) Bank Account Dr.
To Asset Account
(Being the sale proceeds)

ii) Provision for Depreciation Account Dr.
To Asset Account
(Being transfer of provision for depreciation on the asset sold)

iii) Asset Account Dr.
To Profit and Loss Account
(Being transfer of profit on sale of the asset)
or
Profit and Loss Account Dr.
To Asset Account
(Being transfer of loss on sale of the asset)

2. When Provision for Depreciation Account is not maintained

a) For charging depreciation:
Depreciation Account Dr.
To Asset Account
(Being depreciation provided)

b) For transferring depreciation to Profit and Loss Account
Profit and Loss Account Dr.
To Depreciation Account
(Being transfer of depreciation)

c) When the asset is sold:

i) Bank Account Dr.
To Asset Account
(Being sale proceeds)

ii) Asset Account Dr.
To Profit and Loss Account
(Being transfer of profit on sale of asset)
or
Profit and Loss Account Dr.
To Asset Account
(Being transfer of loss on sale of the asset)

A firm can adopt any method for recording depreciation. But in practice, most of the firms follow the second method under which provision for Depreciation Account is not opened and all entries are made directly in the concerned asset account. Hence, we shall follow this method for the treatment of depreciation.

## 8.8 METHODS FOR PROVIDING DEPRECIATION

As stated earlier there are various methods of calculating the amount of depreciation to be charged from year to year. Different methods are adopted to suit the nature of each asset. It is also possible that different concerns may follow different methods for depreciating the same asset. The following are the principal methods for providing depreciation.

1. Fixed Instalment Method
2. Diminishing Balance Method
3. Annuity Method
4. Depreciation Fund Method
5. Insurance Policy Method
6. Revaluation Method
7. Depletion Method
8. Machine Hour Rate Method

Of the above eight methods used for providing depreciation, the first two viz., Fixed Instalment Method and Diminishing Balance Method are the most commonly used methods. These are taken up in this unit and the remaining method shall be discussed in Unit 21.

### 8.8.1 Fixed Instalment Method

This method is also called 'equal instalment method' or 'straight line method'. Under this method. a fixed and equal amount is charged as depreciation every year during the life time of an asset. When this amount of depreciation is presented on a graph paper it would show a straight line parallel to the X-axis, and hence the alternative name 'straight line method'. This method writes off a fixed percentage of the original cost of the asset every year so that the asset is reduced to zero or its salvage value at the end of its working life. The annual amount of depreciation to be charged under this method can be calculated with the help of the following formula:

$$\text{Annual Depreciation} = \frac{\text{Original Coat - Scrap Value}}{\text{Life of the Asset in number of years}}$$

Or $D = \frac{C - S}{N}$

Look at illustration 1 and see how the amount of annual depreciation has been calculated and the concerned asset account prepared from year to year.

**Illustration 1**

Ravikiran & Sons purchased machinery on January 1, 2015 for Rs. 22,000 and spent Rs. 3,000 on its erection. The asset is expected to last for four years after which its break up value is estimated to Rs. 5,000. Find out the amount of depreciation to be charged every year and show how the Machinery Account would appear for four years assuming that the machine is sold for Rs. 1,000 at the end. Also show how the balance of Machinery Account would appear in the Balance Sheet.

**Solution:**

The annual depreciation is calculated as follows :

$$D = \frac{C - S}{N}$$

$$= \frac{(22,000 + 3,000 - 5,000)}{4}$$

$$= \frac{20,000}{4}$$

= Rs. 5,300

**Machinery Account**

Dr. Cr.

| | | | | | |
|---|---|---|---|---|---|
| 2015 | | Rs. | 2015 | | Rs. |
| Jan. 1 | To Bank A/c | 22,000 | Dec. 31 | By Depreciation A/c | 5,000 |
| Jan. 1 | To Cash A/c (erection charges) | 3,000 | " 31 | By Balance c/d | 20,000 |
| | | 25,000 | | | 25,000 |
| 2016 | | | 2016 | | |
| Jan. 1 | To Balance b/d | 20,000 | Dec. 31 | By Depreciation A/c | 5,000 |
| | | | " 31 | By Balance c/d | 15,000 |
| | | 20,000 | | | 20,000 |
| 2017 | | | 2017 | | |
| Jan.1 | To Balance b/d | 15,000 | Dec. 31 | By Depreciation A/c | 5,000 |
| | | | " 31 | By Balance c/d | 10,000 |
| | | 15,000 | | | 15,000 |
| 2018 | | | 2018 | | |
| Jan. 1 | To Balance b/d | 10,000 | Dec. 31 | By Depreciation A/c | 5,000 |
| | | | " 31 | By Bank A/c | 1,000 |
| | | | | By Balance c/d | 4,000 |
| | | 10,000 | | | 10,000 |

**Balance Sheet as on December, 31, 2015**

| | | | |
|---|---|---|---|
| | | | Rs. |
| | Machinery | 22,000 | |
| | Add : Erection charges | 3,000 | |
| | | 25,000 | |
| | Less : Depreciation | 5,000 | 20,000 |

**Balance Sheet as on December, 31,2016**

| | | | |
|---|---|---|---|
| | Machinery | 20,000 | |
| | Less : Depreciation | 5,000 | |
| | | | 15,000 |

Balance Sheet as on December, 31,2017

| | | | |
|---|---|---|---|
| | Machinery | 15,000 | |
| | Less : Depreciation | 5,000 | |
| | | | 10,000 |

Balance Sheet as on December, 31,2018

| | | | |
|---|---|---|---|
| | Machinery | 10,000 | |
| | Less : Depreciation | 5,000 | |
| | | 5,000 | |
| | Less : Sale proceeds | 1,000 | |
| | | 4,000 | |
| | Less : Write off | 4,000 | |

In practice, the purchase and sale of an asset, is a continuous exercise. Hence, you should know how the calculation of depreciation will be made in such situations and the transactions recorded in the concerned asset account. Look at illustration 2 and study how the asset account appears in such situations.

**Illustration 2**

Arivind & Co. purchased a plant worth Rs. 2,00,000 on January 1, 2017. On June 30, 2017 an additional plant was bought for Rs. 50,000. On December 31, 2018 a part of the plant bought on January 1, 2017 costing Rs. 4,000 was sold for Rs. 3,000.

Prepare Plant and Machinery Account for years 2017 and 2018 providing depreciations at 10% per annum on fixed instalment method. The accounts are closed on December 31, every year.

**Solution:**

**Plant and Machinery Account**

Dr. Cr.

| | | | | | |
|---|---|---|---|---|---|
| 2017 | | Rs. | 2017 | | Rs. |
| Jan. 1 | To Bank A/c | 2,00,000 | Dec. 31 | By Depreciation A/c | 22,500 |
| Jan. 1 | To Bank A/c (erection charges) | 50,000 | “ 31 | By Balance c/d | 2,27,500 |
| | | 2,50,000 | | | 2,50,000 |
| 2018 | | | | | |
| Jan. 1 | To Balance b/d | 2,27,500 | 2018 | | |
| | | | Dec. 31 | By Bank A/c | 3,000 |
| | | | “ 31 | By Depreciation A/c | 25,000 |
| | | | | By P & L A/c | 200 |
| | | | | By Balance c/d | 1,99,300 |
| | | 2,27,500 | | | 2,27,500 |

**Working Notes:**

| | | Rs. |
|---|---|---|
| **1.** | **Depreciation for 2017** | |
| | On Rs. 2,00,000 for one year | 20,000 |
| | (10/10,00 of 2,00,000) | |
| | On Rs. 50,000 for six months | 2,500 |
| | (10/100 × 50,000 × 6/12) | |
| | | 22,500 |
| **2.** | **Depreciation for 2018** | |
| | On Rs. 2,50,000 for one year | |
| | (10/100 of 2,50,000) | 25,000 |
| **3.** | **Loss on Sale of Plant** | |
| | Depreciated value of plant sold | |
| | as on December 31, 2018 | |
| | (Rs. 4,000-Rs. 800) | 3,200 |
| | Less : Sale Proceeds | 3,000 |
| | Loss on Sale | |
| | | 200 |

**Advantages**

1. It is easily understandable and is simple to apply.

2. Amount of depreciation does not vary from year to year.

3. Under this method the book value of asset is reduced either to zero or scrap value as the case may be.

4. In this method deprecation charge spreads equally over the entire period of its anticipated working life. Therefore, it is considered particularly suitable for those assets which get depreciated more on account of lapse of time such as lease-holds, patents etc.

**Disadvantages**

1. It does not reflect the correct charge on account of depreciation when the effective utilisation of the asset varies from year to year.

2. It does not recognise the reality that as an asset becomes older, the amount spent for repairs and renewals goes on increasing. It is common knowledge that when the asset is brand new, repair bill would be either nil or very small. But, as the machine is progressively subjected to wear and tear, the repairs bill would increase considerably. Thus the combined charge on account of depreciation and repairs will not be uniform throughout the life of the asset. The increasing repairs bill unjustifiably burden the later years of asset life with heavier combined charges.

3. It does not take into account the loss of interest on the money invested in the asset. Certain other methods (annuity method) while calculating depreciation also take interest aspect into account.

## 8.8.2 Diminishing Balance Method

Under this method, though the rate of depreciation is fixed, it is calculated on the written down value of the asset. Consequently the amount of depreciation to be charged goes on reducing from year to year. For example, a machine was purchased on January 1, 2016 for Rs. 10,000. It is to be depreciated at 15% per annum under the diminishing balance method. In this case, the depreciation for 2016 would be Rs. 1,500 (15% of 10,000), for 2017 it would be Rs. 1,275 (15% of 8,500), and for 2018 it would work out as Rs. 1,084 (15% of 7,225). Thus you will notice that the annual depreciation goes on reducing. Hence, it is also known as 'reducing insta1met method'. This method is considered better than the fixed instalment method because with reducing instalments of depreciation the combined effect of repairs and depreciation will be more or less uniform throughout the life of the asset.

Look at illustration 3 and see how the amount of depreciation is computed every year and recorded in the concerned asset account.

**Illustration 3**

Kishore Ltd. purchased a tractor costing Rs. 1,00,000 on January 1, 2014. The rate of depreciation to be charged was fixed at 20% per annum. Write up Tractor Account for five years ending December 31, 2018, under diminishing balance method.

**Tractor Account**

Dr. Cr.

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | Rs. | 2014 | | Rs. |
| Jan. 1 | To Bank A/c | 1,00,000 | Dec. 31 | By Depreciation A/c | 20,000 |
| | | | Dec. 31 | By Balance c/d | 80,000 |
| | | 1,00,000 | | | 1,00,000 |
| 2015 | | | 2015 | | |
| Jan. 1 | To Bank A/c | 80,000 | Dec. 31 | By Depreciation A/c | 16,000 |
| | | | Dec. 31 | By Balance c/d | 64,000 |
| | | 80,000 | | | 80,000 |
| 2016 | | | 2016 | | |
| Jan. 1 | To Bank A/c | 64,000 | Dec. 31 | By Depreciation A/c | 12,800 |
| | | | Dec. 31 | By Balance c/d | 51,200 |
| | | 64,000 | | | 64,000 |
| 2017 | | | 2017 | | |
| Jan. 1 | To Bank A/c | 51,200 | Dec. 31 | By Depreciation A/c | 10,240 |
| | | | Dec. 31 | By Balance c/d | 40,960 |
| | | 51,200 | | | 51,200 |
| 2018 | | | 2018 | | |
| Jan. 1 | To Bank A/c | 40,960 | Dec. 31 | By Depreciation A/c | 8,192 |
| | | | Dec. 31 | By Balance c/d | 37,768 |
| | | 40,960 | | | 40,960 |

Now look at illustration 4. It deal with the situation when additions and disposals are made during the course of the year and a part of the asset is replaced.

**Illustration 4**



Harinath purchased on January 1, 2016, a plant for Rs. 50,000. On July 1, 2016 an additional plant worth Rs. 20,000 was purchased and on July 1. 2017, the plant purchased on January 1, 2016 having become obsolete is sold off for Rs. 20,000. On July 1, 2018, a new plant was purchased for Rs. 60,000 and the plant purchased on July 1, 2016 was sold for Rs. 15,000. Depreciation is to be provided at 10% p.a. on the written down value every year. Show the Plant Account.

**Plant Account**

Dr. Cr.

| | | | | | |
|---|---|---|---|---|---|
| 2016 | | Rs. | 2016 | | Rs. |
| Jan. 1 | To Bank A/c | 50,000 | Dec. 31 | By Depreciation A/c | 6,000 |
| Jan. 1 | To Bank A/c (erection charges) | 20,000 | " 31 | By Balance c/d | 64,000 |
| | | 70,000 | | | 70,000 |
| 2017 | | | 2017 | | |
| Jan. 1 | To Balance b/d | 64,000 | July, 1 | By Bank A/c | 20,000 |
| | | | Dec. 31 | By P & L A/c (loss on sale) | 22,750 |
| | | | Dec. 31 | By Depreciation A/c | 4,150 |
| | | | Dec. 31 | By Balance c/d | 17,100 |
| | | 64,000 | | | 64,000 |
| 2018 | | | 2018 | | |
| Jan. 1 | To Balance b/d | 17,100 | July, 1 | By Bank A/c | 15,000 |
| Jan. 1 | To Bank A/c | 60,000 | Dec. 31 | By P & L A/c (loss on sale) | 1,245 |
| | | | Dec. 31 | By Depreciation A/c | 3,855 |
| | | | Dec. 31 | By Balance c/d | 57,000 |
| | | 77,100 | | | 77,100 |

**Working Notes:**

**1. Depreciation for 2016**

| | Rs. |
|---|---|
| 10% on Rs. 50,000 for one year | 5,000 |
| 10% on Rs. 20,000 for six months | 1,000 |
| | 6,000 |

**2. Depreciation for 2017**

| | |
|---|---|
| 10% on Rs. 45,000 for six months (upto June 30, 2017) | 2,250 |
| 10% on Rs. 19,000 for one year | 1,900 |
| | 4,150 |

**3. Loss on plant sold on July 1, 2017**

| | |
|---|---|
| Depreciated value as on 2017 | |
| 50,000 — 5,000 — 2,250 | 42,750 |
| Less : Sale proceeds | 20,000 |
| Loss on sale | 22,750 |

**4. Depreciation for 2018**

| | |
|---|---|
| 10% on Rs. 17,100 for six months | 855 |
| 10% on Rs. 60,000 for six months | 3,000 |
| | 3,855 |

**5 . Loss on plant sold on July 1, 2018**

| | |
|---|---|
| Depreciated value as on 1.7.2018 | |
| 20,000 — 1,000 — 1,900 — 855 | 16,245 |
| Less: Sale proceeds | 15,000 |
| Loss on sale | 1,245 |

**Advantages**

This method is also simple to understand and easy to follow, though calculation of depreciation is slightly complicated. It ensures a fairly even charge to Profit and Loss Account on account of both depreciation and repairs. This is possible because the amount of depreciation decreases year after year while the charge for repairs goes n increasing year after year.

**Disadvantages**

One of the important limitations of this method is that the value of an asset cannot be brought down to zero. Hence, even after the asset is put out of use it may have certain book value. This method also does not take into account the loss of interest on the money invested in the asset. The determination of a suitable rate of depreciation is also difficult under this method. The formula generally used for this purpose is as follow:

$$\text{Rate of Depreciation} = 1 - n\sqrt{\frac{\text{Scrap Value}}{\text{Original Cost}}}$$

This looks quite complicated as compared to the fixed installment method. This method is considered suitable for assets like plant and machinery where the repairs are insignificant in earlier years but increase considerably in later years. It is popularly known as 'written down value method' because the depreciation is computed on the written down value every year. There are however, other methods of computing depreciation under the diminishing balance method such as 'sum of year digits method' and 'double declining balance method'. These are also called accelerated depreciation method, because under all these methods the amount of depreciation charged in earlier years is more compared to that of the later years.

### 8.8.3 Difference between Fixed Instalment Method and Diminishing Balance Method

The difference between the fixed instalment method and the diminishing balance method can be summarised as follows:

| Fixed Instalment Method | Diminishing Balance Method |
|---|---|
| 1. Depreciation is calculated on the original cost | Depreciation is calculated written down value |
| 2. Depreciation instalment is the same every year. | Depreciation instalment goes on reducing every year. |
| 3. The balance in the asset account will reduce to zero at the expiry of the working life of the reduce to zero. asset. | The balance in the asset account will never reduce to zero. |
| 4. The combined cost on account of depreciation and repairs is low during the initial years and high during later years. | The combined cost on account of depreciation and repairs is more or less equal throughout. |
| 5. Calculation of the rate of depreciation is easy. | Calculation of the rate of depreciation is difficult |
| 6. It is suitable for assets which get depreciated more on account of the expiry of time | It is suitable for assets which require heavy repairs in later years of their working life. |

**Check Your Progress B**

1. List the factors influencing the amount of depreciation.

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

2. Name various methods of computing depreciation.

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

3. State whether the following statements are True or False.

   i) Depreciation is a temporary change in the value of an asset.

   ii) While calculating depreciation, the scrap value (salvage value) must be taken into account.

   iii) Under fixed instalment method of providing depreciation the combined effect of repairs and depreciation is uniform over the year

iv) Under the diminishing balance method it would be possible to reduce the value of an asset to zero.

v) The interest involved in the investment on assets purchased is ignored under both the fixed instalment and the diminishing balance methods.

vi) When a Provision for Depreciation Account is maintained, the asset is shown at the original cost in the Balance Sheet

## 8.8.4 Change of Method

Sometimes a firm may decide to change the method of depreciation it had adopted i.e., it may change the method of depreciation from fixed instalment method to reducing instalment method or vice versa. If it decides to implement the change with prospective, effect, there is no problem because no adjustment is necessary in respect of depreciation charged in earlier years. All that is necessary is to charge depreciation from that year onwards according to the new method decided.

However, when it is decided to change the method with retrospective effect i.e., with effect from a prior date (usually from the date of acquisition of an asset) it would be necessary to adjust the depreciation charged till date. Suppose a firm was depreciating its machinery under the fixed instalment method during the past three years. It has now decided to change the method to written down value method with retrospective effect. In such a case it would be necessary to take the following steps:

1. Calculate the amount of depreciation already charged till the date of change according to old method.
2. Calculate the amount of depreciation that would have been charged under the new method now proposed to be adopted.
3. If the amount of depreciation under the new method is more than what was charged under the old method, such difference should be credited to the asset account in current year and debited to the Profit and Loss Account.
4. If, on the other hand, the amount of depreciation under the new method is less than what was charged under the old method such a difference should be debited to the asset account in current year and credited to the Profit and Loss Account.
5. As the difference in depreciation amount is adjusted to the current value of asset in the asset account, the asset account will appear at its new value, from the date of change and depreciation will be charged according to the new method in subsequent years.

Look at illustration 6. It will help you to clearly understand the procedure to be followed when a change of method is desired with retrospective effect.

**Illustration 5**

Sharat & Sons purchased a car for Rs. 1,00,000 on January 1, 2015. The car was depreciated at 10% under the written down value method. On January1, 2018 they wanted to change the method of depreciation from reducing instalment method to straight line method without & changing the rate. Show the asset account from 2015 to 2018.

**Solution:** 

**Car Account**

Dr. Cr.

| Date | Particulars | Rs. | Date | Particulars | Rs. |
|---|---|---|---|---|---|
| 2015 | | | 2015 | | |
| Jan. 1 | To Bank A/c | 1,00,000 | Dec. 31 | By Depreciation A/c | 10,000 |
| | | | Dec. 31 | By Balance c/d | 90,000 |
| | | 1,00,000 | | | 1,00,000 |
| 2016 | | | 2016 | | |
| Jan. 1 | To Bank A/c | 90,000 | Dec. 31 | By Depreciation A/c | 9,000 |
| | | | Dec. 31 | By Balance c/d | 81,000 |
| | | 90,000 | | | 90,000 |
| 2017 | | | 2017 | | |
| Jan. 1 | To Bank A/c | 81,000 | Dec. 31 | By Depreciation A/c | 8,100 |
| | | | Dec. 31 | By Balance c/d | 72,900 |
| | | 81,000 | | | 64,000 |
| 2018 | | | 2018 | | |
| Jan. 1 | To Bank A/c | 72,900 | Dec. 31 | By P & L A/c (diff.) | 2,900 |
| | | | Dec. 31 | By Depreciation A/c | 10,000 |
| | | | Dec. 31 | By Balance c/d | 60,000 |
| | | 72,900 | | | 72,900 |
| 2019 | | | | | |
| Jan. 1 | To Balance b/d | 60,000 | | | |

**Notes:** 1. If the firm had followed the fixed instalment method right from the beginning (1.1.2015), the value of car as on 1.1.2018 would be Rs. 70,000 worked out as follows:

| | Rs. |
|---|---|
| Original cost | 1,00,000 |
| Less: Depreciation for years at Rs. 10,000 p.a. (10% of 1,00,000) | 30,000 |
| Value of Car as on 1.1.2018 | 70,000 |

But from the Car Account you find that the opening balance on 1.1.2018 is Rs. 72,900. This means that under the written down value method the amount of depreciation charged during the three years was Rs. 27,100 (1,00,000 — 72,900) as against Rs. 30,000 required under the fixed instalment method. Hence. the difference between the two amounts i.e., Rs. 2,900 (30,000 — 27,100) must be charged as additional depreciation so as to adjust the asset account.

