



320en16

16

FINANCIAL STATEMENTS : AN INTRODUCTION



Notes

In the previous lessons you have learnt to record the business transactions in various books of accounts and their posting into ledger. You have also learnt about balancing the account and preparing the trial balance. One of the most important purposes of accounting is to ascertain financial results, i.e., profit or loss of the business operations of a business enterprise after a certain period and financial position on a particular date. For this certain financial statements are prepared which are termed as income statement (i.e. Trading and Profit & Loss Account) to know what the business has earned during a particular period and the Position Statement (i.e. Balance Sheet) to know the financial position of the business enterprise on a particular date.

In this lesson you will learn about the financial statements that are prepared by a profit organisations.



OBJECTIVES

After studying this lesson you will be able to :

- explain the meaning and the objectives of preparing financial statements;
- classify the financial statements into Trading and Profit & Loss Account and Balance Sheet;
- distinguish between capital expenditure and revenue expenditure, capital receipts and revenue receipts;
- explain the purpose of preparing Trading Account and Profit and Loss Account;
- draw the format of Trading Account and Profit and Loss Account and
- prepare the Balance Sheet.

16.1 FINANCIAL STATEMENTS : MEANING AND OBJECTIVES



Notes

When a student has studied for a year, he/she wants to know how much he/she has learnt during that period. Similarly, every business enterprise wants to know the result of its activities of a particular period which is generally one year and what is its financial position on a particular date which is at the end of this period. For this, it prepares various statements which are called the financial statements.

Financial statements are the statements that are prepared at the end of the accounting period, which is generally one year. These include Income Statement i.e. Trading and Profit & Loss Account and Position statement i.e. Balance Sheet.

Objectives of preparing Financial Statements

Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that specified period.

Financial statements are generally of two types (a) Income Statement which comprises of Trading Account and Profit & Loss Account, and (b) Position Statement i.e., the Balance Sheet.

Following are the objectives of preparing financial statements: -

1. **Ascertaining the results of business operations :** Every businessman wants to know the results of the business operations of his enterprise during a particular period in terms of profits earned or losses incurred. Income statement serves this purpose.
2. **Ascertaining the financial position :** Financial statements show the financial position of the business concern on a particular date which is generally the last date of the accounting period. Position statement i.e. Balance Sheet is prepared for this purpose.
3. **Source of information :** Financial statements constitute an important source of information regarding finance of a business unit which helps the finance manager to plan the financial activities of the business and making proper utilisation of the funds.
4. **Helps in managerial decision making :** The Manager can make comparative study of the profitability of the concern by comparing the results of the current year with the results of the previous years and make his/her managerial decisions accordingly.

5. **An index of solvency of the concern :** Financial statements also show the short term as well as long term solvency of the concern. This helps the business enterprise in borrowing money from bank and other financial institutions and/or buying goods on credit.

Importance of Financial Statements

- i. **Pertaining to Finance :** The term “financial statement” doesn’t make sense at first. Numbers are for counting while statements need words, so how could these two mix together? But when seen as “money statements,” then suddenly it’s a crucially important matter.
- ii. **Facilitate in Decision Making :** Not only is it important for you, but for the management and stockholders as well. It’s important for the management because financial statements speak of the company’s success and competence, whereas stockholders refer to financial statements to know whether or not to invest in a company. In other words, financial statements tell whether the company made or lost money.
- iii. **Showing the Operational Performance :** Financial statement hold the secrets of a company. Aside from stating whether the company earns or loses money, they also provide clues on where the mangement might find more resources to boost its revenue. In addition, financial statements reveal a company’s past performance and potential.

Capital Expenditure and Revenue Expenditure, Capital Receipts and Revenue Receipts

The preparation of Trading Account and Profit and Loss Account requires the knowledge of revenue expenditure, revenue receipts and capital expenditure and capital receipts. The knowledge shall facilitate the classification of revenue items and put them in the Trading account and Profit and Loss Account on one hand and prepare Balance Sheet based on capital items (expenditure as well as receipts) on the other hand.

Capital Expenditure refers to the expenditure incurred for acquiring fixed assets or assets which increase the earning capacity of the business. The benefits of capital expenditure to the firm extend to number of years. Examples of capital expenditure are expenditure incurred for acquiring a fixed asset such as building, plant and machinery etc.

Revenue expenditure, on the other hand, is an expenditure incurred in the course of normal business transactions of a concern and its benefits are availed of during the same accounting year. Salaries, carriage etc. are examples of revenue expenditure.



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There is another category of expenditure called **deferred revenue expenditure**. These are the expenses incurred during one accounting year but benefits from the same are available wholly or in part in future periods also. These expenditures are otherwise of a revenue nature. Example of deferred revenue expenditure are heavy expenditure on advertisement say for introducing a new product in the market, expenditure incurred on research and development, etc.