2 The depreciation to be charged for the year 2018 would be Rs. 10.000 i.e., 10% on Rs. 1,00,000 as required under the fixed instalment method. From this year onwards Rs. 10,000 will be charged as depreciation every year.

## 8.9 LET US SUM UP

Depreciation is a permanent and gradual diminution in the value of an asset caused by usage and effusion of time.

It represents the expired cost of a fixed asset which mist be charged to the Profit and Loss Account and deducted from the value of the asset concerned Unless it is so treated, the Profit and Loss Account will not show true profit or toss for the year and the Balance Sheet will not reflect the correct financial position. The amount of depreciation to be charged is determined by taking into account: (i) the cost of asset, (ii) the estimated useful life, and (iii) the estimated salvage value.

There are essentially two methods of recording the depreciation in books of a account (i) By maintaining a Provision for Depreciation Account, and (ii) Without maintaining a Provision for Depreciation Account.

When a provision for Depreciation Account is maintained the depreciation is credited to this account from year to year. Its accumulated balance is transferred to the asset account only at the end of the life of the asset or when the same is sold. But when provision for Depreciation Account-is not maintained, the depreciation is directly credited to the asset account every year. Of course, in the Balance Sheet the asset will always be shown at the depreciated value.

There are various methods of calculating the amount of depreciation. Of these, the two most common methods are : (i) fixed instalment method, and (ii) diminishing balance method, Under the fixed instalment method an equal amount is charged as depreciation year after year while under the diminishing balance method the amount of depreciation goes on reducing year after year. Both have their merits and demerits. But, the diminishing balance method is considered better because the combined cost on account of depreciation and repairs is uniformly distributed over the working life of an asset. Although the amount of depreciation under these two methods differ, the method of recording it in the books of account is the same.

Sometimes, a concern may decide to change the method of depreciation. If the change is to take effect from current years, it does not involve much problem. But if it is with retrospective effect, it would require the calculation of depreciation according to both the methods and the difference will have to be adjusted before the depreciation cap be charged according to changed method.

## 8.10 KEY WORDS

**Amortisation:** Writing off the expired cost of an intangible asset.

**Depreciation:** Permanent and gradual diminution in value of a fixed asset.

**Obsolescence:** Becoming out of date, a cause for depreciation in value of asset.

**Residual Value:** Expected realisable amount, when the asset is sold out at the end of its useful life.

**Salvage Value:** Same as residual or scrap value.

**Written Down Value:** Book value of an asset after deducting depreciation from the original cost. It is also called depreciated value.

## 8.11 SOME USEFUL BOOKS

Gupta R.L and M. Radhaswamy, 2018. Advanced Accountancy, Volume 1, Sultan Chand & Sons, New Delhi.

Maheshwari S.N., 2018. Introduction to Accounting, Vikas Publishing House: New Delhi.

Path, V.A. and J. S. Korlahalli, 2018. Principles and Practice of Accounting,

R. Chand & Co., New Delhi.

Shukla, M.C. and T.S. Grewal, 2018. Advanced Accounts, S. Chand & Co., New Delhi.

William Pickles, 1992. Accountancy, E . L. B .S. and Pitman, London.

## 8.12 ANSWERS TO CHECK YOUR PROGRESS

A 3. i) False ii) True iii) True iv) False v) False vi) False vii) False viii) True

B 3. i) False ii) True iii) False iv) False v) True vi) False.

## 8.13 TERMINAL QUESTIONS/EXERCISES

**Questions**

1. Define depreciation. Distinguish it from depletion, amortisation and obsolescence.

2. Explain the need and significance of depreciation. What factors should be considered for determining the amount of depreciation?

3. Enumerate the methods of calculating depreciation. Discuss the advantages and disadvantages of fixed instalment method.

4. What are the merits and demerits of written down value method? Distinguish it from the straight line method.

5. Describe the methods of recording depreciation in books of account. How is the balance of the Provisions for Depreciation Account shown in the Balance Sheet?

**Exercises**

1, A cold storage plant was purchased on July 1, 2016 for Rs. 1,00,000. Show the V plant Account under (a) the Straight Line Method and (b) the..Written Down Value Method. Rate of depreciation charged is 20%. What is the balance of plant at the end of the third year?

(Answer : Balance at the end of the third year (a) under Straight Line Method Rs. 40,000; and (b) under Written Down Value Method: Rs. 51,200).

2. Suresh purchased plant and machinery for Rs. 50,000 on July 1, 2014. The asset was to be depreciated at the rate of 10 per cent per annum on written down value basis. The machinery was sold on January 1, 2018 for Rs. 32,000. Write up Machinery Account assuming accounting year to end on December 31 every year.

   (**Answer:** Loss on sale Rs. 2,627)

3. On 1-8-2016, a machine was purchased by a manufacturing concern for Rs. 60,000 and it spent for its overhaul and installation Rs. 10,000. Its effective life was estimated to be ten years and residual value at the end of its life time was estimated to be Rs. 10,000. Show Machine Account for the first three years assuming that the concern decided to depreciate it under the fixed instalment method. The accounting year ends on December 31.

   (**Answer:** Balance of Machine Accounts as on January 1, 2019: Rs. 55,000)

4. Ashok Ltd has bought machinery for Rs. 1,00,000 including a boiler worth Rs. 10,000. The Machinery Account has been credited for depreciation on the written down value method for the past four years at the rate of 10%. During the fifth year the boiler became useless on account of damage to some of its vital parts; the damaged boiler is sold for Rs. 5,000. Write up the Machinery Account.

   (**Answer:** Loss on sale of machinery Rs. 1,561; Balance of Machinery Account as at the end of fifth year Rs. 59,049.)

5. Navrang & Co., whose accounting year is the calendar year, purchased machinery costing Rs. 60,000 on July 1, 2016. It purchased further machinery on September 1, 2016 costing Rs. 30,000. On January 1, 2018 one-third of the Machinery installed on June 1, 2016 became obsolete and was sold for Rs. 5,000. Depreciation is being written off on fixed instalment system, at 10% per annum. Prepare the machinery account as would appear in the ledger of the company for the years 2016, 2017 and 2018.

   (**Answer: B**alance of Machinery Account as on January 1, 2019 : Rs. 53,000).

6. On October 1, 2016 Raghavan & Sons purchased machinery for Rs. 30,000 and spent Rs. 3,000 on installing it. On January 1, 2017, the firm purchased another machinery for Rs. 20,000. On June 30, 2018 the machinery purchased on January 1, 2017 was sold for Rs. 16,000 and on the same date a fresh plant was installed at a cost of Rs. 25,000.

   The company writes off 10% depreciation on the diminishing balance method. The accounts are closed every year on December 31. Show the Machinery account for the years 2016, 2017 and 2018.

   (**Answer :** Balance of Machinery Account as on January 1, 2019: Rs. 39,950)

7. On July 1, 2015, a company purchased a plant for Rs. 2,00,000. Depreciation was provided at 10% per annum on straight line method on December 31, every year. With effect from January 1, 2017 the company decided to change the method of depreciation to diminishing balance method @ 15% per annum with retrospective effect. On July 1, 2018, the plant was sold for Rs. 1,20,000. Prepare Plant Account from 2015 to 2018).

   (**Answer :** Loss on sale of plant: Rs. 3,637.

8. Work out problem No. 7 assuming that (a) the asset was originally depreciated on written down value method at 20% and that (b) now it is desired to change the method to fixed instalment method with retrospective effect, rate of depreciation remaining same.

   (**Answer:** Profit on sale of plant Rs. 40,000).

| | |
|---|---|
| **Note** : | These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only. |

# UNIT 9 FINAL ACCOUNTS-I

## Structure



## 9.0 OBJECTIVES

After studying this unit, you will be able to:

- explain the purpose of preparing final accounts;
- prepare a trial balance from a given list of balances;
- prepare trading and profit and loss account;
- prepare balance sheet;
- prepare manufacturing account and calculate cost of goods produced; and
- present the final accounts in vertical form.

## 9.1 INTRODUCTION

You know that the final accounts are primarily prepared for ascertaining the operational result and the financial position of the business. They consist of (1) Profit and Loss Account, and (ii) Balance Sheet. The Profit and Loss Account reveals the profit earned or loss incurred (operational result) during the accounting year and the Balance Sheet indicates the financial position as at the end of the year. In this unit, you will learn about the basic framework of final accounts including their presentation in vertical form.

## 9.2 FINAL ACCOUNTS AND TRIAL BALANCE

You know final accounts are prepared with the help of a Trial Balance which shows all the ledger balances as at the end of an accounting period. Generally, when you are asked to prepare final accounts, you are given a properly prepared Trial Balance and you have no difficulty in identifying the items of incomes, expenses, assets, and liabilities. But, sometimes you may not be given a proper Trial Balance. You may simply be asked to prepare the final accounts from the list of closing balances extracted from the books of some firm. In such a situation, it will be helpful if you first prepare the Trial Balance and then the final accounts. Hence it is important that you should know how to prepare the Trial Balance from a given list of balances.

Normally when a Trial Balance is to be prepared, you have full details of ledger accounts with you. You can easily ascertain whether a particular account has a debit balance or a credit balance, and prepare the Trial Balance without any difficulty. The problem arises when you are given a list but it is not indicated whether the account has a debit balance or a credit balance. Under such a situation you will have to determine the nature of each balance before you prepare the Trial Balance. In this exercise, your knowledge of rules of debit and credit will help you. For example you know that in case of nominal accounts all expenses and losses are debited and all incomes and gains are credited. Similarly, you know the rules for real and personal accounts according to which the account of assets like cash, machinery debtors, etc. will show debit balances while accounts like capital, creditors, etc. will show credit balances. For convenience however, a few guidelines should help you. They are

a) All accounts of expenses (including purchases) and losses will be debit balances.

b) All accounts of Income (including sales) and gains will be credit balances.

c) All accounts of assets will be debit balances.

d) Allaccounts of liabilities will be credit balances.

e) Capital Account will normally be a credit balance.

f) Drawings Account will be a debit balance.

However, the problem may arise with regard to some items like rent, discount, commission and interest as they can be expenses as well as incomes. In such cases, the nature of the balance is usually indicated by mentioning (Dr.) or (Cr.) against each item, or the word 'received' or 'paid' is written after each item. This helps you to treat the item correctly. But, if there is only one item for which no such indication is given you can proceed with the preparation of Trial Balance and work out the totals of both the columns. You will find that the total of one column will be less than the other. This means that the unidentified balance pertains to the column which is short. For example, there is an item of commission of Rs. 300 appearing in the list of balances and it is not indicated whether it is paid or received. When you prepare the Trial Balance you will find that the debit total is short by Rs. 300. This would mean that the Commission Account has a debit balance. Now if you show it as such in the Trial Balance, it will tally.

Look at illustration 1 and see how the Trial Balance has been prepared from a given list of balances where the nature of each balance has not been indicated.

**Illustration 1**

Prepare a Trial Balance from the following balances extracted from the books of Sudhakaras on March 31, 2018.

| | Rs. | | Rs. |
|---|---|---|---|
| Opening Stock | 40,000 | Drawings | 10,000 |
| Purchases | 4,10,000 | Wages | 7,300 |
| Sales | 4,29,000 | Salaries | 11,000 |
| Purchases Returns | 1,250 | Outstanding Expenses | 1,000 |
| Sales Returns | 2,500 | Prepaid Expenses | 750 |
| Carriage Inwards | 1,500 | Postage | 900 |
| Carriage Outwards | 2,500 | Discount Received | 375 |
| Bank Overdraft | 21,000 | Discount Allowed | 1,000 |
| Cash | 4,000 | Bad Debts | 750 |
| Capital | 1,27,750 | Sundry Debtors | 1,00,000 |
| Sundry Creditors | 37,500 | Interest | 3,500 |
| Loans | 41,375 | Interest Received | 3 00 |
| Investments | 10,000 | Provision for Bad Debts | 1,750 |
| Accrued Income | 600 | Furniture & Fixture | 7,500 |
| Machinery | 47,500 | | |

**Solution:**

**Trial Balance to Sudhakar as on March 31, 2018**

| Particulars | Dr. Balances | Cr. Balances |
|---|---|---|
| | Rs. | Rs. |
| Opening Stock | 40,000 | |
| Purchases | 4,10,000 | |
| Sales | | 4,29,000 |
| Purchases Returns | | 1,250 |
| Sales Returns | 2,500 | |
| Carriage Inwards | 1,500 | |
| Carriage Outwards | 2,500 | |
| Bank Overdraft | | 21,000 |
| Cash | 4,000 | |
| Capital | | 1,27,750 |
| Sundry Creditors | | 37,500 |
| Loans | | 41,375 |
| Investments | 10,000 | |
| Accrued Income | 600 | |
| Machinery | 47,500 | |
| Drawings | 10,000 | |
| Wages | 7,300 | |

| | | |
|---|---|---|
| Salaries | 11,000 | |
| Outstanding Expenses | | 1,000 |
| Prepaid Expenses | 750 | |
| Postage | 900 | |
| Discount Received | | 375 |
| Discount Allowed | 1,000 | |
| Bed Debts | 750 | |
| Sundry Debtors | 1,00,000 | |
| Interest | 3,500 | |
| Interest Received | | 300 |
| Provision for Bad Debts | | 1,750 |
| Furniture & Fixture | 7,500 | |
| Total | 6,61,300 | 6,61,300 |

In illustration 1, the Trial Balance has tallied i.e, the total of debit balances column is equal to the total of credit balances column. This would mean that each balance has been entered in the appropriate amount column of the Trial Balance. This is not always true. It is quite possible that even when the Trial Balance has tallied, some balances may not have been entered in the correct columns. Look at illustration 2. You will find that the Trial Balance has tallied (the totals of both Dr. balancesand Cr. balances is the same i.e., Rs. 91,650 but there are a number of items which have been shown in the wrong columns. For example, bank overdraft which should have been shown in the Cr. balances column has been included in the Dr. balancescolumn and Furniture which should have appeared in Dr...balancescolumn has been shown in the Cr. balances column. So, the Trial Balance has been rewritten and all items shown correctly. Such situation arises on account of the compensating effect of the errors which is very rare.

**Illustration 2**

An inexperienced accountant provides you with the following Trial Balance. In case you find it to be incorrect,1 prepare it again so as to remove its defects.

Trial Balance as on June 30, 2018

| **Name of Account** | **L.F.** | **Dr. Balances** | **Cr. Balances** |
|---|---|---|---|
| Stock (Opening) | | Rs. | Rs. |
| Buildings Bills | | 10,500 | |
| Payable Bank | | 31,500 | |
| Overdraft | | 1,800 | |
| Capital | | 1,500 | |
| Furniture | | | 45,000 |
| Discount Allowed | | | 12,000 |
| Sales | | 90 | |
| Loan from Suresh | | 39,000 | |

| | | | |
|---|---|---|---|
| Carriage Inwards | | 2,400 | |
| Bills Receivable | | 270 | 3,000 |
| Purchases | | | 24,000 |
| Salaries | | | 3,300 |
| Investments | | 3,000 | |
| Interest on Investments | | | 1,650 |
| Returns Inwards | | 900 | |
| Returns Outwards | | 300 | |
| Insurance Premium | | 360 | |
| Interest on Loan | | 30 | |
| Advertisement | | | 1,200 |
| Drawings | | | 1,500 |
| Total | | 91,650 | 91,650 |

**Solution:**

**Revised Trial Balance as on June 30, 2018**

| Name of Account | L.F. | Dr. Balances | Cr. Balances |
|---|---|---|---|
| | | Rs. | Rs. |
| Stock (opening) | | 10,500 | |
| Buildings | | 31,500 | |
| Bills Payable | | | 1,800 |
| Bank Overdraft | | | 1,500 |
| Capital | | | 45,000 |
| Furniture | | 12,000 | |
| Discount Allowed | | 90 | |
| Sales | | | 39,000 |
| Loan from Suresh | | | 2,400 |
| Carriage Inwards | | 270 | |
| Bills Receivable | | 3,000 | |
| Purchases | | 24,000 | |
| Salaries | | 3,300 | |
| Investments | | 3,000 | |
| Interest on investments | | | 1,650 |
| Returns Inwards | | 900 | |
| Returns Outwards | | | 300 |
| Insurance Premium | | 360 | |
| Interest on Loan | | 30 | |
| Advertisement | | 1,200 | |
| Drawings | | 1,500 | |
| | | 91,650 | 91,650 |

**Check Your Progress A**

1) Mention against each item whether it will generally show a debit balance or a credit balance.

| Items | | Nature of Balance Debit or Credit |
|---|---|---|
| i) | Sales Returns | .............................. |
| ii) | Carriage Inwards | .............................. |
| iii) | Carriage Outwards | .............................. |
| iv) | Capital | .............................. |
| v) | Loss by fire | .............................. |
| vi) | Overdraft | .............................. |
| vii) | Drawings | .............................. |
| viii) | Returns Outwards | .............................. |
| ix) | Bills Receivable | .............................. |
| x) | Goodwill | .............................. |
| xi) | Rent Paid | .............................. |
| xii) | Commission Received in Advance | .............................. |

## 9.3 TRADING AND PROFIT AND LOSS ACCOUNT

You know the Profit and Loss Account is prepared for ascertaining the profit or loss of the business. This is worked out in two stages. In the first stage, we work out the gross profit or gross loss and in the second stage, the net profit or net loss. Hence, the profit and Loss Account is divided into two sections. The first section is called Trading Account. It reveals the gross profit or gross loss. The second section is called Profit and Loss Account which shows the net profit or net loss.

### 9.3.1 Trading Account

As stated above, the Trading Account is prepared for ascertaining the gross profit or gross loss. The gross profit is defined as the excess of sales revenue over cost of goods sold. This can be presented in the form of an equation as follows.

Gross Profit = Net Sales — Cost of Goods sold

Where i) Net Sales = Total Sales — Sales Returns

ii) Cost of Goods Sold = Opening Stock + Net Purchases + Direct Expenses — Closing Stock

You know the terms 'Opening Stock' and 'Closing Stock' refer to the value of unsold goods as at the beginning of the year and at the end of the year respectively. Such stock may also include the semi-finished goods and raw materials. In order to arrive at the cost of goods sold. the opening stock is added to the net purchases while the closing stock is deducted. The term 'Direct Expenses' refer to those expenses which are incurred on the goods purchased till they are brought to the place of business for sale These include expenses such as freight, insurance, import duty, dock dues, clearing charges, octroi duty, carriage, cartage, etc. The administrative expenses, selling and distribution expenses, interest paid, etc. are termed as indirect expenses and therefore, are excluded from the cost of goods sold.

Look at illustrations 3 and 4 and study how Cost of Goods Sold and the Gross Profit are computed.

**Illustration 3**

The following figures have been extracted from the books of a firm. Calculate the Cost of Goods Sold.

| | Rs. |
|---|---|
| Stock as on 1.1.2018 | 1,00,000 |
| Purchases for 2018 | 15,00,000 |
| Purchases Returns | 40,000 |
| Carriage Inwards | 20,000 |
| Octroi | 80,000 |
| Freight | 15,000 |
| Stock as on 31.12.2018 | 1,70,000 |

**Solution:**

| | |
|---|---|
| Opening Stock | 1,00,000 |
| Add: Net Purchases | |
| (Purchases Rs. 15,00,000 | |
| Purchases Returns Rs. 40,000) | 14,60,000 |
| Carriage Inwards | 20,000 |
| Octroi | 80,000 |
| Freight | 15,000 |
| | 16,75,000 |
| Less: Closing Stock | 1,70,000 |
| Cost of Goods Sold | 15,05,000 |

**Illustration 4**

On January 1, 2018 a firm had stock of goods valued at Rs. 20,000. During the year the following transactions took place.

| | Rs. |
|---|---|
| Sales | 5,00,000 |
| Purchases | 3,00,000 |
| Carriage Inwards | 3,000 |
| Freight Inwards | 5,000 |
| Sales Returns | 10,000 |
| Clearing charges | 22,000 |
| Purchases Returns | 5,000 |

The closing stock of goods on December 31, 2018 is Rs. 40,000.

**Solution:**

| | Rs. | Rs. |
|---|---|---|
| Sa1e | 5,00,000 | |
| Less: Sales Returns | 10,000 | |
| Net Sales | | 4,90,000 |
| Less: Cost of Goods Sold | | |
| Opening Stock | 20,000 | |
| Add: Purchases | 3,00,000 | |
| | 3,20,000 | |
| Less: Purchases Return | 5,000 | |
| | 3,15,000 | |
| Add: | | |
| Carnage Inwards | 3,000 | |
| Freight Inwards | 5,000 | |
| Clearing Charges | 22,000 | |
| | 3,45,000 | |
| Less: Closing Stock | 40,000 | |
| | | 3,05,000 |
| Gross Profit | | 1,85,000 |

**Form of Trading Account :**The Equation for Gross Profit is also known as Trading Account Equation. This equation forms the basis of preparing the Trading Account. The Trading Account, like any other account in the ledger, has two sides—debit and credit. The opening stock,purchases (less returns) and all direct expenses are shown on the debit side of the Trading Account while sales (less returns) and the closing stock on the credit side. The gross profit appears as the last item on the debit side which, in fact is the excess of the total of credit side over the total of debit side. If however, the total of the debit side exceeds the total of the credit side, it will be treated as gross loss. This is shown as the last item on the debit side of the Trading Account. The gross profit/gross loss thus worked out is transferred to the Profit and Loss Account. Look at the Figure 9.1 for the form of Trading Account.

**Fig. 9.1**
**Form of Trading Account**

**Trading Account of**
**(Day, Month and Year)**

Dr. Cr.

| Particulars | Amount | Amount | Particulars | Amount | Amount |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| To Opening Stock | | ..... | By Sales | ..... | |
| To Purchases | ..... | | Less: Sales Returns | ..... | |
| Less Purchases Returns | ..... | ..... | | | |
| To Direct Expenses (specify individually) | | ..... | By closing Stock | | ..... |
| To Gross Profit | | | | | |
| (Transferred to Profit | | ..... | | | |
| and Loss Account) | | ..... | | | ..... |

Based on the data given in illustration 4, the Trading Account will be prepared as follows.

**Trading Account of . ... .**

**for the year ending December 31, 2018**

Dr. Cr.

| Particulars | Amount | Amount | Particulars | Amount | Amount |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| To Opening Stock | | 20,000 | By Sales | 5,00,000 | Rs. |
| To Purchases | 3,00,000 | | Less: Returns | 10,000 | 4,90,000 |
| Less: Returns | 5,000 | 2,95,000 | | | |
| To Carriage Inwards | | 3,000 | By Closing Stock | | 40,000 |
| To Freight | | 5,000 | | | |
| To Clearing Charges | | 22,000 | | | |
| To Gross Profit | | 1,85,000 | | | |
| (Transferred to (P&L A/c) | | | | | |
| | | 5,30,000 | | | 5,30,000 |

**Some Important Points**

1. **Purchases :** This item refers to the goods purchased for resale and includes both cash and credit purchases. The purchases of assets which are meant for permanent use in business such as machinery furniture, etc., are not included in the purchases. The amount taken to Trading Account will be the net amount of purchases (after deducting purchase returns/returns outwards.) If the proprietor has taken away some goods from the business for his personal use, the same should also be deducted from the total purchases.

2. **Sales:** It includes both cash and credit salesof goods and refers to the net amount of sales (after deducting sales returns-returns inwards). Sales of old furniture, car, machinery, etc. are not included in the sales. Similarly, sales of old newspapers etc. are also excluded from sales. Such items are shown as miscellaneous income in the Profit and Loss Account.

3. **Wages:** Wages are usually treated as a direct expense and so shown in the Trading Account. The difficulty arises when wages are clubbed with salaries (an indirect expense) and the Trial Balance includes a single amount for 'Wages and Salaries'. In such a situation, the amount may be shown in the Trading Account. It is based on the assumption that the item includes the salaries of the supervisory staff in the factory itself. But, if the item in the Trial Balance reads 'Salaries and Wages' it will be taken to the Profit and Loss Account on the assumption that the item includes wages of the office staff only. It should be noted that wages paid in connection with the purchases of fixed assets or the construction of building should not be charged to Trading Account. They are to be included in the cost of the concerned fixed asset. There is another important aspect in relation to wages which must be clarified. If a Manufacturing Account is prepared the wages paid to the factory labour is debited to Manufacturing Account about which you will learn later in this unit.

4. **Freight, Carriage and Cartage:** When paid in connection with purchases of goods, they are shown in the Trading Account. Such freight and carriage are also termed as 'Freight Inwards' and 'Carriage Inwards' respectively. 'Freight Outwards' and 'Carriage Outwards' relate to sales and therefore taken to the debit of Profit and Loss Account.

5. **Royalties:** Royalties refer to the payments made for the use of copyright or a patent. The amount of royalty is generally based on the quantity produced. It is, therefore, treated as a direct expense and charged to Trading Account. But if it is calculated on the basis of quantity sold as in case of books, it is shown in the Profit and Loss Account. Royalties are also paid to the Government for extraction of minerals such as coal, diamond, gold, etc. These are charged to the Profit and Loss Account of the mining companies. You will learn about the accounting of such royalties later under a separate course.

### 9.3.2 Profit and Loss Account

After ascertaining the gross profit by preparing the Trading Account, the businessman proceeds to prepare the Profit and Loss Account in order to work out the net profit/ net loss. You know the net profit is the excess of gross profit and other incomes over the indirect expenses and losses. So, while preparing the Profit and Loss Account, we show gross profit and other incomes such as rent received, discount received, commission received, interest and dividends etc. on the credit side, and all indirect expenses and losses on the debit side. Indirect expenses include all administrative, selling and distribution expenses such as salaries, rent and taxes, postage and stationery, insurance, depreciation, interest paid, office lighting, advertising, packing carriage outwards, etc., while losses refer to items like loss by fire, loss by theft etc. The difference between the two sides of the Profit and Loss Account represent either the net profit or net loss. If the total of the credit side is higher than the total of the debit side, the difference is called net profit and if the debit side total exceeds the credit side total, the difference is called net loss. The net profit/net loss belongs to the proprietor and it is therefore transferred to his Capital Account. Look at figure 9.2. It shows various expenses, losses, incomes, etc., which usually appear in the Profit and Loss Account

**Fig. 9.2**

**Profit and Loss Account …………………..**

**for the period ended …………………**

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

| **Particulars** | **Amount** | **Particulars** | **Amount** |
|---|---|---|---|
| | **Rs.** | | **Rs.** |
| To Gross Loss, if any, (Transferred from Trading Account) | | By Gross Profit, if any (Transferred from Trading Account) | |
| To Salaries | | By Interest Received | |
| To Rent, Rates and Taxes | | By Discount Received | |
| To Postage and Telegrams | | By Rent Received | |
| To Telephone Charges | | By Commission Received | |
| To Printing and Stationery | | By Dividend Received | |

| | | | |
|---|---|---|---|
| To Legal Expenses | | By Other Incomes and Gains | |
| To Insurance | | By Net Loss (Transferred to Capital Account) | |
| To Office Lighting | | | |
| To Bad Debts | | | |
| To Depreciation | | | |
| To Advertising | | | |
| To Travelling Expenses | | | |
| To Carriage Outwards | | | |
| To Trade Expenses | | | |
| To Discount Allowed | | | |
| To Interest Paid | | | |
| To Repairs and Renewals | | | |
| To Loss by Fire | | | |
| To Loss by Theft | | | |
| To Other Expenses and Losses, if any | | | |
| To Net Profit (Transferred to Capital Account) | | | |

**Notes:**

1. The heading for the Profit and Loss Account, as in the case of the Trading Account, indicates the name of the business or proprietor and the period for which it is being prepared.

2. In addition to the items shown in the above form, there are certain items such as depreciation, bad debts, provision for doubtful debts, interest on capital, interest on drawings, etc., which appear in the Profit and Loss Account as a result of the adjustment entries. We shall discuss them in Unit 10.

**Some Important Points**

1. **Rent, Rates and Taxes:** These are charges levied by the municipal bodies on the house property. It is a common item of indirect expenses debited to the Profit and Loss Account.

2. **Insurance:** Generally, assets are insured to cover the risk of loss, say, by fire. Premium paid to the insurance company should be treated as a business expense. When assets such as factory building, factory machinery, etc. are insured, the insurance premium should be debited to Trading Account. If on the other hand, the premium is paid for insurance of assets in the office building, office furniture, etc., it should be charged to Profit and Loss Account.

3. **Bad Debts:** Bad debts denote the amount which could not be recovered from the debtors to whom the goods were sold on credit. It is a loss and so debited to the Profit and Loss Account. You will learn more about their treatment in Unit 9.

4. **Depreciation:** Depreciation means decrease in the value of fixed assets due to normal wear and tear. You know that every fixed asset such as machinery, furniture, vehicle, etc. depreciates in value on account of its constant use. Such reduction in their value is a loss to the business and so charged to the Profit and Loss Account. If, however, a Manufacturing Account is also prepared, depreciation on machinery and factory building is charged to the Manufacturing

Account, while depreciation on office building, office furniture, office equipment, etc. is charged to the Profit and Loss Account.

5. **Trade Expenses:** This item represents various small expenses incurred in the business. They are also called General Expenses, Sundry Expenses or Miscellaneous Expenses.

6. **Packing:**The cost of packing materials such as polythene bags, wrapping materials, etc. for delivery is a distribution expense and hence charged to Profit and Loss Account. Where packing is essential to make the products fit for sale in the market as in the case of cigarettes, biscuits, medicines, oil, etc. it is called ‘packaging’ and such expenditure is charged to the Trading Account.

7. **Samples:** Generally, samples of goods are distributed free of charge to increase sales. The cost of such samples should be treated as a selling expense and so debited to Profit and Loss Account.

8. **Income Tax:** It is the tax payable by a person on his income. In the case of a sole trading concern, the tax paid by the proprietor on the profits of the business is treated as a personal expense. Hence, it should be added to drawings or directly deducted from capital.

**Illustration 5**

Prepare Profit and Loss Account from the following balance extracted from,the books of a business for the year 2018.

| | Rs. |
|---|---|
| Gross Profit | 1,85,000 |
| Salaries | 20,000 |
| Rent and Rates | 5,000 |
| Stationery | 1,000 |
| Postage | 500 |
| Insurance | 2,000 |
| Repairs | 1,500 |
| Depreciation | 5,000 |
| Advertisement | 5,000 |
| Discount (Dr.) | 500 |
| Commission of Salesmen | 5,000 |
| Bad Debts | 2,000 |
| Loss by Fire | 2,000 |
| Interest on Investments | 2,500 |
| Profit on sale of Investments | 2,000 |

**Solution:**

**Profit and Loss Account of …………..…**
**for the year ending December 31, 2018**

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

| **Particulars** | **Amount** | **Particulars** | **Amount** |
|---|---|---|---|
| | **Rs.** | | **Rs.** |
| To Salaries | 20,000 | By Gross Profit | 1,85,000 |
| To Rent and Rates | 5,000 | (Transferred from | |
| To Stationery | 1,000 | Trading A/c) | |

| | | | |
|---|---|---|---|
| To Postage | 500 | By Interest on Investments | 2,500 |
| To Insurance | 2,000 | By Profit on Sale of | |
| To Repairs | 1,500 | Investments | 2,000 |
| To Depreciation | 5,000 | | |
| To Advertisement | 5,000 | | |
| To Discount | 500 | | |
| To Commission to Salesmen | 5,000 | | |
| To Bad Debts | 2,000 | | |
| To Loss by Fire | 2,000 | | |
| To Net Profit | | | |
| (Transferred to | | | |
| Capital Account) | 1,40,000 | | |
| | 1,89,500 | | 1,89,500 |

In Practice, the Trading Account and the Profit and Loss Account are combined and one account called 'Trading and Profit and Loss Account' is prepared. This account is divided into two parts. The first part shows the Gross Profit and the second part shows the Net Profit.

Look at illustration 6 and see how combined Trading and Profit and Loss Account will be prepared.

**Illustration 6**

From the following figures, prepare Trading and Profit and Loss Account of Lakshmi & Co. for the year ended December 31, 2018.

| | Rs. |
|---|---|
| Stock on January 1, 2018 | 40,000 |
| Purchases | 98,000 |
| Commission Received | 650 |
| Rent, Rates and Taxes | 8,600 |
| Salaries & Wages | 12,000 |
| Sales | 1,62,100 |
| Returns Inwards | 2,400 |
| Returns Outwards | 3,000 |
| Sundry Expenses | 2,500 |
| Bank Charges | 50 |
| Discount Received | 750 |
| Carriage on Purchases | 2,000 |
| Discount Allowed | 530 |
| Carriage on Sales | 1,700 |
| Lighting and Heating | 2,200 |
| Postage | 300 |
| Income from Investments | 500 |
| Commission Paid | 1,000 |
| Interest paid on a bank loan | 550 |

The stock on December 31, 2018 was valued at Rs. 26,000

**Solution:**

**Trading and Profit & Loss Account of Lakshmi & Co.**
**for the year ended December 31, 2018**

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

| Particulars | | Amount | Particulars | | Amount |
|---|---|---|---|---|---|
| To Opening Stock | | 40,000 | By Sales | 1,62,100 | |
| To Purchases | 98,000 | | Less: Returns | 2,400 | 1,59,700 |
| Less: Returns | 3,000 | 95,000 | By closing Stock | | 26,000 |
| To Carriage on Purchase | | 2,000 | | | |
| To Gross Profit c/d | | 48,700 | | | |
| | | 1,85,700 | | | 1,85,700 |
| To Rent. Rates and Taxes | | 8,600 | By Gross Profit b/d | | 48,700 |
| To Salaries and Wages | | 12,000 | By Commission Received | | 650 |
| To Sundry Expenses | | 2,500 | By Discount received | | 750 |
| To Bank Charges | | 50 | By Income from Investments | | 500 |
| To Discount Allowed | | 530 | | | |
| To Carriage on Sales | | 1,700 | | | |
| To Postage | | 300 | | | |
| To Commission Paid | | 1,000 | | | |
| To Interest paid on loan | | 550 | | | |
| To Lighting & Heating | | 2,200 | | | |
| To Net Profit | | 21,170 | | | |
| | | 50,600 | | | 50,600 |

## 9.3.3 Closing Entries

You learnt that all nominal accounts which represent items of expenses and incomes are closed at the end of the accounting year by transfer to either the Trading Account or the Profit and Loss Account. The journal entries passed for such transfer are called closing entries. You also know that accounts relating to expenses and losses always show debit balances while those representing incomes show credit balances. In order to close an account which shows a debit balance and is to be transferred to the Trading Account we credit the account concerned with an amount equal to its balance and debit the Trading Account, For example, the Carriage Inwards Account Shows a debit balance of Rs. 6,000. The closing entry for this will be as follows:

| | | Rs. | Rs. |
|---|---|---|---|
| Trading A/c | Dr. | 6,000 | |
| To Carriage Inwards A/c | | | 6,000 |

Similarly, an account which shows a credit balance, will be closed by debiting it with an amount equal to the balance and crediting the Trading Account or Profit and Loss Account, as the case may be. The closing entries are passed in the Journal Proper and it is necessary to pass such entries for preparing the Trading and Profit and Loss Account. The entries required for the items which are to be transferred to the Trading Account are as follows:

1. Trading Account Dr.
   To Stock Account (opening)
   To Purchases Account
   To Sales Returns Account
   To Direct Expenses Accounts (to be credited individually)

2. Sales Account Dr.
   Purchases Returns Account Dr.
   Stock Account (closing) Dr.
   To Trading Account
   Trading Account
   To Profit and Loss Account
   (for Gross Profit)

**Note:** If there is gross loss, the closing entry will be just the reverse of the above.

When the closing entry is passed for gross profit or gross loss, the Trading Account stands closed.

The entries required for items to be transferred to the Profit and Loss Account are as follows:

1. Profit and Loss Account Dr.
   To Expenses/Losses Accounts
   (to be credited individually)

2. Incomes/Gains Accounts Dr.
   (to be debited individually)
   To Profit and Loss Account

3. Profit and Loss Account Dr.
   To Capital Account
   (for Net Profit)

**Note:** If there is net loss, the closing entry will be just the reverse of the above.

Let us see how closing entries for the items given in illustration 4 will be passed. These are as follows:

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| | **Name of Account** | **L.F.** | **Dr. Balances** | **Cr. Balances** |
|---|---|---|---|---|
| 2018 | | | Rs. | Rs. |
| Dec. 31 | Trading A/c Dr. | | 1,42,400 | |
| | To Opening Stock A/c | | | 40,000 |
| | To Purchase A/c | | | 98,000 |
| | To Sales Returns A/c | | | 2,400 |
| | To Carnage Inwards A/c | | | 2,000 |
| | (Being closing entry) | | | |
| Dec. 31 | Sales Ac Dr. | | 1,62,100 | |
| | Purchases Returns A/c Dr. | | 3,000 | |
| | Closing Stock A/c Dr. | | 26,000 | |
| | To Trading A/c | | | 1,91,100 |
| | (Being closing entry) | | | |

| | | | | |
|---|---|---|---|---|
| Dec. 31 | Trading A/c Dr.<br>To Profit and Loss A/c<br>(Being transfer of gross profit) | | 48,700 | <br>48,700 |
| Dec. 31 | Profit and Loss A/c Dr.<br>To Rent, Rates & Taxes A/c<br>To Salaries &Wages A/c<br>To Sundry Expenses A/c<br>To Bank Charges A/c<br>To Discount Allowed A/c<br>To Carriage Outwards A/c<br>To Postage A/c<br>To Commission Paid A/c<br>To Interest Paid A/c<br>To Lighting &Heating A/c<br>(Being closing entry) | | 29,430 | <br>8,600<br>12,000<br>2,500<br>50<br>530<br>1,700<br>300<br>1,000<br>550<br>2,200 |
| Dec. 31 | Commission Received A/c Dr.<br>Discount Received A/c Dr.<br>Income from Inv. A/c Dr.<br>To Profit and Loss A/c<br>(Being closing entry) | | 650<br>750<br>1,500 | <br><br><br>2,900 |
| Dec. 31 | Profit and Loss A/c Dr.<br>To Capital A/c<br>(Being transfer from NP) | | 21,170 | <br>21,170 |

**Check Your Progress B**

1. Distinguish between Direct and Indirect Expenses.

   ........................................................................................................

   ........................................................................................................

   ........................................................................................................

2. What is the purpose of preparing a Trading Account?

   ........................................................................................................

   ........................................................................................................

   ........................................................................................................

   ........................................................................................................

3. State whether the following statements are **True** or **False.**

   i) The gross profit is the difference of total sales and credit sales ………………………………………..………….

   ii) Direct expenses are those expenses which are directly attributable to purchase of goods for resale …………………… ……….

   iii) Stock is valued at cost or market price whichever is lower …….. ..........……….

iv) The net profit is the excess of gross profit and other incomes over the indirectexpenses and losses …… …….……………..………….

v) Income tax paid in case of a proprietary x concernischarged to Profitand Loss Account ……………………..………..….

vi) Trade Expensesarecharged to Trading Account ……………………..…

4 Fill in the blanks:

i) CarriageOutwardsisan example of ……………. expenses.

ii) Cost of goods sold is equal to opening stock plus ………less .......... .

iii) Cost of samples distributed free of cost are treated as …………expenses.

iv) All direct expenses are debited to …………….Account.

v) Loss on Account of theft is ……………… to Profit and Loss Account.

vi) Wages and salaries are charged to………….. ….…………..

5 Ascertain the cost of goods sold from the following data:

| | Rs. |
|---|---|
| Direct Expenses | 8,000 |
| Opening Stock | 12,000 |
| Purchases | 80,000 |
| Interest Paid | 500 |
| Closing Stock | 10,000 |

## 9.4 BALANCE SHEET

After ascertaining the net profit or net loss by preparing the Trading and Profit and Loss Account, the final step in preparing final accounts is the preparation of Balance Sheet. The purpose of Balance Sheet is to ascertain the financial position of a business i.e., to know what the business owes and what it owns on a certain date. Hence it shows all assets and liabilities of the business as at the end of the accounting year.

You know that final accounts are prepared from the Trial Balance. All items of expense and income appearing in Trial Balance are transferred to the Trading and Profit and Loss Account. The remaining items which represent the balances of personal and real accounts are shown in the Balance Sheet. The accounts showing debit balances represent assets and those showing credit balances represent liabilities.

Look at Figure 9.3 and note how various assets and liabilities appear in the Balance Sheet.