Difference between Capital Expenditure and Revenue Expenditure

<i>Basis of Difference</i>	<i>Capital Expenditure</i>	<i>Revenue Expenditure</i>
1. Purpose	It is incurred for acquiring fixed assets.	It is incurred for the maintenance of fixed assets.
2. Earning capacity	It increases the earning capacity of the business.	It helps in maintaining the earning capacity of the business intact.
3. Periodicity of benefit	Its benefits are spread over a number of years.	Its benefits accrue only in one accounting year.
4. Placement in financial statements	It is an item of Balance Sheet and is shown as an item of asset.	It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two.
5. Occurrence of expenditure	It is non-recurring in nature.	It is usually a recurring expenditure.

Capital and Revenue Receipts

Capital receipts are receipts which do not arise out of normal course of business. Examples of such receipts are sale of fixed assets, and raising of loans etc. Such receipts are not treated as income of the enterprise.

Revenue receipts are receipts which arise during the normal course of business, Sale of goods, rent from tenants, dividend received, etc. are some of the examples of revenue receipts. They are the items of incomes of the business entity.

Distinction between Capital Receipts and Revenue Receipts

<i>Basis of Difference</i>	<i>Capital Receipt</i>	<i>Revenue Receipt</i>
Source	Receipts that do not arise during the normal course of business.	Receipts that arise during the normal course of business.
Nature	These are of capital nature and hence are not treated as items of income of the business.	These are of revenue nature and hence are treated as items of income of the business.
Occurrence	These are of non-recurring in nature.	These are recurring in nature.



Notes



INTEXT QUESTIONS 16.1

I. Classify the following items of expenditure into capital expenditure revenue expenditure and deferred revenue expenditure

- (i) Amount spent on purchase of machine.
- (ii) Expenditure incurred on repairs of building.
- (iii) Heavy expenditure on advertisement to introduce a new product in the market.
- (iv) Purchase of motor vehicle for business use.

II. One important objective of financial statements is to ascertain the results of business operations. List the other objectives of the financial statements:

- (a)
- (b)
- (c)
- (d)

16.2 TRADING ACCOUNT

Income statement consists of Trading and Profit and Loss Account. Let us, first study the Trading Account. A business firm either purchases goods from others and sells them or manufactures and sells them to earn profit. These are known as trading activities. A statement is prepared to know the results in terms of profit or loss of these activities. This statement is called Trading Account.



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Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit. Cost of goods sold is subtracted from the net sales of the business of that accounting year. In case the total sales value exceeds the cost of goods sold, the difference is called Gross Profit. On the other hand, if the cost of goods sold exceeds the total net sales, the difference is Gross Loss. All accounts related to cost of goods sold such as opening stock, net purchases i.e. purchase less returns outward, direct expenses such as wages, carriage inward etc. and closing stock with net sales (i.e. Sales minus Sales returns) are posted to the Trading Account. Then this account is balanced. Credit balance shows the gross profit and debit balance shows the gross loss.

It is necessary to understand the meaning of cost of goods sold before preparing Trading Account.

Cost of goods sold and gross profit

A business enterprise either purchases goods or manufactures goods to sell in the market. Cost of goods sold is computed to know the profit earned (Gross Profit) or loss incurred (Gross Loss) from the trading activities of a business unit for a particular period.

Cost of goods sold = the amount of goods purchased + expenses incurred in bringing the goods to the place of sale or expenses incurred on manufacturing the goods (called direct expenses).

In case there is a stock of goods to be sold in the beginning of the year or at the end of the year, the cost of goods is calculated as follows :

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

Gross Profit = Net sales – Cost of goods sold

Illustration 1

Calculate the cost of goods sold from the following information :

	₹
Opening stock	10000
Closing stock	8000
Purchases	80000
Carriage on purchases	2000
Wages	6600

Solution :

$$\begin{aligned}
 \text{Cost of Goods Sold} &= \text{Opening Stock} + \text{Purchases} + \text{Direct Expenses} \\
 &\quad (\text{Carriage on Purchases} + \text{Wages}) - \text{Closing Stock} \\
 &= ₹ [10,000 + 80,000 + 86,00 \\
 &\quad \quad (\text{i.e. } 2,000 + 6,600) - 8,000] \\
 &= ₹ 90600
 \end{aligned}$$

Illustration 2

Calculate cost of goods sold and gross profit from the following information.

Sales	₹ 62500
Sales Returns	₹ 500
Opening Stock	₹ 6400
Purchases	₹ 32000
Direct Expenses	₹ 4200
Closing Stock	₹ 7200

Solution :

		₹
Net sales		
(Sales-Sales Returns i.e. 62500 – 500)		62000
Less : Cost of goods sold		
Opening Stock	6400	
Add Purchases	32000	
Add Direct Expenses	4200	
Less : Closing Stock	(7200)	35400
Gross Profit		26600
Or Gross profit = Net sales – cost of goods sold		
= 62000 – 35400 = 26600		

Illustration 3

From the following information for the year ending 31st March, 2014 furnished by Mr. Vikram, a trader, calculate cost of goods sold and also calculate Gross Profit/Gross Loss of business.