**Table 9:3 : Balance Sheet of ………..**
**as on ……………..**

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

| **Liabilities** | **Amount** | **Assets** | **Amount** . |
|---|---|---|---|
| **Current Liabilities** | Rs. | **Current Assets** | Rs. |
| Bank Overdraft | ……… | Cash in hand | ……… |
| Bills Payable | ……… | Bills Receivable | ……… |
| Sundry Creditors | ……… | Cash at bank | ……… |

| | | | |
|---|---|---|---|
| | | Sundry Debtors | ……… |
| **Long-term Liabilities** | | Closing Stock | ……… |
| Loan | ……… | **Investments and** | |
| Mortgages | ……… | **Fixed Assets** | |
| Capital Balance ..... | | Vehicles | ……… |
| Add: Net Profit ..... | | Furniture | ……… |
| | | Plant & Machinery | ……… |
| Less: Drawings ..... | ……… | Land & Buildings | ……… |
| | | Goodwill | ……… |
| | ……… | | ……… |

You should know that the Balance Sheet is prepared to ascertain the financial position at a particular point of time and not for a period. Hence the heading of the Balance Sheet will always read 'Balance Sheet as on ……….'(usually last date of the accounting year).

The total of assets should always be equal to the total of liabilities. If however, they do not tally, it would mean that some errors have been committed while preparing the final accounts. You must recheck the treatment of all items including the arithmetical aspect, and make the corrections where necessary so that the Balance Sheet tallies.

**Assets:** The term 'assets' denote the economic resources (property) of the business and includes all current and fixed assets. You know current assets are those assets which are likely to be realised within a period of one year (or during the normal operating cycle) and includes cash, stock, debtors, bills receivable, short-term investments, etc. The fixed assets, on the other hand, are those assets which are acquired for use in the business over a long period. They may be tangible like machinery and furniture, or intangible like goodwill, patents, etc. The assets also include certain expenses and losses which have not been written off in full. Examples of such expenses are: formation expenses, expenses incurred on issue of shares and debentures, unwritten amount of expenditure on advertising, etc. These are shown as the last item under 'Assets' in the Balance Sheet.

**Liabilities:** The term 'liabilities' denote all claims against the assets of the business whether those of the outsiders (creditors) or those of the owners of the business. The outsider's claim may be sub-divided into (i) current liabilities, and (ii) long-term liabilities. These are shown separately in the Balance Sheet (see Figure 9.3). The current liabilities are those obligation which are likely to be met within one year (or during the normal operating cycle). The long-term liabilities refer to item like loans which are not to be paid in the near future. The owner's claim is shown as capital after adjusting it with the amount of net profit and drawings during the year.

Look at illustration 7 and see how Balance Sheet is prepared from given list of balances.

**Illustration 7**

From the following balances extracted from the books of Deepak Brothers, prepare Balance Sheet as on December 31, 2018.

| | Rs. | | Rs. |
|---|---|---|---|
| Capital | 12,00,000 | Bills Payable | 40,000 |
| Net Profit for 2018 | 6,00,000 | Debtors | 2,50,000 |

| | | | |
|---|---|---|---|
| Land & Buildings | 7,00,000 | Bills Receivable | 50,000 |
| | | Loan | 1,60,000 |
| Plant & Machinery (after depreciation) | 4,00,000 | Bank Overdraft | 20,000 |
| | | Cash in hand | 60,000 |
| Furniture (afterdepreciation) | 50,000 | Loose Tools | 50,000 |
| Investment | 3,50,000 | Goodwill | 1,00,000 |
| Creditors | 2,00,000 | Closing stock | 1,85,000 |
| Trade marks | 25,000 | | |

**Solution:**

**Balance Sheet of Deepak Brothers as on December 31, 2018**

| Liabilities | | Amount | Assets | Amount |
|---|---|---|---|---|
| **Current Liabilities** | | **Rs.** | **Current Assets** | **Rs,** |
| Bank Overdraft | | 20,000 | Cash in Hand | 60,000 |
| Bills Payable | | 40,000 | Bills Receivable | 50,000 |
| Sundry Creditors | | 2,00,000 | Sundry Debtors | 2,50,000 |
| | | | Stock in Hand | 1,85,000 |
| | | | Investments | 3,50,000 |
| **Long-term Liabilities** | | | | |
| Loan | | 1,60,000 | | |
| **Capital** | | | **Fixed Assets** | |
| Balance as on | | | Loose Tools | 50,000 |
| Jan. 1, 2018 | 12,00,000 | | Furniture | 50,000 |
| Add: Net Profit | 6,00,000 | 18,00,000 | Plant & Machinery | 4,00,000 |
| | | | Land & Buildings | 7,00,000 |
| | | | Trade Marks | 25,000 |
| | | | Goodwill | 1,00,000 |
| | | 22,20,000 | | 22,20,000 |

Now Look at illustration 8. It shows how the Trading and Profit and Loss Account and the Balance Sheet are prepareed from a given Trial Balance.

**Illustration 8**

From the following Trial Balance of Gupta & Sons, prepare Trading and Profit and Loss Account for the year ended December 31, 2018 and a Balance Sheet as on that date.

**Trial Balance**

| Particulars | Dr. Balances | Cr. Balances |
|---|---|---|
| | Rs. | Rs. |
| Capital | | 5,00,000 |
| Sales | | 10,00,000 |
| Sales Returns | 25,000 | |
| Purchases | 5,00,000 | |
| Purchase Returns | | 15,000 |
| Inventory on 1.1.2018 | 60,000 | |
| Land &Pilings | 4,00,000 | |
| Plant & Machinery | 2,50,000 | |

| | | |
|---|---|---|
| Furniture | 1,00,000 | |
| Wages | 50,000 | |
| Carriage Inwards | 10,000 | |
| Carriage Outwards | 5,000 | |
| Cartage | 5,000 | |
| Salaries | 40,000 | |
| Loan | | 2,60,000 |
| Debtors | 1,50,000 | |
| Creditors | | 85,000 |
| Bills Receivable | 40,000 | |
| Acceptances | | 10,000 |
| General Expenses | 20,000 | |
| Rent & Rates | 10,000 | |
| Investments | 50,000 | |
| Cash in Hand | 50,000 | |
| Bank Overdraft | | 10,000 |
| Discount Allowed | 4,500 | |
| Depreciation on Plant & Machinery | 50,000 | |
| Interest on Investments | | 5,000 |
| Interest on Bank Overdraft | 500 | |
| Goodwill | 60,000 | |
| Bad Debts | 5,000 | |
| | 18,85,000 | 18,85,000 |

The inventory on December 31, 2018 was valued at Rs. 1,00,000.

**Solution:**

**Trading and Profit & Loss Account of Gupta & Sons**
**For the year ended December 31, 2018**

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

| **Particulars** | | **Amount** | **Particulars** | | **Amount** |
|---|---|---|---|---|---|
| | | Rs. | | | Rs. |
| To Inventory (Opening) | | 60,000 | By Sales | 10,00,000 | |
| To Purchases | 5,00,000 | | Less: Returns | 25,000 | 9,75,000 |
| Less: Returns | 15,000 | 4,85,000 | By Inventory (Closing) | | 1,00,000 |
| To Wages | | 50,000 | | | |
| To Carriage Inwards | | 10,000 | | | |
| To Cartage | | 5,000 | | | |
| To Gross Profit c/d | | 4,65,000 | | | |
| | | 10,75,000 | | | 10,75,000 |
| To Carriage Outwards | | 5,000 | By Gross Profit b/d | | 4,65,000 |
| To Salaries | | 40,000 | By Interest on Investment | | 5,000 |
| To General Expenses | | 20,000 | | | |
| To Rent and Rates | | 10,000 | | | |
| To Discount | | 4,500 | | | |
| To Bad debts | | 5,000 | | | |
| To Depreciation | | 50,000 | | | |

| | | | |
|---|---|---|---|
| To Interest on Bank overdraft | 500 | | |
| To Net Profit (Transferred to Capital Account) | 3,35,000 | | |
| | 4,70,000 | | 4,70,000 |

**Balance Sheet of Gupta & Sons as on December 31, 2018**

| Liabilities | | Amount | Assets | Amount |
|---|---|---|---|---|
| | | Rs. | | Rs. |
| Capital | 5,00,000 | | | |
| Add: Net Profit | 3,35,000 | 8,35,000 | Goodwill | 60,000 |
| Loan | | 2,60,000 | Land & Building | 4,00,000 |
| Creditors | | 85,000 | Plant & Machinery | 2,50,000 |
| Acceptances | | 10,000 | Furniture | 1,00,000 |
| Bank Overdraft | | 10,000 | Investment | 50,000 |
| | | | Inventory (closing) | 1,00,000 |
| | | | Debtors | 1,50,000 |
| | | | Bills Receivables | 40,000 |
| | | | Cash in Hand | 50,000 |
| | | 12,00,000 | | 12,00,000 |

**Note:** In the above Balance Sheet all assets and liabilities have been shown ü' the order of permanence.

## 9.5 VERTICAL PRESENTATION OF FINAL ACCOUNTS

The Trading and Profit and Loss Account and the Balance Sheet have so far been presented as a two-sided statement.But, in practice, it is not necessary to present the final accounts in this form. Nowadays many firms present them in a simpler and more intelligible form which is called a 'narrative style' or 'vertical presentation'. According to this style the Trading and Profit and Loss Account as well as the Balance Sheet are shown in the form of vertical statements. This form of presentation is adopted by many companies for publication of their final accounts. It helps the users of financial statements to appreciate the significance of different items without any difficulty. They can easily interpret the data and judge the profitability and the financial position of the company.

Look at Figure 9.4 and study how various items are shown in the Trading and Profit and Loss Account and the Balance Sheet in vertical form.

**Table 9.4 : Trading and Profit and Loss Account of .........for ........... the year ended ..........................**

| | Rs. | Rs. |
|---|---|---|
| SALES | | ……… |
| **Less Cost of Goods Sold:** | | |
| Opening Stock | ……… | |
| Add: Purchases | ……… | |
| Add: Direct Expenses | ……… | |

| | | |
|---|---|---|
| | ......... | |
| Less Closing Stock | ......... | |
| | | ......... |
| GROSS PROFIT | | ......... |
| Add Other incomes | | ......... |
| **Less Indirect Expenses :** | | |
| Salaries | ......... | |
| Rent | ......... | |
| Sundry Expenses | ......... | |
| Insurance | ......... | ......... |
| NET PROFIT | | ......... |

**Balance Sheet of................**
**as on ............**

| | | | |
|---|---|---|---|
| ***Fixed Assets:*** | | | |
| Land and Buildings | | ......... | |
| Plant and Machinery | | ......... | |
| Furniture and Fixtures | | ......... | |
| Vehicles | | ......... | ......... |
| ***Current Assets:*** | | | |
| Stock-in-hand | | ......... | |
| Debtors | | ......... | |
| Cash at bank | | ......... | |
| Cash in hand | | ......... | |
| | | ......... | |
| ***Less Current Liabilities:*** | | | |
| Creditors | .............. | | |
| Bills Payable | .............. | ......... | |
| Working Capital | | | ......... |
| ***Financed by:*** | | | |
| **Capital:** | | | |
| Balance as on 1.1.2018 | | ......... | |
| Add Net Profit for the year | | ......... | |
| | | ......... | |
| Less: Drawings | | ......... | ......... |
| Loans | | | ......... |
| | | | ......... |

Look at illustration 9 and study how Trading and Profit and Loss Account and the Balance Sheet have been prepared for vertical presentation.

**Illustration 9**

From the information given in illustration 6, prepare Trading and Profit and Loss Account and the Balance Sheet in the vertical form.

***Solution:***

*Trading and Profit and Lass Account of Gupta & Sons*
*for the year ended December 31, 2018*

| | Rs. | Rs. |
|---|---|---|
| **Sales Less Returns** | | |
| (Rs. 10,00,000—Rs. 25,000) | | 9,75,000 |
| **Less: Cost of Goods Sold:** | | |
| Inventory (beginning) | 60,000 | |
| Add: Purchases less Returns | | |
| (Rs. 5,00,000—Rs. 15,000) | 4,85,000 | |
| Add: Wages | 50,000 | |
| Add: Carriage Inwards | 10,000 | |
| Add: Cartage | 5,000 | |
| | 6,10,000 | |
| Less: Inventory (ending) | 1,00,000 | 5,10,000 |
| **GROSS PROFIT** | | 4,65,000 |
| Add: interest on Investments | | 5,000 |
| | | 4,70,000 |
| Less: Indirect Expenses: | | |
| Cartage | 5,000 | |
| Salaries | 40,000 | |
| General Expenses | 20,000 | |
| Rent and Rates | 10,000 | |
| Discount | 4,500 | |
| Bad Debts | 5,000 | |
| Interest on Bank Overdraft | 500 | |
| Depreciation | 50,000 | |
| | | 1,35,000 |
| **NET PROFIT** | | 3,35,000 |

**Balance Sheet of Gupta & Sons as on December 31, 2018**

| | | |
|---|---|---|
| ***Fixed Assets:*** | | |
| Goodwill | 60,000 | |
| Land & Building | 4,00,000 | |
| Plant & Machinery | 2,50,000 | |
| Furniture | 1,00,000 | |
| Investments | 50,000 | |
| | | 8,60,000 |
| ***Current Assets:*** | | |
| Inventory (ending) | 1,00,000 | |
| Debtors | 1,50,000 | |
| Bills Receivables | 40,000 | |
| Cash in hand | 50,000 | |
| | 3,40,000 | |

| | | | |
|---|---|---|---|
| ***Less: Current Liabilities:*** | | | |
| Creditors | 85,000 | | |
| Acceptances | 10,000 | | |
| Bank overdraft | 10,000 | 1,05,000 | 2,35,000 |
| Working Capital | | | 10,95,000 |
| ***Financed by:*** | | | |
| Capital Balance on 1.1.2018 | | 5,00,000 | |
| Add: Net Profit | | 3,35,000 | 8,35,000 |
| Long Term Loans | | | 2,60,000 |
| | | | 10,95,000 |

**Check Your Progress C**

1. What is a Balance Sheet?

   ...................................................................................................................

   ...................................................................................................................

   ...................................................................................................................

2. Why firms use vertical form of presenting the final accounts?

   ...................................................................................................................

   ...................................................................................................................

   ...................................................................................................................

3. Complete the following sentences choosing one of the two alternatives given within brackets.

   i) Assets represent ………..balances of personal and real accounts. (debit! credit)

   ii) All liabilities which become due within one year are classified as ……….liabilities. (long-term/current)

   iii) Unwritten off amount of a deferred revenue expenditure is shown on the …………side of the Balance Sheet. (asset/liabilities)

   iv) Totals of assets and liabilities are always …………..(different/equal)

   v) Loose Tools are classified as ………..assets. (fixed/current)

   vi) Mortgages are classified as …………..liabilities. (current/long-term)

## 9.6 MANUFACTURING ACCOUNT

In case of trading concerns you can find out the cost of goods and the gross profit by preparing a Trading Account. But a manufacturing concern has to first prepare another account called Manufacturing Account with the help of which it works out the cost of goods produced. The cost of goods produced is then transferred to the Trading account for ascertaining the cost of goods sold and the gross profit.

A manufacturing concern purchases raw materials from the market and converts them into finished goods for sale. The cost of goods produced thus includes two major costs: (i) cost of raw materials consumed, and (ii) cost of conversion. These are explained below.

**Cost of Raw Materials Consumed:** This represents the cost of rawmaterials used in course of manufacture which can be worked out by adjusting the opening and closing stocks of raw materials in the purchases of raw materials. For example, a firm purchased raw materials worth Rs. 6,50,000 during 2018, and its stock of raw materials on January 1, 2018 (opening stock) was Rs. 70,000 and on December 31, 2018 (closing stock) Rs. 90,000. The cost of raw materials consumed during 2018 will be worked out as follows:

| | Rs. |
|---|---|
| Opening Stock of Raw Materials | 70,000 |
| Add: Purchases of Raw Materials | 6,50,000 |
| | 7,20,000 |
| Less: Closing Stock of Raw Materials | 90,000 |
| Cost of Raw Materials Consumed | 6,30,000 |

The direct expenses incurred on the purchases of raw materials such as freight, import duty, dock dues, cartage, etc. can also be included in the cost of raw materials consumed. But the usual practice is to show them separately on the debit side of the Manufacturing Account.

Cost of Conversion:This includes all expenses incurred in the factory such as wages paid to labour, salaries of supervisory staff, factory rent and rates, motive power, repairs to plant and machinery, depreciation on plant and machinery, etc. All these expenses are debited to the Manufacturing Account.

Look at Figure 9.5 for the performing of a Manufacturing Account.

**Manufacturing Account of Fig. 9.5 for the period end ...........................**

Dr. Cr.

| Particulars | Amount | Amount | Particulars | Amount | Amount |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| To Work-in progress at the beginning | | ...... | By Sale of Scrap | | ....... |
| To Raw Materials Consumed: Opening Stock of Raw Materials | ...... | | By Work-in-Progress at the end | | ....... |
| Add: Purchases of Raw Materials | ...... | | By Cost of Goods Produced (Transferred to Trading Account) | | ....... |
| Less: Closing Stock of Raw Materials | ...... | ...... | | | |
| To Carriage Inwards | | ...... | | | |
| To Freight, Import | | ...... | | | |
| Duty, Dock Dues, etc. | | ...... | | | |
| To Manufacturing Wages | | ...... | | | |
| To Motive Power | | ...... | | | |

| | | | | |
|---|---|---|---|---|
| To Coal, Gas and Water | | ...... | | |
| To Oil and Grease | | ...... | | |
| To Factory Lighting & Heating | | ...... | | |
| To Factory Insurance | | ...... | | |
| To Repairs to Factory Building | | ...... | | |
| To Repairs to Plant and Machinery | | ...... | | |
| To Depreciation on Factory Buildings | | ...... | | |
| To Depreciation on Plant | | ...... | | |
| and Machinery | | ...... | | ...... |

**Some Important Points**

Scrap: The term 'scrap' is used for waste materials coming out of the manufacturing process. Cuttings of cloth in readymade garments factory and metal cuttings in engineering factories are some examples of scrap. Any amount realised from the sale of scrap must be adjusted in the cost of goods produced. Hence, it is credited to the Manufacturing Account.

**Work-in-Progress:** It is quite likely that at the end of the year, there may be certain goods which are still in the process of manufacture. Such goods are called 'semi-finished goods' or 'work-in-progress'. There will always be some work-in- progress at the beginning as well as at the end of the accounting year. Their cost must be adjusted while working out the cost of goods produced. Hence the opening work-in-progress is shown on the debit side of the Manufacturing Account while the closing work-in-progress s shown on its credit side.

**Stock of Finished Goods:** Besides the stock of raw materials and semi-finished goods every firm will have the stock of finished goods. This is to be adjusted in the cost of goods sold and not in the cost of goods produced. Hence, it is not shown in the Manufacturing Account. As you learnt earlier, it will be shown in the Trading Account.

Look at illustration 10 and see how Manufacturing Account is to be prepared.

**Illustration 10**

Prepare Manufacturing Account from the following particulars relating to the year 2018.

| | Rs. |
|---|---|
| Purchases of Raw Material | 1,00,000 |
| Stock on 1.1.2018 | |
| Raw Materials | 10,000 |
| Work-in-Progress | 5,000 |
| Finished goods | 25,000 |
| Factory wages | 15,000 |
| Factory Rent | 5,000 |
| Fuel & Power | 2,000 |
| Carriage Inwards | 1,000 |
| Repairs of Plant | 2,000 |
| Depreciation on Plant | 5,000 |
| Sale of Scrap | 500 |

| | |
|---|---|
| Stock on 31.12.2018 | 20,000 |
| Raw Materials | 7,500 |
| Work-in-Progress | 30,000 |
| Finished Goods | |

Solution:

Manufacturing Account for the year ended December 31, 2018

| Particulars | | Amount | Particulars | Amount |
|---|---|---|---|---|
| | | Rs. | | Rs. |
| To Work-in-Progress at the beginning | | 5,000 | By Sale of Scrap | 500 |
| To Raw Materials Consumed | | | By Work-in-Progress at the end | 7,500 |
| Opening Stock | 10,000 | | By Cost of Goods Produced (transferred to Trading Account) | 1,17,000 |
| Add: Raw Purchased | 1,00,000 | | | |
| | 1,10,000 | | | |
| Less: Closing Stock | 20,000 | 90,000 | | |
| To Factory Wages | | 15,000 | | |
| To Factory Rent | | 5,000 | | |
| To Fuel & Power | | 2,000 | | |
| To Carriage Inwards | | 1,000 | | |
| To Repairs of Plant | | 2,000 | | |
| To Depreciation on Plant | | 5,000 | | |
| | | 1,25,000 | | 1,25,000 |

You will observe that the stock of finished goods has not been shown in the Manufacturing Account. As stated earlier, it is to be taken to the Trading Account. Now, suppose the sales for the year 2018 were Rs. 1,60,000. The Trading Account will appear as follows

**Trading Account of for the year ending December, 31 2018**

| Particulars | Amount | Particulars | Amount |
|---|---|---|---|
| | Rs. | | Rs. |
| To Opening stock of Finished Goods | 25,000 | By Sales | 1,60,000 |
| To Cost of Goods Produced (Transferred from Mfg. A/c) | 1,17,000 | By Closing stock of Finished Goods | 30,000 |
| To Gross Profit (Transferred to Profit & Loss A/c) | 48,000 | | |
| | 1,90,000 | | 1,90,000 |

You have learnt that a manufacturing concern has to prepare Manufacturing Account before preparing the Trading and Profit and Loss Account. Though considered desirable but many firms do not do so because it is not compulsory. You will also generally be asked to prepare only the Trading Account without preparing the

Manufacturing Account. In such a situation you will show all items of Manufacturing Account in the Trading Account itself. In other words, cost of raw materials consumed, expenses on purchases of raw materials, all manufacturing expenses, the opening and closing work-in-progress, sale of scrap, etc. will also be shown in the Trading Account. But, as per common practice, the items like depreciation and repairs to plant and machinery and factory building will be shown in the Profit and Loss Account and not in the Trading Account.

## 9.7 LET US SUM UP

At the end of the accounting year the businessman prepares the final accounts with the help of a Trial Balance. The final accounts consist of (i) Profit and Loss Account and (ii) Balance Sheet. The Profit and Loss Account is prepared for ascertaining the net profit/net loss of the business during the year and the Balance Sheet is prepared for ascertaining its financial position as at the end of the year.

The Profit and Loss Account is divided into two sections. The first section called Trading Account reveals the gross profit or gross loss and the second section called Profit and Loss Account shows the net profit or net loss. Gross profit is defined as the excess of sale revenue over the cost of goods sold which also includes the direct expenses. The net profit is worked out by-crediting the Profit and Loss Account with the amount of gross profit and other incomes and debiting it with all indirect expenses and losses. In practice, we usually prepare a combined Trading and Profit and Loss Account. It is also necessary to pass closing entries for transferring all expenses and incomes to the Trading and Profit and Loss Account.

The Balance Sheet shows all assets and liabilities of the business. The assets represent the debit balances of the real and personal accounts plus the unwritten off amounts of deferred revenue expenses. The liabilities, on the other hand, represent the credit balances of real and personal accounts including capital. The total assets should always be equal to the total of liabilities.

The manufacturing concerns may also prepare a Manufacturing Account for ascertaining the cost of goods produced, which is then transferred to the Trading Account for ascertaining the cost of goods sold and the gross profit. This, however, is not compulsory. Most manufacturing concerns prepare the Trading Account directly y showing all-expenses incurred in the factory (including cost of raw materials consumed) in the Trading Account itself.

## 9.8 KEY WORDS

**Closing Stock:** Goods remaining unsold at the end of the accounting year.

**Cost of Conversion:** Expenses incurred in the factory (for converting raw materials into finished goods.)

**Cost of Goods Sold:** Difference between the cost of goods available for sale and the cost of goods in stock.

**Cost of Production:** It is the cost of goods produced which includes cost of raw materials consumed and all manufacturing expenses.

**Current Assets:** Assets which are likely to be realised within a period of one year or during the operating cycle. They are also called floating assets.

**Current Liabilities:** Liabilities which are likely to be paid within one year or during the operating cycle. They are also called short-term liabilities.

**Direct Expenses:** Expenses incurred on the goods purchased till they are brought to the place of business.

**Fictitious Assets:** Expenses and losses not yet written off and shown as assets in the Balance Sheet.

**Fixed Assets:** Assets acquired for use in the business for a long period. They are also called non-current assets.

**Gross Profit:** Excess of sales revenue over the cost of goods sold.

**Indirect Expenses:** All expenses other than direct expenses. These include expenses incurred in connection with general administration, financial matters and selling and distribution of goods.

**Intangible Assets:** Assets in the form of rights which cannot be seen or touched such as goodwill, patents, etc.

**Net Profit:** Excess of gross profit and other incomes over the indirect expenses and losses in the business.

**Non-Current Liabilities :** Liabilities payable after a long time. They are also called long-term liabilities.

**Owner's Capital:** Claim of owners against the assets of the business. It is also called owner's equity and is equal to excess of assets over outside liabilities.

**Opening Stock:** Stock of goods as at the beginning of the accounting year.

**Scrap:** Waste material which arises in the course of manufacture.

**Tangible Assets:** Assets which have physical form and can be seen and touched such as buildings, machinery, etc.

**Work-in-Progress**: Goods in respect of which some work still remains to be done. They are also called semi-finished goods.

## 9.9 SOME USEFUL BOOKS

Maheshwari, S.N. 2018. Introduction to Accounting, Vikas Publishing House: New Delhi.

Patil, V.A. and J.S. Korlahalli. 1986. Principles and Practice of Accounting, R. Chand & Co., New Delhi.

William Pickles. 1992. Accountancy, E.L.B:s. and Pitman: London.

Gupta, R.L. and M. Radhaswamy. 2018. Advanced Accountancy; Sultan Chand & Sons: New Delhi.

Shukla, M.C. and T.S. Grewal. 2018. Advanced Accountancy, S. Chand & Co.: New Delhi.

## 9.10 ANSWERS TO CHECK YOUR PROGRESS

A 1. i) Debit ii) Debit iii) Debit iv) Credit v) Debit
vi) Credit vii) Debit viii) Credit ix) Debit x) Debit
xi) Debit xii) Credit

B 3. i) False ii) rue iii) True iv) True v) False vi) False.

4. i) indirectii) purchases, closing stock iii) selling iv) Trading v)debited

vi) Trading Account

5. Rs. 90,000

C 3. i) debit ii) current iii) asset iv) equal v) fixed vi) long-term

## 9.11 TERMINAL QUESTIONS/EXERCISES

**Questions**

1. Distinguish between:
   a) Cost of Goods Sold and Cost of Goods Processed
   b) Gross Profit and Net Profit
   c) Direct Expenses and Indirect Expenses
   d) Trading Account and Manufacturing Account
   e) Profit and Loss Account and Balance Sheet
2. Give closing entries for Trading and Profit and Loss Account.
3. What is a Balance Sheet? Describe different methods of arranging assets and liabilities.

**Exercises**

1. Find out the Cost of Goods Sold from the following figures extracted from the books of Allied Ltd. for the year 2018:

| | Rs. |
|---|---|
| Stock (1.1.2018) | 50,000 |
| Purchases | 10,00,000 |
| Sales | 15,00,000 |
| Purchases Returns | 50,000 |
| Stock (31-1-2018) | 70,000 |
| Direct Expenses | 60,000 |
| Indirect Expenses | 1,00,000 |

(**Answer:** Rs. 9,90,000)

2. Find out the Cost of Goods Sold and Gross Profit from the following figures:

| | Rs. |
|---|---|
| Inventory in the beginning | 60,000 |
| Purchases Less Returns | 6,00,000 |
| Carriage Inwards | 20,000 |
| Cartage Outwards | 30,000 |
| Cartage and Freight | 10,000 |
| Wages | 50,000 |
| Sales Less Returns | 12,00,000 |
| Inventory at the end | 40,000 |

(**Answer:** Cost of Goods Sold Rs, 7,00,000; Gross Profit Rs. 5,00,000.)

3. From the data given in Question No. 2 prepare Trading Account

4. From the following balances of Shyam Sunder, prepare Profit and Loss Account for the year ended March 31, 2018.

| | Rs. |
|---|---|
| Office Expenses | 5,280 |
| Advertising | 3,000 |
| Legal Charges | 5,000 |
| Postage and Telephone Charges | 6,400 |
| Salaries and Wages | 60,000 |
| Travelling Expenses | 2,500 |
| Interest Received | 600 |
| Rent, Rates and Taxes | 20,800 |
| Insurance | 2,400 |
| Office Lighting | 1,500 |
| Stationery | 1,200 |
| Repairs | 920 |
| Miscellaneous Income | 800 |
| Commission Paid | 4,000 |
| Bank Charges | 200 |

The Gross Profit for the year was Rs. 73,000

(**Answer:** Net Loss Rs. 38,000)

5. The following balances have been extracted from the books of Plaza Electricals Ltd. for the year 2018.

| | Rs. |
|---|---|
| Sales | 5,00,000 |
| Purchases | 3,00,000 |
| Return Inwards | 10,000 |
| Return Outwards | 15,000 |

| | |
|---|---|
| Opening Stock | 30,000 |
| Wages | 20,000 |
| Carnage Inwards | 5,000 |
| Carriage Outwards | 3,000 |
| Salaries | 25,000 |
| General Expenses | 10,000 |
| Rent and Rates | 4,000 |
| Advertisement | 5,000 |
| Bad debts | 3,000 |
| Insurance | 3,000 |
| Trade Expenses | 2,000 |
| Depreciation | 5,000 |

It was further given that the value of stock on December 31, 2018 was Rs. 50,000. You are required to prepare Trading and Profit and Loss Account of Plaza Electrical Ltd. for the year ending December 31, 2018.

(**Answer:** Gross Profit Rs. 2,00,000; Net Profit Rs. 1,40,000)

6. From the following data pertaining to the transactions of Mehta Bros. for the year 2018, prepare Trading and Profit and Loss Account for the year ending December 31, 2018.

| | Rs. |
|---|---|
| Sales | 10,00,000 |
| Purchases | 6,00,000 |
| Sales Returns | 20,000 |
| Purchases Returns | 10,000 |
| Inventory (beginning) | 40,000 |
| Wages | 50,000 |
| Carriage Inwards | 20,000 |
| Carriage Outwards | 15,000 |
| Trade Expenses | 10,000 |
| Cartage and Freight | 5,000 |
| Salaries | 30,000 |
| General Expenses | 10,000 |
| Insurance | 6,000 |
| Rent & Rates | 5,000 |
| Distribution Expenses | 6,000 |
| Discount Received | 1,000 |
| Discount Allowed | 2,000 |
| Bad Debts | 2,000 |
| Depreciation | 8,000 |
| Interest on Investments | 20,000 |
| Interest on Bank Deposits | 1 ,000 |
| Interest on Bank Overdraft | 500 |
| Loss of Goods by Fire | 2,500 |

It was further given that the value of Inventory on December 31, 2018 was Rs. 80,000

(**Answer:** Gross Profit Rs. 3,55,000: Net Profit Rs. 2,80,000,

7 . From the following balances of Hitesh, prepare a Balance Sheet as on December 31, 2018

| | Rs. |
|---|---|
| Hitesh's Capital | 41,000 |
| Drawings | 6,100 |
| Wife's Loan | 4,000 |
| Sundry Creditors | 45,000 |
| Cash in Hand | 250 |
| Cash at Bank | 4,000 |
| Sundry Debtors | 40,500 |
| Patents | 2,000 |
| Plant and Machinery | 20,000 |
| Land and Building | 26,000 |
| Stock in Hand | 36,500 |

Net Profit for the year was Rs. 45,350

(**Answer:** Balance Sheet Total Rs. 1,29,250)

8. From the following Trial Balance of Sameer, prepare Trading and Profit and Loss Account for the year ended September, 30, 2018, and Balance sheet as on that date.

Trial Balance as on September 30, 2018

| **Name of Account** | **Dr. Balances Rs.** | **Cr Balances Rs** |
|---|---|---|
| Capital | | 40,000 |
| Drawings | 7,500 | |
| Stock on July 1, 2017 | 8,000 | |
| Purchases | 47,250 | |
| Sales | | 90,000 |
| Carriage Inwards | 2,300 | |
| Returns .Inwards | 2,000 | |
| Returns Outwards | | 1,500 |
| Wages | 7,000 | |
| Plant and Machinery | 30,000 | |
| Furniture and fittings | 7,500 | |

| | | |
|---|---|---|
| Coal, Gas and Water | 2,100 | |
| Power | 2,000 | |
| Salaries | 9,000 | |
| Discount Allowed | 750 | |
| Discount Received | | 600 |
| Office Rent | 2,400 | |
| Factory Rent | 3,000 | |
| Postage and telephone | 900 | |
| Insurance | 250 | |
| Sundry Expenses | 800 | |
| Trade Debtors | 20,000 | |
| Trade Creditors | | 27,150 |
| Cash in hand | 700 | |
| Cash at Bank | 4,100 | |
| Carriage Outwards | 1,700 | |
| | 1,59,250 | 1,59,250 |

The Stock on September 30, 2018 was valued at Rs. 9,250.

(**Answer:**Gross Profit Rs. 27,100; Net Profit Rs. 11,900; Balance Sheet Total Rs. 71,550)

9. The following figures have been extracted from the books of a manufacturer.

| | Rs. |
|---|---|
| **Stock 1.1.2018** | |
| Raw Materials | 25,000 |
| Work-in-Progress | 10,000 |
| Finished Goods | 50,000 |
| Purchases of Raw Materials | 3,00,000 |
| Factory Wages | 40,000 |
| Factory Rent | 5,000 |
| Fuel & Power | 5,000 |
| Carriage Inwards | 2,500 |
| Repairs of Plant | 25,000 |
| Depreciation on Plant | 25,000 |
| Sale of Scrap | 2,000 |
| **Stock on 31.12.2018** | |
| Raw Materials | 40,000 |
| Work-in-Progress | 15,000 |
| Finished Goods | 60,000 |

You are required to prepare a Manufacturing Account and ascertain the Cost of Goods Produced.

(**Answer:**Cost of Goods Produced: Rs. 3,75,500)

10. From the following Trial Balance, prepare Manufacturing Account and the Trading and Profit and Loss Account for the year ended March 31, 2018, and

**Balance Sheet as at the end of the year.**

| Name of Account | Dr. Balances | Cr Balances |
|---|---|---|
| | Rs. | Rs |
| Opening Stock of Raw Materials | 60,000 | |
| Opening Stock of Finished Goods | 32,000 | |
| Opening Stock of the Work-in- Progress | 10,000 | |
| Capital | | 1,44,000 |
| Purchase of Raw Materials | 5,00,000 | |
| Sales | | 8,00,000 |
| Purchase of Finished Goods | 16,000 | |
| Carriage Inwards | 8,000 | |
| Wages | 1,00,000 | |
| Salaries (75% Factory) | 52,000 | |
| Commission | 6,000 | |
| Bad Debts | 4,000 | |
| Insurance | 8,000 | |
| Rent, Rates and Taxes | | |
| (50% Factory) | 24,000 | |
| Postage and Telegram | 5,600 | |
| Miscellaneous Expenses | 3,200 | |
| Travelling and Conveyance | | |
| (50% Factory) | 7,000 | |
| Carriage Outwards | 5,200 | |
| Machinery | 80,000 | |
| Furniture | 10,000 | |
| Debtors | 1,20,000 | |
| Creditors | | 1,07,000 |
| | 10,51,000 | 10,51,000 |

The Closing Stocks are as follows:

| | |
|---|---|
| Raw Materials | 80,000 |
| Work-in-Progress | 24,000 |
| Finished Goods | 16,000 |

(**Answer:** Cost of Production Rs. 6,26,750; Gross Profit Rs. 1,41,250; Net Profit Rs. 79,000; Balance Sheet Rs. 3,30,000.

**Note** : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

# UNIT 10 FINAL ACCOUNTS-II

## Structure



## 10.0 OBJECTIVES

After studying this unit you should be able to:

- explain why adjustment entries are necessary at the time of preparing the final accounts;
- list the items in respect of which adjustments are usually made;
- pass the necessary adjustment entries; and
- prepare final accounts with adjustments.

## 10.1 INTRODUCTION

In Unit 8 you learnt about the preparation of simple final accounts. They did not involve any adjustments. In practice, however, you are always required to make some adjustments while preparing the final accounts. It is because there may be many expenses and incomes relating to the current year which are still to be brought into the books of account. Then there may be certain items recorded in current year's books which actually relate to the previous year or the next year. Unless such items are duly adjusted in the books of account, the final accounts will not reveal the true and fair view of the state of affairs of the business. In this unit you will learn about all items which require adjustments and study how such adjustments are made in books of account and how they are incorporated in the final accounts.

## 10.2 NEED FOR ADJUSTMENTS

You know that the financial reporting requires the summarisation of business operations for a specific accounting period. It is quite possible that certain transactions recorded in current year's books may partly relate to the previous year or to the following year. It is also possible that certain expenditure incurred during the current year has not yet been paid and so not recorded. Similarly, there may be certain incomes earned during the current year which have not been recorded because they have not yet been received; If such items are not adjusted or brought into current year's books of account, the summary presented in the form of final accounts will not reveal the true picture. Let us take the example of an amount of Rs. 600 paid on July 1, 2018 towards insurance premium. You know any general insurance usually covers a period of twelve months. Suppose the accounting year is ending on December 31, 2018 it would mean that half the amount of insurance premium paid on July 1, 2018 pertains to the next accounting year i.e., 2019. Therefore, while preparing the final accounts of 2018, the expenditure on insurance premium that should be debited to the Profit and Loss Account is Rs. 300 (Rs. 600 paid Rs. 300 pertaining to 2019). The remaining amount of Rs. 300 will be carried forward and charged to the Profit and loss Account of 2019. Take another example. The wages of workers for the month of December, 2018 were paid on January 7, 2019. This means the Wages Account of 2018 does not include the wages for the month of December 2018. Such unpaid wages termed as 'Wages outstanding' have to be brought into the books and debited to the Trading Account along with the wages already paid. Similarly, adjustment may also become necessary in respect of certain incomes received in advance or those which are outstanding as at the end of the accounting year. Apart from these, there are certain items which cannot be recorded on day-to-day basis such as depreciation, interest on capital, etc. They are generally adjusted at the time of preparing the final accounts.

All items which need alteration or which are to be brought into books at the time of preparing final accounts are called 'adjustments'. The purpose of making various

adjustments is to ensure that the final accounts reveal the true financial position of the business. Therefore, when you are to prepare the final accounts of any business, you are provided with a Trial Balance and some additional information in respect of the adjustments to be made.

## 10.3 TREATMENT OF ADJUSTMENTS IN FINAL ACCOUNTS

There are several items which need adjustment at the time of preparing the final accounts. Some of the important and common adjustments are listed below:

1. Closing Stock
2. Outstanding or Accrued Expenses
3. Prepaid or Unexpired Expenses
4. Outstanding or Accrued Incomes
5. Incomes Received in Advance (Unearned Income)
6. Depreciation
7. Interest on Capital
8. Interest on Drawings
9. Interest on Loan
10. Bad Debts
11. Provision for Bad Debts
12. Provision for Discount on Debtors
13. Provision for Discount on Creditors
14. Manager's Commission
15. Abnormal Loss
16. Drawing of Goods by the Proprietor

Let us now discuss the nature of each item of adjustment and its treatment in the final accounts. In this connection you must remember that the general principle of. double entry has to be fully followed. Hence, for bringing any item into the books of account or adjusting the amount of any expense or income, you have to ensure that theamount is debited to one account and credited to another; and while showing it in the final accounts the item should appear at two places, one representing the debit and the other representing the credit, otherwise the Balance Sheet will not tally. Usually, each adjustment will first appear in the Trading and Profit and Loss Account and then in the Balance Sheet.

### 10.3.1 Closing Stock

You know that all goods purchased or produced during the year are not completely sold out by the end of the year. Some goods always remain unsold as at the end of the year which are called 'Closing Stock'. The Closing Stock does not usually appear in the Trial Balance. It is mostly given in the form of additional information. Since Gross Profit/Gross Loss cannot be worked out without accounting for the closing stock it is brought into books by means of the following adjustment entry.

Closing Stock A/c Dr.

To Trading A/c

The closing stock is treated in the final accounts as follows:

i) On the credit side of Trading Account: shown as a separate item, and

ii) On the assets side of the Balance Sheet: shown as a separate item under Current Assets.

Adjusted Purchases and Closing Stock: Sometimes the closing stock may be giver in the Trial Balance itself. This would mean that both the opening and the closing stocks have been adjusted in the purchases. In such a situation, the opening stock will not appear in the Trial Balance. The Trial Balance will show only the figures of adjusted purchases and the closing stock. The adjusted purchases are in fact the cost of goods sold. They have been worked out by adding the opening stock to purchases and subtracting the closing stock therefrom. Hence, the adjusted Purchases are shown on the debit side of the Trading Account. In such a situation there is no need to show closing stock in the Trading Account as it already stands adjusted in purchases. It will be shown only on the asset side of the Balance Sheet.