*Notes*



Notes

	₹
Sales	1,20,000
Purchases	80,000
Octroi	1,600
Carriage on purchases	4,500
Purchase Returns	2,400
Opening Stock	27,600
Closing Stock	32,400

Solution :

Cost of goods sold :

	₹
Opening stock	27,600
Add Net Purchases	
(₹ 80,000 – ₹ 2,400)	77,600
Add carriage on Purchases	4,500
Add Octroi	1,600
Cost of goods available for sale	1,11,300
Less closing stock	32,400
Cost of goods sold	78,900

Gross Profit :

	₹
Sales	1,20,000
Less : Cost of goods Sold	78,900
Gross Profit	41,100

Need of Trading Account

Trading Account serves the following purposes :

- 1. Knowledge of Gross Profit :** Trading Account gives information about Gross Profit. It is the profit earned by a business enterprise from its trading activities. The percentage of gross profit on sales reflects the degree of success of business.

2. **Knowledge of All Direct Expenses :** All direct expenses are debited to trading Account. Direct expenses are the expenses that can be directly attributed to purchase or manufacturing of goods for sale. Percentage of Direct expenses on sales of current year when compared with the same of previous years, helps the manager to exercise control over direct expenses.
3. **Precaution against Future Losses :** Trading Account, if shows gross loss, reasons for this loss can be found out and necessary corrective steps can be taken.



Notes

FORMAT OF TRADING ACCOUNT

Trading Account of
for the year ending

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Dr. Opening Stock			Cr.
Purchases		Sales	
Less Purchase Returns		Less: Sales Returns	
Direct Expenses :		Closing stock	
Carriage Inward		Gross loss transferred to	
Freight		Profit & Loss Account	
Wages			
Fuel & Power			
Excise Duty			
Factory Rent			
Heating & Lighting			
Factory Rent & Insurance			
Work Managers Salary			
Gross Profit transferred to Profit & Loss Account			

Important Items of Trading Account

Important items of Trading account are :



Notes

1. **Stock :** Stock refers to the goods lying unsold on a particular date. It can be of two types : **(a) Opening stock and (b) Closing stock**
 - (a) Opening Stock :** Opening stock refers to the value of goods lying unsold at the beginning of the accounting year. It is shown on the debit side of the Trading Account. In the first year of business there is no opening stock.
 - (b) Closing Stock :** It is the value of goods lying unsold at the end of the accounting year. It is valued at the cost price or market price whichever is less. It is shown on the credit side of the Trading Account.
2. **Purchases :** Purchases mean total items purchased for resale during the year. It can be both in cash and on credit. Purchases are shown on the debit side of the Trading Account. These are always shown as net purchases i.e. amount of purchases returned (Purchase returns or return outwards) is deducted from the total amount of purchases made. Goods received on consignment basis are never treated as purchases. Similarly, goods received on 'sale or return' basis are never treated as purchases.
3. **Sales :** Sales refer to the total revenue from sale of goods of the business enterprise for which the Trading Account is being prepared. It includes both cash sales and credit sales. These are recorded on the credit side of the Trading Account. Sales are shown at their net value i.e. sales return or returns inward is deducted from the total sales. Cash sales plus credit sales minus sales returns constitute net sales. Goods sent on 'sale or approval' are not part of sales until approval is received.
4. **Direct Expenses :** Direct expenses are the expenses that can be attributed directly to the purchase of goods or goods manufactured. These are shown on the debit side of the Trading Account. These are shown at the amount as shown in the Trial Balance. For example, wages are recorded on the debit side of Trading Account at the amount shown in the Trial Balance.

Important Items of Direct Expenses

1. Wages i.e. wages relate to production. If amount under this head includes wages paid for construction of building or manufacturing of furniture for office it will be subtracted from the amount of wages.
2. Carriage, Cartage and Freight i.e. amount paid for carriage of goods purchased for sale or raw material purchased for manufacturing.
3. Other such direct expenses are customs and import duty, packing materials, gas, electricity water, fuel, oil, gas greese, heating and lighting, factory rent and insurance and many more such items.

5. Gross Profit/Gross Loss : It is the excess of net sales revenue over cost of goods sold. Gross Profit is equal to net sales minus cost of goods sold. If total of the credit side exceeds the total of debit side, the excess amount is termed as 'gross profit' and is shown on the debit side of Trading Account. On the other hand if debit side is more than the credit side, the difference in amount is called gross loss and is shown on the credit side of the Trading Account.