### 10.3.2 Outstanding Expenses

Outstanding expenses are those expenses which have been incurred during the current accounting year but have not been paid till the end of the year. They are also called 'expenses accrued'. The common examples of such expenses are the salaries, wages and rent for the last month of the accounting year paid in the first month of the next year. Since they remained unpaid as at the end of accounting year, no entry might have been passed in the books of account. So, they must be taken into account while preparing the Trading and Profit and Loss Account otherwise it will not reveal the correct amount of profit or loss. The following adjustment entry is passed in respect of outstanding expenses.

Concerned Expense A/c Dr.
To Outstanding Expenses A/c

The outstanding expenses will be treated in final accounts as follows:

i) Added to the concerned expenses in the Trading and Profit and Loss Account, and

ii) Shown on the liabilities side of the Balance Sheet as a separate item under Current Liabilities.

### 10.3.3 Prepaid Expenses

Sometimes, the benefit of some expenses will be available not only in the current accounting year but also during the next year. That portion of expense the benefit of which is yet to be received is called 'prepaid expense'. It is also called 'unexpired expense'. Examples of such expenses are unexpired insurance, interest paid in advance, etc. In such situations it is necessary to find out the unexpired portion and ad just it in the concerned expense, Thefollowing adjustment entry is passed in respect of the prepaid expenses:

Prepaid Expenses A/c Dr.
To Concerned Expense A/c

The Prepaid expenses will be treated in final accounts as follows:

i) Subtracted from concerned expense in the Trading and Profit and Loss Account, and

ii) Shown on the assets side of the Balance Sheet as a separate item under Current Assets.

### 10.3.4 Accrued Income

Accrued Incomes are those incomes which have been earned during the current accounting year but have not been received till the end of the year. They are also called 'outstanding incomes' or 'incomes earned but not yet received'. Examples of such incomes are commission receivable, income on investments due but not yet received, etc. The following adjustment entry is passed in respect of accrued income.

Accrued Income A/c Dr.
To Concerned Income A/c

The Accrued income is treated in final accounts as follows:

i) Added to the concerned income in the Profit and Loss Account, and

ii) Shown on the asset side of the Balance Sheet as a separate item under Current Assets.

### 10.3.5 Income Received in Advance

Any income which belongs to the next accounting year but has been received during the current accounting year is called 'income received in advance' or 'unearned income. It is the income in respect of which the service is yet to be provided. Examples of such incomes are rent received in advance, interest received in advance, etc. In such a situation, the unearned portion of the income will have to be adjusted while preparing the final accounts. The following adjusting entry is passed in respect of the unearned income.

Concerned Income A/c Dr.
To Income Received in Advance A/c

The unearned income is treated in final accounts as follows:

i) Deducted from the concerned income in the Profit and Loss Account, and

ii) Shown on the liabilities side of the Balance Sheet as a separate item under Current Liabilities.

Look at illustration 1 and see how adjustments are made in the final accounts in respect of outstanding expenses, prepaid expenses, outstanding incomes and incomes received in advance.

**Illustration 1**

Show how you will record the following items in the Profit and Loss Account and the Balance Sheet.

The Trial Balance showed the following balances as on December 31, 2018:

| | Rs. |
|---|---|
| Salaries | 10,000 |
| Wages | 20,000 |
| Rent Received | 6,600 |
| Commission Received | 2,000 |
| Interest on Investments | 6,000 |

**Additional Information**

i) Salaries amounting to Rs. 2,000 are outstanding.

ii) Wages include Rs. 1,560 paid in advance.

iii) Interest on investment includeRs. 1,200 for the months of January, February and March, 2019.

iv) Rent for the month of December amounting to Rs. 600 is not yet received.

Gross profit for the year is Rs. 40,000 and other expenses amounted to Rs. 10,000

**Profit and Loss Account for the year ended December 31, 2018**

| Particulars | Amount | Particulars | Amount |
|---|---|---|---|
| | Rs. | | Rs. |
| To Salaries 10,000 | | By Gross Profit b/d | 40,000 |
| Add: Outstanding 2,000 | 12,000 | By Rent Received 6,600 | |
| To Wages 20,000 | | Add: Outstanding 600 | |
| Less: Prepaid 1,500 | 18,500 | | 7,200 |
| To Other Expenses | 10,000 | By Commission Received | 2,000 |
| To Net Profit (Transferred to Capital A/c) | 13,500 | By Interest on Investments 6,000 | |
| | | Less: Received in Advance 1,200 | 4,800 |
| | 54,000 | | 54,000 |

**Balance Sheet**
**As on December 31, 2018**

| Liabilities | Amount | Assets | Amount |
|---|---|---|---|
| **Current Liabilities:** | Rs. | **Currents Assets:** | Rs, |
| Salaries Outstanding | 2,000 | Wages Prepaid | 1,500 |
| Interest Received in Advance | 1,200 | Rent Outstanding | 600 |

## 10.3.6 Depreciation

Depreciation means decrease in the value of fixed assets due to their usage and the passage of time. You know the fixed assets are used for the purpose, of earning revenue. Therefore, the fall in their value should be considered as an expense or loss incurred in realising such revenue and should be charged to the Profit and Loss Account. Depreciation is not recognised on day-to-day basis. It is brought into the books only at the end of the accounting period by passing the following journal entry.

Depreciation A/c Dr.
 To Concerned Asset A/c

Depreciation is treated in final accounts as follows:

i) On the debit side of the Profit and Loss Account: shown as a separate item giving details of depreciation on each fixed asset, and

ii) Deducted from the concerned asset in the Balance Sheet.

Sometimes depreciation is given in the Trial Balance itself. This is possible only if the entry in respect of depreciation has already been passed in the books of account. **In**

**such a situation depreciation will be shown in the Profit and Loss Account only.** It need not be adjusted in the fixed assets in the Balance Sheet because the fixed assets already stand reduced by the amount of depreciation.

Depreciation is generally calculated at the given rate for the period for which the asset has been used in the accounting year. Thus, if an-asset is purchased during the current year the depreciation should be calculated from the date of acquisition till the end of the year. If the date on which the additions were made is not given, you should calculate depreciation on additions also for the full year. In the case of old assets, depreciation is calculated on the opening balance. Look at illustration 2 and study how depreciation is treated at the time of preparing the final account.

**Illustration 2**

The following are the balances of assets as on January 1, 2018:

| | |
|---|---|
| | Rs. |
| Plant and Machinery | 1,20,000 |
| Furnitur | 18,000 |

A new machinery costing Rs. 30,000 was acquired on July, 1, 2018. Depreciation is to be provided on Plant and Machinery at 10% and on furniture at 5% per annum. Show how depreciation will be shown in the final accounts.

**Solution :**

**Calculation of Depreciation**

| | | |
|---|---|---|
| | | Rs. |
| On Furniture at 5% on Rs. 18,000 | | 900 |
| On Plant and Machinery: | | |
| 10% on Rs. 1,20,000 for one year | 12,000 | |
| 10% on Rs. 30,000 for six months | 1,500 | 13,500 |
| | | 14,400 |

**Solution:**

**Treatment in Final Accounts**

| Particulars | | Amount | Particulars | Amount |
|---|---|---|---|---|
| | | Rs. | | Rs. |
| **To Depreciation :** | | | | |
| Plant and Machinery | 13,500 | | | |
| Furniture | 900 | 14,400 | | |

**Balance Sheet as on December 31, 2018**

| Particulars | Amount | Particulars | | Amount |
|---|---|---|---|---|
| | Rs. | | | Rs. |
| | | **Fixed Assets:** | | |
| | | Plant and Machinery | 1,20,000 | |
| | | Add: New Machinery | 30,000 | |
| | | | 1,50,000 | |
| | | Less: Depreciation | 13,500 | 1,36,500 |
| | | Furniture | 18,000 | |
| | | Less: Depreciation | 900 | 17,100 |

### 10.3.7 Interest on Capital

You know thefinds provided by the proprietor to the business constitute capital. Sometimes, the proprietor may like to know the profits made by the business after taking into consideration the interest on this capital. In such a situation interest is allowed at a certain rate on the capital. It is calculated on the capital at the beginning of the year. If, however, any additional capital is introduced during the year, interest on additional capital will also be calculated from the date on which it was brought into Final Account, the business. Such interest is treated as an expense for the business and the following adjustment entry is passed to bring it into the books of account.

Interest on Capital A/c    Dr.

To Capital A/c

Interest on capital is treated in final accounts as follows:

i) On the debit side of Profit and Loss Account: shown as a separate item of expense and

ii) Added to Capital on the liabilities side of Balance Sheet. You should note that normally no interest on capital is to be provided.

### 10.3.8 Interest on Drawings

In case interest is allowed to the proprietor on his capital, it is a usual nractice to also charge interest on his drawings. Interest on drawings will be a gain for the business and the following adjustments entry is passed to bring it into the books of account.

Capital A/c or Drawings A/c    Dr.

To Interest on Drawings A/c

Interest on Drawings is treated in final accounts as follows:

i) On the credit side of Profit and Loss Account: shown as a separate item, and

ii) Deducted from Capital on the liabilities side of Balance Sheet.

Interest on drawings is calculated at a given rate from the date of withdrawal till the end of the year. In case no date is mentioned, the interest is charged for six months assuming the amounts were drawn evenly throughout the year. Look at illustration 3 and see how interest on drawings is calculated when the amount and the dates of withdrawal are given.

**Illustration 3**

| | Rs. |
|---|---|
| Feb. 1 | 4,000 |
| Apr. 1 | 6,000 |
| Jul. 1, | 6,000 |
| Oct 31 | 2,000 |
| Dec. 31 | 5,000 |

Calculate the interest chargeable to the proprietor if the rate of interest on drawings is 15% per annum.

**Solution:**

| Date (1) | Amount (2) | Months upto December 31 (3) | Product 2 ò 3 (4) |
|---|---|---|---|
| Feb. 1 | 4,000 | 11 | 44,000 |
| Apr. 1 | 6,000 | 9 | 54,000 |
| Jul. 1 | 3,000 | 6 | 18,000 |
| Oct. 31 | 2,000 | 2 | 4,000 |
| Dec. 31 | 5,000 | 0 | 0 |
| | | | 1,20,000 |

Interest on Drawings $= \frac{15}{100} \times 1,20,000 \times \frac{1}{12} = \text{Rs.}1,500$

Another way of calculating interest on drawings is to calculate it individually on each withdrawal and then add them.

## 10.3.9 Interest on Loan

If the firm has taken some loan, it has to pay interest thereon. Hence, when we notice a loan Account in the Trial Balance, we must find out whether the full amount of due on loan has been paid or not. The rate of interest and the date on which the loan was taken is usually given. If, however, the date on which loan was taken is not given, it means that it is an old loan and full year's interest has to be provided. In any case, you should calculate the exact amount of interest due and find Out from the Trial Balance whether the same has been paid or not. Generally, you will find that the interest has been paid but it is less than what is due. In such a situation, the difference is regarded as outstanding interest and the same must be adjusted at the time of preparing the final accounts. Suppose there is an item of 10% loan (taken on April 1, 2018) of Rs. 20,000 appearing in the Trial Balance. Assuming the accounting year ends on December 31, the total interest on loan will work out as Rs. 1,500 (at 10% on Rs. 20,000 for nine months). On going through the Trial Balance you find that the interest paid is Rs. 1,000 only. It means Rs. 500 (Rs. 1,500— Rs. 1,000) is the outstanding interest. This must be shown in final accounts accordingly i.e., Rs. 1,500 (Rs. 1,000 + Rs. 500 outstanding) as interest on loan on the debit side of the Profit and Loss Account and Rs. 500 as outstanding Interest under current liabilities in the Balance Sheet.

It is possible that the adjustments given outside the Trial Balance already include this item. But, if they do not even then you have to account for it. This is called an implied adjustment.

**Check Your Progress A**

1. Fill in the blanks

   i) Every adjustment has a ............................ effect.

   ii) Closing stock is shown on the side ....................... of the Balance Sheet.

iii) Prepaid expenses are also called .......................... expenses.

iv) Income received in advance is .......................... for the business.

v) .................... is a decrease in the value of a fixed asset due to wear and tear.

vi) Interest on Drawings is from .................. the capital in the Balance Sheet.

2 State whether the following statements are True or False.

i) Every adjustment affects either Trading and Profit and Loss Account or the Balance Sheet.

ii) Outstanding expense is first added to the relevant expense account and then shown on the liabilities side of the Balance Sheet.

iii) Interest on loan is an income for the business.

iv) Depreciation is deducted from the relevant fixed asset in the Balance Sheet and Profit and Loss Account

v) Proprietor is always entitled to interest on the capital invested.

### 10.3.10 Bad Debts

Sometimes, a debtor may fail to pay his debt either partially or completely. The amount of debt which cannot be recovered from the debtor is called Bad Debts and it will be a loss to the business. The following journal entry is passed when a debt becomes bad.

Bad Debts A/c Dr.
To Concerned Debtor's A/c

The effect of this entry will be (i) debtor's personal account stands, closed, and (ii) a new account called 'Bad Debts Account is opened in the books.

The total amount of bad debts incurred during the year appears as a separate item in the Trial Balance and the sundry debtors appear at the reduced amount. The bad debts like any other expense or loss are charged to the Profit and Loss Account.

Bad Debts given outside the Trial Balance: Sometimes, the bad debts to be written off may be stated outside the TrialBalance as an adjustment item, It means that such bad debts have not yet been written off. In other words, the entry for such bad debts has not been passed. It is necessary to record such bad debts at the time of preparing the final accounts. This is done by passing the following adjustment entry:

Bad Debts Account Dr.
To Sundry Debtors

Such additional bad debts usually called 'further bad debts' are treated in finalaccounts as follows:

i) On the debit side of Profit and Loss Account: shown as addition to bad debts already written off, and

ii) On the assets side of the Balance Sheet: shown as deduction from Sundry Debtors.

It is important to remember the difference between the treatment of bad debts given inside the TrialBalance and the bad debts given outside the Trial Balance. The bad debts given inside the Trial Balance and also those given outside the Trial Balance will be shown in the Profit and Loss Account. But only those bad debts will be deducted from Sundry Debtors in the Balance Sheet which are given outside the Trial Balance.

### 10.3.11 Provision for Bad Debts

In any business where goods are sold on credit, bad debts usually occur. When it is certain that a debt will not be recovered, the amount is written off as bad debt. But, it is also likely that some of the remaining debts may not be recovered in full. From experience we know that certain percentage of amounts due from debtors may not be recovered. This will be a loss to the business. You have learnt that accordingly to 'conservatism concept' all possible losses must be provided for. Hence, it is a common practice to make a suitable provision for doubtful debts at the time of preparing the final accounts. Otherwise, the Profit and Loss Account will not reveal the correct amount of profit or loss and the Balance Sheet will not show the true position of sundry debtors. The Provision for doubtful debts is usually calculated as a certain percentage of the total amount due from sundry debtors after writing of all known bad debts.

Provision for doubtful debts is also called 'Provision for Bad Debts' or 'Provision for Bad and doubtful Debts. Such a provision is made by debiting the amount of doubtful debts to the Profit and Loss Account. Thus, the journal entry for creating such provision will be as follows:

Profit and Loss A/c Dr.
To Provision for Bad Debts A/c

You will notice that when a debt is irrecoverable it is written off by crediting it to the personal account of the respective customer. But, when a debt is doubtful of recovery, the personal account of the customer will not be credited as the recovery is still possible. Hence, the creation of provision for bad debts does not affect the balance of debtors personal accounts. However, while showing sundry debtors in the Balance Sheet the amount of such provision is subtracted therefrom.

When provision for bad debts already exists in the books, the provision created for doubtful debts at the end of a particular year will be carried forward to the next year and it will be used for meeting the loss due to bad debts incurred during the next year. The provision for bad debts brought forward from the previous year is called 'opening provision' or 'old provision'. When such provision already exists, the loss due to bad debts during the current year will be adjusted against the Same, and while making provision for bad debts required at the end of the current year called 'new provision' the balance of old provision should also be taken into account. Let us take an example and understand how these adjustments are done. Suppose old provision on January 1, 2018 was Rs. 1,000. The bad debts written off during 2018 amounted to Rs.600 and the new provision required on December 31, 2018 is Rs. 1,500. In such a situation, the

Profit and Loss Account will be debited with Rs. 1,100 as calculated below:

| | Rs. |
|---|---|
| Existing Provision for Bad Debts | 1,000 |
| Less: Bad Debts | 600 |
| Surplus provision available | 400 |
| Provision required at the end of the year | 1,500 |
| Less: Surplus of old provision | 400 |
| Amount to be debited to Profit and Loss Account | 1,100 |

The above aspects will be shown on the debit side of the Profit and Loss Account as follows:

**Profit and Loss Account of the year ended………**

Dr. Cr.

| | | Rs. | | Rs. |
|---|---|---|---|---|
| To Provision for Bad Debts | | | | |
| Bad Debts | 600 | | | |
| Add: New Provision | 1,500 | | | |
| | 2,100 | | | |
| Less: Old Provision | 1,000 | 1,100 | | |

If however, the total of new provision and the actual bad debts are less than the old provision, the details will be shown on the credit side of the Profit and Loss Account as follows:

**Profit and Loss Account for the year ended……….**

Dr. Cr.

| | Rs. | | | Rs. |
|---|---|---|---|---|
| | | By Provision for Bad Debts | | |
| | | Old Provision | ……. | |
| | | Less: Bad Debts | ……. | |
| | | Less: New Provision | ……. | |

In this connection you should note the following points.

1. If some bad debts are given in adjustments (further bad debts) they should also be taken into account.
2. The new provision should be calculated on sundry debtors after adjusting the amount of further bad debts.
3. In Balance Sheet only the further bad debts as given in adjustments and the new provision for bad debts should be subtracted from sundry debtors.

The following are the journal entries required when the provision for bad debts exists in the books:

**a) Forwriting off further bad debts given outside the Trial Balance:**

Bad Debts A/c Dr.
To Sundry Debtors

**b) For transferring the total bad debts to the provision for Bad Debts Account:**

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

**c) For debiting the Profit and Loss Account with the excess of the new pr' the total bad debts over the old provision:**

Profit and Loss Account A/c Dr.
To Provision for Bad Debts A/c

**d) For crediting the Profit and Loss Account with excess of the old provision over the total baddebts plus new provision:**

Provision for Bad Debts A/c Dr.
To Profit and Loss A/c

Look at illustration 4 and see how bad debts and provision for bad debts are recorded in the final Accounts.

**Illustration 4**

An extract from a Trader's Trial Balance on December 31, 2018 is given below:

| **Name of the Account** | **Dr.** | **Cr.** |
|---|---|---|
| | Rs. | Rs. |
| Sundry Debtors | | |
| Band Debts | 64,000 | |
| Provision of Bad Debts | 4,000 | 7,000 |

**Adjustments:** Write off further bad debts Rs. 2,000 and create a provision for doubtful debts at 5% on debtors. Pass the necessary journal entries and show Bad Debts and Provision for Bad Debts Accounts. Also show their treatment in the final accounts.

**Journal**

| | | | |
|---|---|---|---|
| 2018 | | Rs | Rs. |
| Dec. 31 | Bad Debts A/c Dr. | 2,000 | |
| | To Sundry Debtors | | 2,000 |
| | (Being bad debts written off) | | |
| " 31 | Provision for Bad Debts A/c Dr. | 6,000 | |
| | To Bad Debts A/c | | 6,000 |
| | (Being bad debts transferred to Provision for Bad Debts Account) | | |
| " 31 | Profit and Loss A/c Dr. | 2,100 | |
| | To Provision for Bad Debts A/c | | 2,100 |
| | (Being the Provision required for doubtful debts) | | |

**Bad Debts Account**

| | | | | | |
|---|---|---|---|---|---|
| 2018 | | Rs. | 2018 | | Rs. |
| Dec. 31 | To Balance b/d | 4,000 | Dec. 31 | By Prov. Fro Bad Debts | 6,000 |
| Dec. 31 | To Sundry Debtors | 2,000 | | | |
| | | 6,000 | | | 6,000 |

**Provision for Bad Debts Account**

| | | | | | |
|---|---|---|---|---|---|
| 2018 | | Rs | 2018 | | Rs. |
| Dec. 31 | To Bad Debts A/c | 6,000 | Dec. 31 | By Balance b/d | 7,000 |
| " 31 | To Balance c/d | 3,100 | | By Profit and Loss A/c | 2,100 |
| | | 9,100 | 2019 | | 9,100 |
| | | | Jan. 1 | By Balance b/d | 3,100 |

**Note :** The new provision for bad debts has been calculated at 5% on Rs. 62,000 (sundry debtors Rs. 64,000 – further bad debts Rs. 2,000)

**Profit and Loss Account**
**For the year ended December 31, 2018**

| | | Rs. | | Rs. |
|---|---|---|---|---|
| To Provision for Bad Debts | | | | |
| Bad Debts | 4,000 | | | |
| Add : Further Bad Debts | 2,000 | | | |
| Add : New Provision | 3,100 | | | |
| | 9,100 | | | |
| Less : Old Provision | 7,000 | 2,100 | | |

**Balance Sheet**
**as at December 31, 2018**

| | Rs. | | | Rs. |
|---|---|---|---|---|
| | | **Current Assets :** | | |
| | | Sundry Debtors | 64,000 | |
| | | Less : Further Bad Debts | 2,000 | |
| | | | 62,000 | |
| | | Less : Provision Bad Debts | 3,100 | 58,900 |

## 10.3.12 Provision for Discount on Debtors

You know cash discount is allowed to debtors as an incentive for prompt payment. When the discount is allowed it is recorded through the Cash Book and posted to the credit side of the concerned debtor's personal accounts. But, in the case of debts outstanding at the end of the current year, discounts will be allowed in the next year if the debtors make prompt payments. So, as in the case of anticipated loss on account of doubtful debts, a provision must be made for the discount likely to be allowed to the debtors in the next year, such a provision is known as the 'Provision for Discount on Debtors' it is also calculated as a percentage on the net sundry debtors (remaining after subtracting the provision for bad debts and further bad debts). For example, if Sundry Debtors amount to Rs. 40,000 and the firm wants to create a provision for bad debts at 5% and a provision for discount at 2% on the debtors they will be calculated as follows:

i) The Provision for bad debts will be calculated at 5% on Rs. 40,000. It will amount to Rs. 2,000.

ii) The Provision for discount at 2% will be calculated on the debtors after subtracting the provision for bad debts i.e., on Rs. 38,000 (Rs. 40,000— Rs. 2,000). It will amount to Rs. 760.

Note that when both provision for bad debts and provision for discount on debtors are to be calculated, the provision for bad debts is calculated first and then provision for discount is worked out on debtors after subtracting the provision for bad debts.

The adjustment entry for provision for discount on debtors is as follows:

Profit and Loss A/c Dr.
To Provision for Discount on Debtors A/c
(Being the Provision made for discount on debtors)

The Provision for discount on debtors will be shown in the final accounts as follows:

i) On the debit side of Profit and Loss Account: shown as a separate item, and

ii) On the assets side of Balance Sheet: shown as a deduction from Sundry Debtors.

The balance of the provision for Discount on Debtors Account will be carried forward to the next year and the discounts allowed if any, in the next year will be set off against the provision for itself. The method of dealing with discounts allowed and provision for discount on debtors in the next year is similar, to the method followed in case of bad debts and provision for bad debts.

### 10.3.13 Provision for Discount on Creditors

When prompt payment is received we allow cash discount to debtors. Similarly, we receive discount from the creditors when prompt payments are made by us. So the expected gain on account of discounts receivable from creditors in the next year should also be taken into account at the time of preparing the final accounts. Such a provision is called 'Provision for Discount on Creditors'.

It is calculated as a percentage on Sundry Creditors. The creation of such a provision, however, goes against the Conservatism Concept. Hence, it is usually avoided in practice. But you must learn how it is treated in final accounts if such a provision is required.

The adjustment entry for provision for discount on creditors is passed as follows:

Provision for Discount on Creditors A/c Dr.
To Profit and Loss Account
(Being the Provision made for discount on creditors)

The provision for discount on creditors will appear in the final accounts as follows:

i) On the credit side of Profit and Loss Account: shown as a separate item, and

ii) On the liabilities side of the Balance Sheet: shown as a deduction from Sundry Creditors.

The balance of the Provision for Discount on Creditors Account will also be carried forward to the next year and the discount received, if any, will be adjusted against the provision itself.

### 10.3.14 Manager's Commission

Sometimes, the manager may also be entitled to a commission on profits earned by the business. Such commission is usually calculated as a fixed percentage on profits. Suppose the Net Profit of a firm after taking into consideration all expenses except the manager's commission is Rs. 60,000 and the manager is entitled to a commission of 5% on profits before charging such commission. His commission will work out as Rs. 3,000. However, it is still to be paid and therefore should be treated as an outstanding expense. It will be debited to Profit and Loss Account and also shown as a current liability in the Balance Sheet.

In the above example, manager's commission has been calculated on profits before charging the commission. But, sometimes, it is to be calculated on profit after charging such commission. In such a situation, the commission will be calculated by the following formula:

**Percentage of Commission**

$$\frac{\text{Percentage of Commission}}{100 + \text{Percentage of Commission}} \times \text{Net Profit before Commission}$$

If, in the above example, the manager's commission were to be calculated on profits after charging such commission, it will be as follows.

$$\frac{5}{100+5} \times 60{,}000 = \frac{5}{105} \times 60{,}000 = \text{Rs. } 2{,}857$$

The above amount can also be verified. After charging manager's commission the Net Profit will work out to Rs. 57,143 (Rs. 60,000—Rs. 2,857). Now calculate 5% on Rs. 57,143. It works out to Rs. 2,857 which means the amount of commission calculated by the given formula is correct.

### 10.3.15 Abnormal Loss of Stock

In the course of business some loss of stock may also occur. It may occur in transit or at the godown. Such loss of stock may be normal or abnormal. Normal loss is due to inherent characteristics of goods such as evaporation, subdivision, drying up of goods, etc. On the other hand, if the loss occurs on account of reasons which are accidental or very rare, the loss is termed as abnormal loss. The examples of such losses are theft of goods, destruction of goods by fire, etc.

The abnormal loss does not require any special treatment in the books of account. It is absorbed by the remaining units whose cost is inflated by such loss. But, the abnormal loss has to be shown separately in the books of account. After the amount of such loss is ascertained, the following adjustment entry is passed.

| | |
|---|---|
| Loss by Fire A/c | Dr. |
| To Trading Account | |
| (Being stock lost by fire) | |

To avoid the burden of loss due to abnormal circumstances the businessmen may get the stock insured. Thus, the loss may be

1. Uninsured,
2. Fully insured, or
3 . Partially insured.

Let us see what will be the accounting treatment in the above three situations.

1. When the stock's is not insured: In case the stock is not insured the total abnormal loss will be transferred to the Profit and Loss Account and the following entry will be passed.

   Profit and Loss A/c Dr
   To Loss by Fire A/c

2 When the stock Isfully Insured: When the stock is fully insured, the total amount of loss is paid by the insurance company. In that case the company does not suffer fly loss.

   So, nothing is debited to the Profit and Loss Account. The journal entry passed is as follows.

   Insurance Company Dr.
   To Loss by Fire A/c

3. When the loss is partially insured: In case the loss is partially insured the amount of insurance claim is debited to Insurance Company's Account and the remaining loss (the amount to be borne by the business) is debited to Profit and Loss Account. The following journal entry is passed.

   Insurance Company Dr.
   Profit and Loss A/c Dr.
   To Abnormal Loss A/c

Thus, the treatment of abnormal loss in final accounts is as follows.

a) Credit the Trading Account with the total loss.

b) i) In case of uninsured stock debit Profit and Loss Account with full amount.

   ii) In case of fully insured loss, insurance claim will be shown as an asset in the Balance Sheet.

   iii) In case of partially insured loss, the amount of insurance claim is shown as an asset in the Balance Sheet and the remaining amount of loss is debited to the Profit and Loss Account.

Look at illustration 5 and see how abnormal loss is treated in the books of account.

**Illustration 5**

On December 30, 2018 the stock worth Rs. 40,000 was destroyed by fire. The stock was insured and the insurance company admitted a claim of Rs. 30,000 only. Pass the necessary journal entries and show how it will be treated in final accounts.

**Journal**

| Date | Particulars | | Dr. Amount | Cr. Amount |
|---|---|---|---|---|
| 2018 Dec.31 | Loss by Fire A/c<br>To Trading A/c<br>(Being stock lost by fire) | Dr.<br><br>Rs. | 40,000 | <br><br>40,000 |

| | | | | |
|---|---|---|---|---|
| " 31 | Insurance Company | Dr. | 30,000 | |
| | Profit and Loss A/c | Dr. | 10,000 | |
| | To Lossby Fire A/c | | | 40,000 |

**Trading Account**
**For the year ended December 31, 2018**

Dr. Cr.

| | | | Rs. |
|---|---|---|---|
| | | By Loss of Fire | 40,000 |

**Profit and Loss Account**
**For the year ending December 31, 2018**

Dr. Cr.

| | | Rs. | | Rs. |
|---|---|---|---|---|
| To Loss by fire | 40,000 | | | |
| Less: Insurance claim | 30,000 | 10,000 | | |

**Balance Sheet**
**As at December 31, 2018**

**For the year ending December 31, 2018**

Dr. Cr.

| | | | Rs. |
|---|---|---|---|
| | . | **Current Assets:** | |
| | | Claim due from insurance company | 30,000 |

## 10.3.16 Drawing of Goods by the Proprietor

You know when the proprietor takes away some goods from the business for his personal use it is recorded in books of account by passing the following journal entry.

Drawings Account Dr.
To Purchases Account

So, if you find that it has not been recorded in the books of account, you have to make the necessary adjustment in final accounts. The treatment in final accounts will be as follows:

i) On the Debit side of the Trading Account: Deduct it from Purchases.

ii) On the Liabilities side of the Balance Sheet: Deduct it from capital either as a separate item or by including it in drawings.

**Check Your Progress B**

1. Why do you create a provision for bad debts?

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2. Why provision for discount on creditors is regarded against the Conservatism Concept?

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.......................................................................................................

3. The Trial Balance shows the following balances.

| | Rs. |
|---|---|
| Debtors | 20,000 |
| Bad Debts | 100 |
| Provision for had Debts | 200 |

**Adjustments:**

a) Bad Debts of Rs. 200 not yet written off.

b) Create a provision for Doubtful Debts at 5% on Debtors

c) Discount on Debtors is to be provided at 2%.

Calculate the provision for Bad Debts and provision for Discount on Debtors.

4. Stock worth Rs. 20,000 was lost by fire. Insurance claim was admitted for three-fourth of the value of goods lost. What amount you will (1) credit to the Trading A/c, (ii) debit to the Profit & Loss A/c, and (iii) show on the asset side of the Balance Sheet.

## 10.4 PREPARATION OF FINAL ACCOUNTS WITH ADJUSTMENTS

You know there are various items which require adjustment at the time of preparing the final accounts. You have learnt how each adjustment is recorded in books through a journal entry and how it is reflected in the final accounts. However, while preparing the final accounts with adjustments you should remember that there is no need to pass the journal entries for any adjustment unless specifically asked to do so. All adjustments must be shown directly in the final accounts. Look at illustration 6 and 7 and see how final accounts are prepared with adjustments.

**Illustration 6**

From the following Trial Balance of Gupta & Sons, prepare Trading and Profit and Loss Account for the year ended December 31, 2018 and a Balance Sheet as on that date.

**Trial Balance**

| Name of the Account | Debit Balances | Credit Balances |
|---|---|---|
| | Rs. | Rs. |
| Capital | | 5,00,000 |
| Sales | | 10,00,000 |
| Sales Returns | 25,000 | |

| | | |
|---|---|---|
| Purchases | 5,00,000 | |
| Purchases Returns | | 15,000 |
| Inventory as on 1.1.18 | 60,000 | |
| Land & Buildings | 4,00,000 | |
| Plant & Machinery | 3,00,000 | |
| Furniture | 1,00,000 | |
| Wages | 50,000 | - |
| Carriage Inwards | 10,000 | |
| Provision for Bad Debts | | 7,000 |
| Carriage Outwards | 5,000 | |
| Cartage | 5,000 | |
| Salaries | 40,000 | |
| Loan | | 2,60,000 |
| Debtors | 1,50,000 | |
| Creditors | | 70,000 |
| Rent | | 8,000 |
| Bills Receivable | 40,000 | |
| Acceptances | | 10,000 |
| General Expenses | 20,000 | |
| Rent & Rates | 10,000 | |
| Investments | 50,000 | |
| Cash in hand | 50,000 | |
| Bank Overdraft | | 10,000 |
| Discount | 4,500 | |
| Bad Debts | 5,000 | - |
| Interest on Investments | | 5,000 |
| Interest on Bank Overdraft | 500 | |
| Goodwill | 60,000 | |
| Total | 18,85,000 | 18,85,000 |

**Additional Information**

1. The value of inventory on December 31, 2018 was Rs. 1,00,000.
2. Depreciation is to be provided on: Land & Building @ 5% p.a. Furniture @ 10% p.a. Plant & Machinery Rs. 50,000.
3. Provision for Bad Debts is to be maintained @ 5% on debtors.
4 Wages are outstanding to the extent of Rs. 4,000 and Salaries to the extent of Rs. 3,000.
5. Rent and Rates are prepaid to the extent of 1/4th of the amount paid.
6. Interest on Investment outstanding is Rs. 1,000.
7. Rent to the extent of Rs. 2,000 has been received in advance.

**Solution:**

**Trading & Profit and Loss Account**
**for the year ended December 31, 2018**

Dr. Cr.

| Particulars | | Amount | Particulars | | Amount |
|---|---|---|---|---|---|
| | | **Rs.** | | | **Rs.** |
| To Inventory as on 1.1.18 | | 60,000 | | | |
| To Purchases | 5,00,000 | | By Sales | 10,00,000 | |
| Less: Purchases Returns | 15,000 | 4,85,000 | Less: Sales Returns | 25,000 | 9,75,000 |
| To Wages | 50,000 | | By Inventory as on 31.12.18 | | 1,00,000 |
| Add: Wages Outstanding | 4,000 | 54,000 | | | |
| To Carriage Inwards | | 10,000 | | | |
| To Cartage | | 5,000 | | | |
| To Gross Profit c/d | | 4,61,000 | | | |
| | | 10,75,000 | | | 10,75,000 |
| To Carriage Outwards | | 5,000 | By Gross Profit b/d | | 4,61,000 |
| To Salaries | 40,000 | | By Rent | 8,000 | |
| Add: Outstanding | 3,000 | 43,000 | Less: Received in advance | 2,000 | 6,000 |
| To General Expenses | | 20,000 | | | |
| | | | By Interest on Investment | 5,000 | |
| To Rent & Rates | 10,000 | | Add: Outstanding | 1,000 | 6,000 |
| Less: Prepaid | 2,500 | 7,500 | | | |
| To Discount Allowed | | 4,500 | | | |
| To Bad Debts | 5,000 | | | | |
| Add: New Provision | 7,500 | | | | |
| | 12,500 | | | | |
| Less: Old Provision | 7,000 | 5,500 | | | |
| To Depreciation on Plant & Machinery | | 50,000 | | | |
| To Interest on Overdraft | | 500 | | | |
| **To Depreciation** | | | | | |
| Land & Building | 20,000 | | | | |
| Furniture | 10,000 | 30,000 | | | |
| To Net Profit (Transferred to Capital A/c) | | 3,07,000 | | | |
| | | 4,73,000 | | | 4,73,000 |

**Balance Sheet as on December 31, 2018**

| Liabilities | | Amount | Assets | | Amount |
|---|---|---|---|---|---|
| | | **Rs.** | | | **Rs.** |
| **Capital** | | | **Fixed Assets** | | |
| Balance | 5,00,000 | | Goodwill | | 60,000 |
| Add: Net Profit | 3,07,000 | 8,07,000 | Land & Building | 4,00,000 | |
| | | | Less: Depreciation | 20,000 | 3,80,000 |

| | | | | |
|---|---|---|---|---|
| **Long Term Liabilities** | | | | |
| Loan | 2,60,000 | Plant & Machinery | 3,00,000 | |
| | | Less: Depreciation | 50,000 | 2,50,000 |
| **Current Liabilities** | | | | |
| Creditors | 70,000 | Furniture | 1,00,000 | |
| Acceptances | 10,000 | Less: Depreciation | 10,000 | 90,000 |
| Bank Overdraft | 10,000 | Investments | | |
| Wages Outstanding | 4,000 | **Current Assets** | | |
| Salaries Outstanding | 3,000 | Cash in hand | | 50,000 |
| Rent Received in Advance | 2,000 | Debtors | 1,50,000 | |
| | | Less: Provision for | | |
| | | Bad Debts | 7,500 | 1,42,500 |
| | | Bills Receivable | | 40,000 |
| | | Closing Stock | | 1,00,000 |
| | | Prepaid Rent & Rates | | 2,500 |
| | | Interest on Investment | | |
| | | Outstanding | | 1,000 |
| | 11,66,000 | | | 11,66,000 |

**Illustration 7**

From the following balances extracted from the book of Aristo Ltd., prepare a Trading and Profit and Loss Account for the year ended December 31, 2018 and a Balance Sheet as on that date.

**Trial Balance**

| Name of the Account | Debit Balances Rs. | Credit Balances Rs. |
|---|---|---|
| Capital | | 2,00,000 |
| Sales | | 5,00,000 |
| Sales Returns | 10,000 | |
| Purchases | 2,40,000 | |
| Purchases Returns | | 10,000 |
| Stock on 1.1.2018 | 40,000 | |
| Land & Buildings | 2,00,000 | |
| Plant & Machinery | 1,00,000 | |
| Wages | 25,000 | |
| Furniture | 50,000 | |
| Provision for Bad Debts | | 5,000 |
| Salaries | 25,000 | |
| Debtors | 82,000 | |
| Creditors | | 1,00,000 |
| Bad Debts | 3,000 | |
| Bills Payable | | 30,000 |

| | | |
|---|---|---|
| Investments | 50,000 | |
| General Expenses | 20,000 | |
| Cash in hand | 5,000 | |
| Cash at bank | 15,000 | |
| Depredation on Land & Buildings | 20,000 | |
| | 8,45,000 | 8,45,000 |

Additional Information

1. The inventory on 31.12.18 has been valued at Rs. 80,000. The inventory of the value of Rs 20,000 was destroyed by fire on 1.12.18 and a claim of Rs. 15,000 was admitted by the insurance company.
2 Depreciation is to be provided on Plant & Machinery and furniture at 10% per annum.
3. Debtors are bad to the extent of Rs. 2,000. Provision for bad debts is to be made at 5% on debtors and a provision for discount on debtors at 2%.
4. Wages for outstanding to the extent of Rs. 5,000.
5. Salaries are prepaid to the extent of Rs. 2,000.
6. Create a provision for discount on creditors at the rate of 1%.
7 Create a provision for repairs to the extent of Rs. 4,000.

**Trading & Profit and Loss Account for the year ended December 31, 2018**

| **Particulars** | | **Amount** | **Particulars** | | **Amount** |
|---|---|---|---|---|---|
| | | Rs. | | | Rs. |
| To Opening Stock | | 40,000 | By Sales | 5,00,000 | |
| | | | Less: Sales Returns | 10,000 | 4,90,000 |
| To Purchases | 2,00,000 | | | | |
| | | | By Closing Stock | | 80,000 |
| Less: Purchases Returns | 10,000 | 1,90,000 | | | |
| To Wages | 25,000 | | By Loss by Fire | | 20,000 |
| Add: Outstanding | 5,000 | 30,000 | | | |
| To Gross Profit c/d | | 3,30,000 | | | |
| | | 5,90,000 | | | 5,90,000 |
| To Salaries | 25,000 | | | | |
| Less: Prepaid | 2,000 | 23,000 | By Gross Profit b/d | | 3,30,000 |
| | | | By Provision for Discount on Creditors | | 1,000 |
| To Bad Debts | 3,000 | | | | |
| Add: Further Bad Debts | 2,000 | | | | |
| Add: New Provision | 4,000 | | | | |
| | 9,000 | | | | |
| Less: Old Provision | 5,000 | 4,000 | | | |
| To General Expenses | | 20,000 | | | |
| To Depreciation on Land & Buildings | | 20,000 | | | |
| To Loss by Fire | | 5,000 | | | |

| | | | |
|---|---|---|---|
| To Depreciation on Plant & Machinery | 10,000 | | |
| To Depreciation on Furniture | 5,000 | | |
| To Provision for Discount on Debtors | 1,520 | | |
| To Provision for Repairs | 4,000 | | |
| To Net Profit (Transferred to Balance Sheet) | 2,38,480 | | |
| . | 3,31,000 | | 3,31,000 |

**Balance Sheet as on December 31, 2018**

| Particulars | | Amount | Particulars | | Amount |
|---|---|---|---|---|---|
| | | Rs. | | | Rs. |
| Capital | 2,00,000 | | Land & Buildings | | 2,00,000 |
| Add: Net Profit | 2,38,480 | | Plant & Machinery | 1,00,000 | |
| | | 4,38,480 | Less: Depreciation | 10,000 | 90,000 |
| Creditors | 1,00,000 | | Furniture | 50,000 | |
| Less: Provision for Discount | 1,000 | 99,000 | Less: Depreciation | 5,000 | 45,000 |
| Bills Payable | | 30,000 | Investments | | 50,000 |
| Wages Outstanding | | 5,000 | Cash in Hand | | 5,000 |
| Provision for Repairs | | 4,000 | Cash at Bank | | 15,000 |
| | | | Closing Stock | | 80,000 |
| | | | Debtors | 82,000 | |
| | | | Less: Further Bad Debts | 2,000 | |
| | | | Less: Provision for Bad | 80,000 | |
| | | | Debts @ 5% | 4,000 | |
| | | | | 76,000 | |
| | | | Less: Provision for Discount | 1,520 | 74,480 |
| | | | Insurance Claim Outstandings | | 15,000 |
| | | | Salaries Prepaid | | 2,000 |
| | | 5,76,480 | | | 5,76,480 |

**Notes:**

1. Depreciation on Land & Buildings is given in the Trial Balance. Hence, it is shown in the Profit and Loss Account only.
2. Provision for Bad Debts has been calculated at 5% on debtors after subtracting further bad debts.
3. Provision for Discount on Debtors has been calculated at 2% on debtors after subtracting further bad debts as well as provision for bad debts.
4. Loss by fire has been charged to Profit and Loss Account after taking into consideration the claim from insurance company.

## 10.5 ADJUSTMENTS GIVEN IN TRIAL BALANCE

You know that the adjustments are usually given outside the Trial Balance and they are shown at two places in the final accounts. But, sometimes a few adjustment items appear in the Trial Balance itself. In illustration 7 you noticed it in respect of depreciation on Land & Buildings. It is possible that items like outstanding or prepaid insurance also appear in the Trial Balance. This happens when the journal entry in respect of an adjustment has already been passed and the same has been posted into the concerned ledger accounts. For example, when you pass journal entry for the adjustment for outstanding salaries, you will debit Salaries Account and credit Salaries Outstanding Account. The Salaries Account already exists in the ledger and the amount of outstanding salaries is also posted thereto. This leads to an increased balance in Salaries Account. But the Salaries Outstanding Account does not exist in the ledger. This will have to be opened and the outstanding amount credited thereto. When the Trial Balance is prepared, it will show the increased balance of Salaries Account in the debit balances column and the balance of Sal:- vies Outstanding Account in the credit balances column. Now the question arises how to treat it in the final accounts. In such a situation, you will simply show Salaries Outstanding in the liabilities. No addition will be made to salaries in the Profit and Loss Account because salaries given in Trial Balance already include this amount. Thus, when salaries outstanding appear in the Trial Balance it is shown in final accounts only at one place. This applies to all items of adjustments when they are included in the Trial Balance.

In actual practice all adjustment items with the exception of closing stock are invariably incorporated in the Trial Balance before preparing the final accounts. The Trial Balance so prepared is called 'Final Trial Balance' or 'Adjusted Trial Balance'.

Look at Chart 10.1 and note how each item of adjustment is treated in final accounts. (i) if it is given outside the Trial Balance, and (ii) if it appears in the Trial Balance itself.

**Chart 10.1**

**Treatment of Adjustment Items in Final Accounts**

| S.No. | Item | Treatment In Final Accounts | |
|---|---|---|---|
| | | **If given in Adjustments** | **If given in Trial Balance** |
| 1. | Closing Stock | i) Credit side of Trading A/c : Shown as a separate item<br>ii) Assets side of Balance Sheet : Shown as a separate item under Current Assets | Assets side of Balance Sheet only |
| 2 | Outstanding Expenses | i) Debit side of Trading A/c or Profit and Loss A/c: Added to the concerned expense<br>ii) Liabilities side of Balance Sheet. Shown as a separate item under Current Liabilities | Liabilities side of Balance Sheet only. |

| | | | |
|---|---|---|---|
| 3. | Prepaid Expenses | i) Debit side of Profit and Loss A/c: Deducted from the concerned expense<br>ii) Assets side of Balance Sheet: Shown as a separate item under Current Assets | Assets side of Balance Sheet only. |
| 4. | Outstanding incomes | i) Credit side of Profit and Loss A/c: Added to the concerned income<br>ii) Asset side of Balance Sheet: Shown as a separate item under Current Assets | Assets side of Balance Sheet only. |
| 5. | Income Received in Advance | i) Credit side of Profit and Loss A/c: Deducted from concerned income<br>ii) Liabilities side of Balance Sheet. Shown as a separate item under Current Liabilities | Liabilities side of Balance Sheet only. |
| 6. | Depreciation | i) Debit side of Profit and Loss A/c: Shown as a separate item<br>ii) Assets side of Balance Sheet: Deducted from the concerned fixed asset | Debit side of Trading & Profit and Loss Account only. |
| 7. | Interest on Capital | i) Debit side of Profit and Loss A/c: Shown as a separate item<br>ii) Liabilities side of Balance Sheet: Added to Capital | Debit side of Profit and Loss Account only. |
| 8 . | Interest on Drawings | i) Credit side of Profit and Loss A/c: Shown as a separate item<br>ii) Liabilities side of Balance Sheet: Deducted from Capital | Credit side of Profit and Loss Account only. |
| 9. | Interest on Loan | i) Debit side of Profit and Loss A/c: Shown as a separate item<br>ii) Liabilities side of Balance Sheet: Added to Loan. | Debit side of Profit and Loss Account only. |
| 10. | Bad Debts | i) Debit side of Profit and Loss A/c: Added to Bad Debts<br>ii) Assets side of Balance Sheet: Deducted from Sundry Debtors | Debit side of Profit and Loss Account only. |
| 11. | Provision for bad debts | i) Debit side of Profit and Loss A/c: shown as a separate item<br>ii) Assets side of Balance Sheet: Deducted from Sundry Debtors | Deduct from sundry debtors assuming it is a closing balance. |

| | | | |
|---|---|---|---|
| 12. | Provision for Discount on Debtors | i) Debit side of Profit and Loss A/c: Shown as a separate item<br>ii) Assets side of Balance Sheet: Deducted from Sundry Debtors | Debit side of Profit and Loss Account only. |
| 13. | Provision for Discount on Creditors | i) Credit side of Profit and Loss A/c: Shown as a separate item<br>ii) Liabilities side of Balance Sheet: Deducted from Sundry Creditors | Credit side of Profit and Loss Account only. |
| 14. | Manager's Commission | i) Debit side of Profit and Loss A/c: Shown as a separate item<br>ii) Liabilities side of Balance Sheet: Shown as a separate item | Liabilities side of Balance Sheet only. |
| 15. | Abnormal Loss | i) Credit side of Trading A/c: Shown as a separate item with full amount of loss<br>ii) Debit Profit & Loss A/c with the uncovered Loss<br>iii) Insurance claim will be shown on Assets side of Balance Sheet under Current Assets | Debit side of Profit and Loss Account only. |
| 16. | Drawing of Goods by the Proprietor | i) Debit side of Trading A/c: Deducted from purchases<br>ii) Liabilities side of Balance Sheet: Deducted from capital | Deduct from Capital. |

**Illustration 8**

From the following Trial Balance of Pitam Stores prepare Trading and profit and Loss Account for the year ended December 31, 2018 and the Balance Sheet as on that date.

**Trial Balance**

| Account | Debit Balances | Credit Balances |
|---|---|---|
| | Rs. | Rs. |
| Capital | | 60,000 |
| Drawings | 5,000 | |
| Purchases | 1,00,000 | |
| Sales | | 2,10,000 |
| Opening Stock | 20,000 | |
| Wages | 15,000 | |
| Wages Outstanding | | 5,000 |
| Carriage Inwards | 2,000 | |
| Salaries | 13,000 | |
| Insurance | 1,500 | |

| | | |
|---|---|---|
| Insurance Prepaid | 1,500 | |
| Income from Investments | | 30,000 |
| Accrued Income from Investments | 10,000 | |
| Machinery | 50,000 | |
| Buildings | 95,000 | |
| Cash in hand | 2,000 | |
| Debtors | 35,000 | |
| Creditors | | 60,000 |
| Depreciation on Buildings | 5,000 | |
| Rent | 10,000 | |
| | 3,65,000 | 3,65,000 |

**Additional Information :** The value of stock on December 31, 2018 was Rs. 40,000.

**Solution:**

**Trading and Profit and Loss Account for the year ended December 31, 2018**

| Particulars | Amount | Particulars | Amount |
|---|---|---|---|
| | **Rs.** | | **Rs.** |
| To Opening Stock | 20,000 | By Sales | 2,10,000 |
| To Purchases | 1,00,000 | By Closing Stock | 40,000 |
| To Wages | 15,000 | | |
| To Carriage Inwards | 2,000 | | |
| To Gross Profit c/d | 1,13,000 | | |
| | 2,50,000 | | 2,50,000 |
| To Salaries | 13,000 | By Gross Profit b/d | 1,13,000 |
| To Insurance | 1,500 | By Income from | |
| To Rent | 10,000 | Investments | 30,000 |
| To Depreciation on Building | 5,000 | | |
| To Net Profit | | | |
| (Transferred to Capital A/c) | 1,13,500 | | |
| | 1,43000 | | 1,43,000 |

**Balance Sheet as on December 31, 2018**

**Dr** **Cr.**

| Liabilities | Amount | | Assets | Amount |
|---|---|---|---|---|
| | Rs. | | | Rs. |
| Capital | 60,000 | | Building | 95,000 |
| Add: Net Profit | 1,13,500 | | Machinery | 50,000 |
| | 1,73,500 | | Closing Stock | 40,000 |
| Less: Drawings | 5,000 | 1,68,500 | Debtors | 35,000 |
| Creditors | | 60,000 | Cash in Hand | 2,000 |
| Wages Outstanding | | 5,000 | Insurance Prepaid | 1,500 |
| | | | Accrued Income from Investments | 10,000 |
| | | 2,33,500 | | 2,33,500 |

## 10.6 LET US SUM UP

At the time of preparing the final accounts a number of items need adjustments. It is because certain expenses may relate to two or more accounting years or certain expenses incurred during the current year may still remain to be paid. Unless Such adjustments are made, the final accounts will not reveal the true picture. Such items are usually given outside the Trial Balance and are shown at two places in the final accounts so as to complete the double entry.

Adjustment entries can be passed in the journal for each item of adjustment. But, normally they are directly adjusted in the final accounts. In practice the adjustment entries are always passed for such items and a revised Trial Balance called 'Adjusted Trial Balance' or 'Final Trial Balance' is prepared. In such a situation, the adjustments will appear in the Trial Balance itself. Any item of adjustment which appears in the Trial Balance is shown only at one place in the final accounts.

## 10.7 KEY WORDS

**Abnormal Loss:** Loss caused by abnormal causes.

**Adjustment Entry:** Journal entry passed to make an adjustment in the relevant accounts.

**Adjustment Item:** An item given outside the Trial Balance which requires adjustment at the time of preparing final accounts.

**Adjusted Purchases:** Amount of purchases after adjusting both the opening and closing stocks.

**Adjusted Trial Balance:** Trial balance prepared after incorporating various adjustments.

**Depreciation:** A permanent decrease in the value of a fixed asset caused by wear and tear or the passage of time.

**Doubtful Debts:** Debts of doubtful recovery.

**Outstanding Expenses:** Expenses incurred during the accounting year but not yet paid.

**Outstanding Incomes:** Incomes earned during the accounting year but not yet received.

**Prepaid Expenses:** Expenses paid but the benefit of which is yet to be received.

**Unearned Income:** Income in respect of which the services are yet to be rendered

## 10.8 SOME USEFUL BOOKS

Maheshwari, S.N., 2018. Introduction to Accounting, VikasPublishing House: New Delhi.

Patil, V.A. and J.S. Korlahalli, 2018. Principles and Practice of Accounting, R. Chand & Co., New Delhi.

William Pickles. 1992. Accountancy, E.LB.S. and Pitman, London.

Gupta, R.L. and M. Radhaswamy, 2018. Advanced Accountancy, Sultan Chand & Sons, New Delhi.

Shukla, M.C. and T.S. Grewal, 2018. AdvancedAccountancy, S. Chand & Co., New Delhi.

## 10.9 ANSWERS TO CHECK YOUR PROGRESS

A 1. i) dual ii) asset iii) unexpired iv) liabilityv) Depreciation vi) subtracted

2. i) False ii) True iii) False iv) True v) False

B 3. Provision for Bad Debts Rs. 990
Provision for Discount on Debtors Rs. 376.20

4. i) Rs. 20,000 ii) Rs. 5,000 iii) Rs. 15,000

## 10.10 TERMINAL QUESTIONS/EXERCISES

**Questions**

1. Why some adjustments become necessary at the time of preparing the final accounts? Name any two items of adjustment and explain how they are shown in the final accounts?

2. Distinguish between:

   a) Outstanding Expenses and Unexpired Expenses

   b) Provision for Discount on Debtors and Provision for Discount on Creditors

   c) Normal Loss and Abnormal Loss

**Exercises**

1. Give journal entries for the following adjustments:

| | | |
|---|---|---|
| i) | Interest received in advance | Rs. 600 |
| ii) | Interest on drawings | Rs. 1,200 |
| iii) | Provision for discount on creditors | Rs. 200 |
| iv) | Loss of goods by theft | Rs. 8,500 |
| v) | Drawings of goods by the proprietor | Rs. 750 |

2. The following information is extracted from the books of a businessman:

| | |
|---|---|
| Debtors as on 31.12.2018 | Rs. 25,000 |
| Bad Debts during 2018 | Rs. 1,000 |

Provision for Bad Debts is to be maintained at 5% of debtors.

A Provision for discount on debtors is also to be made at 2%. You are required to calculate the amounts to be set aside in respect of provision for bad debts and provision for discount on debtors respectively.

(**Answer:** Provision for Bad Debts Rs. 1,250; Provision for Discount on Debtors Rs. 475)

3. The Proprietor withdrew the following amounts during the year ended

| December 31, 2018. | Rs. |
|---|---|
| Feb. 28 | 4,000 |
| May 1 | 6,000 |
| Aug. 31 | 5,000 |
| Nov. 1 | 2,000 |
| Dec. 1 | 1,000 |

Calculate interest on drawings if the rate is 6% per annum.

(**Answer:** Rs. 565)

4. From the following Trial Balance of Puri & Sons as on June 30, 2018, prepare Trading and Profit and Loss Account and the Balance Sheet.

**Trial Balance**

| Name at the Account | Debit | Credit |
|---|---|---|
| | Rs. | Rs. |
| Capital | | 1,00,000 |
| Drawings | 5,000 | |
| Purchases less returns | 2,00,000 | |
| Sales less Returns | | 5,00,000 |
| Inventory (beginning) | 50,000 | |
| Wages | 20,000 | |
| Carriage Inwards | 3,000 | |
| Salaries | 25,000 | |
| Freight | 2,000 | |
| Trade Expenses | 5,000 | |
| Rent | | 20,000 |
| Packing Charges | 2,000 | |
| Land & Buildings | 2,00,000 | |
| Plant & Machinery | 2,50,000 | |

| | | |
|---|---|---|
| Furniture | 50,000 | |
| Bad Debts | 5,000 | |
| Debtors | 75,000 | |
| Creditors | | 80,000 |
| Cash in hand & at bank | 5,000 | |
| Bills Receivable | 3,000 | |
| Loan | 2,00,000 | |
| Total | 9,00,000 | 9,00,000 |

**Additional Information :**

i) Inventory (ending): Rs.. 30,000.

ii) Depreciation is to be provided as follows:

Land&building @ 5%p.a.

Plant & Machinery @ 4% p.a.

Furniture @ 10% p.a.

iii) Debtors are bad to the extent of Rs. 5,000

iv) Salaries are outstanding to the extent of Rs. 5,000.

v) Wages are prepaid to the extent of Rs. 2,000.

vi) Rent received in advance Rs. 3,000.

(Answer: Gross Profit Rs. 2,57,000; Net Profit Rs. 2,02,000; Balance Sheet total Rs. 5,85,000)

5. From the following Trial Balance of Kawatra stores, prepare Trading and Profit and Loss Account for the year ended December 31, 2018, and a Balance Sheet as on that date.

**Trial Balance**

| **Name at the Account** | **Debit** | **Credit** |
|---|---|---|
| Capital | | |
| Drawings | 20,000 | |
| Purchases | 4,00,000 | |
| Purchases Returns | | 10,000 |
| Sales | | 7,00,000 |
| Sales Returns | 20,000 | |
| Inventory (beginning) | 1,00,000 | |
| Land & Building | 3,00,000 | |
| Plant & Machinery | 1,50,000 | |
| Goodwill | 50,000 | |
| Trade Marks | 30,000 | |
| Wages. | 40,000 | |
| Trade Expenses | 20,000 | |
| Furniture | 50,000 | |
| Provision for Bad Debts | | 10,000 |
| Debtors | 1,07,000 | |

| | | |
|---|---|---|
| Bad Debts | 3,000 | |
| Salaries | 60,000 | |
| Creditors | | 1,00,000 |
| Acceptances | | 80,000 |
| Investments | 10,000 | |
| Rent | 15,000 | |
| Distribution Expenses | 5,000 | |
| Cash in hand and at bank | 10,000 | |
| Depreciation on Furniture | 10,000 | |
| Total | 4,00,000 | 4,00,000 |

**Additional information:-**

i) The inventory on December 31, 2018 was valued at Rs. 1,50,000. Inventory of the value Rs. 10,000 was destroyed by fire on 1.12.2018. It was fully insured and a claim of Rs. 10,000 was admitted by the insurance company.

ii) Depreciation is to be provided on the following assets:

Land & Buildings @ 5% p.a.

Plant &Machinery @ 12½% p.a.

iii) Debtors are bad to the extent of Rs. 2,000. Provision of 5% on debtors is to be created in respect of bad debts and a provision for discount on debtors is to be created at 2% of debtors.

iv) Wages are outstanding to the extent of Rs. 10,000.

v) Rent is prepaid to the extent of Rs. 5,000.

vi) The general manager is to be provided a commission of 2% on net profits before charging such commission.

(**Answer:** Gross Profit Rs. 3,00,000; Net Profit Rs. 1,55,887;
Balance Sheet total Rs. 8,29,005)

6. From the following Trial Balance of V. Ramana, prepare his final accounts for the year ended December 31, 2018

| Name of the Account | Dr. | Cr. |
|---|---|---|
| | Rs. | Rs. |
| Capital | | 70,000 |
| Drawings | 10,000 | 2,95,000 |
| Adjusted Purchases | 2,32,500 | 2,95,000 |
| Sales | | |
| Cash in hand | 3,800 | |
| Cash at bank | 12,800 | |
| Salaries | 18,000 | |
| Freight | 1,200 | |
| Advertising | 800 | |
| General Expenses | 5,400 | |
| Furniture | 10,800 | |
| Expenses Outstanding | | 2,500 |
| Depreciation | 2,200 | |
| Building | 39,000 | |
| Discount | 700 | |
| Insurance | 600 | |
| Prepaid Insurance | 300 | |
| Rent Received | | 6,000 |
| Rent Received in Advance | | 3,000 |
| Trade Debtors | 14,100 | |
| Trade Creditors | | 24,000 |
| Loss by Fire | 2,000 | |
| Commission | | 1,500 |
| Stock on December 31, 2017 | 49,200 | 4,03,000 |
| Total | 4,03,000 | 4,03,000 |

7. The Trial Balance of S Karim as on December 31, 2018

| Name of the Account | Dr. | Cr. |
|---|---|---|
| | Rs. | Rs. |
| Capital | | 1,10,000 |
| Drawings | 15,000 | |
| Gross Profit earned during 2018 | | 32,000 |
| Salaries and Wages | 22,000 | |
| Rent and Taxes | 8,400 | |
| Cash in hand | 2,300 | |
| Bank Overdraft | | 8,600 |
| Sundry Debtors and Creditors | | 36,000 |
| Insurance (including premium of | 41,000 | |

| | | |
|---|---|---|
| Rs.400 per annum paid upto | 1,000 | |
| March 31, 2018) | 5,000 | |
| Loose Tools | 500 | 800 |
| Bad Debts | | |
| Provision for Bad Debts | 300 | |
| Entertainment Expenses | | 2,100 |
| Commission | 2,600 | |
| General Charges | 12,000 | |
| Furniture and Fixtures | 60,000 | |
| Plant and Machinery | 19,800 | |
| Stock on December 31, 2017 | | |
| | 1,89,000 | 1,89,000 |

Prepare the Profit and Loss Account for the year ending December 31, 2018 and the Balance Sheet as on that date.

(**Answer :** Net Loss Rs. 11,100: Balance Sheet total Rs. 1,30,500

**Note:** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.