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Goods Sold}$$

$$\text{Gross Loss} = \text{Cost of Goods Sold} - \text{Net Sales}$$



Notes



INTEXT QUESTIONS 16.1

I. Fill in the blanks with suitable word/words :

1. Financial statements are generally of Types.
2. Income statement comprises of A/c and A/c.
3. Trading Account is prepared to ascertain the profit of the business.
4. The percentage of gross profit on sales reflects the degree of of business.

II. Show the result in the following cases

- (a) Sales – sales return =
- (b) Purchases – purchases return =
- (c) Total of the credit column of trading account – total of the debit column of trading account =
- (d) Cost of goods sold – total sales =
- (e) Total of the debt column of trading account - Total of the credit column of trading account =

16.3 TRANSFER ENTRIES

Before preparing Trading Account, closing or transfer journal entries are made in the journal proper of the business enterprise. These journal entries are:

(a) For transferring debit balances

Trading A/c	Dr.
To Opening stock	
To Purchases	



Notes

- To Direct expenses
- To Sales returns
- (Transfer of balances of opening Stock,
Purchases, direct expenses & Sales Returns)
- (b) For transferring credit balances
- Sales A/c Dr.
- Closing stock A/c Dr.
- Purchase Returns A/c Dr.
- To Trading A/c
- (Transfer of credit balances of Sales,
Closing Stock, Purchase return)
- (c) For transferring gross profit
- Trading A/c Dr.
- To Profit & Loss A/c
- (Transferring of gross profit)
- (d) For transferring gross loss
- Profit & Loss A/c Dr.
- To Trading A/c
- (Transferring of gross loss)

Illustration 4

The ledger balances extracted at the close of a trading year on 31st March, 2014 are given as follows

<i>Name of the Account</i>	<i>Amount (₹)</i>
Opening stock	12,000
Purchases	52,000
Sales	74,000
Purchase Returns	2,000
Carriage Inward	800
Wages	4,200
Closing stock	13,500

Pass necessary journal entries in the journal proper.

Solution :

Journal

Date 2014	Particulars	LF	Dr Amount ₹	Cr Amount ₹
March 31	Trading A/c Dr		69,000	
	To Opening stock A/c			12,000
	To Purchases A/c			52,000
	To Wages A/c			4,200
	To Carriage Inward A/c			800
	(Transfer of debit balances to trading Account)			
March 31	Sales A/c Dr		74,000	
	Purchase Returns A/c Dr		2,000	
	Closing stock A/c Dr		13,500	
	To Trading A/c			89,500
	(Transfer of credit items to trading account)			
March 31	Trading A/c Dr		20,500	
	To Profit & Loss A/c			20,500
	(Transfer of gross profit to Profit & Loss Account)			



Notes

Illustration 5

Following balances have been extracted from the ledger of Rohit & Sons at the close of the year 2014.

	₹
Stock (1.1.2014)	21,000
Purchases	1,40,000
Sales	2,24,000
Purchases Returns	8,000



Notes

Sales Returns	12,000
Wages	15,000
Factory Power	12,000
Stock (31.12.2014)	26,500

Make closing journal entries in the journal proper.

Solution :

Journal

<i>Date</i> 2014	<i>Particulars</i>	<i>LF</i>	<i>Dr</i> <i>Amount</i>	<i>Cr</i> <i>Amount</i>
Dec. 31	Trading A/c Dr		2,00,000	
	To Opening stock A/c			21,000
	To Purchases A/c			1,40,000
	To Sales Returns A/c			12,000
	To wages A/c			15,000
	To Factory power A/c			12,000
	(Closing entry of debit items transferred to Trading A/c)			
	Sales A/c Dr		2,24,000	
	Closing stock A/c Dr		26,500	
	Purchase Returns A/c Dr		8,000	
	To Trading A/c			2,58,500
	(Transfer of credit balances to Trading A/c)			
	Trading A/c Dr		58,500	
	To Profit & Loss A/c			5,8500
	(Transfer of Gross Profit)			

**INTEXT QUESTIONS 16.3**

Write the “debit” if the items given below are to be placed in debit side of the Trading A/c and “Credit” if they are placed in the credit side of the Trading Account.

- (i) Closing stock
- (ii) Carriage inward
- (iii) Sales
- (iv) Custom duty

*Notes***16.4 PROFIT & LOSS ACCOUNT**

As stated earlier, income statement consists of two accounts : Trading Account and Profit & Loss Account. You have seen that Trading account is prepared to ascertain the gross profit or gross loss of the trading activities of the business. But these are not the final results of business operations of an enterprise. Apart from direct expenses, there are indirect expenses also. These may be conveniently divided into office and administrative expenses, selling and distribution expenses, financial expenses, depreciation and maintenance charges etc.

Similarly, there can be income from sources other than sales revenue. These may be interest on investments, discount received from creditors, commission received, etc. Another account is prepared in which all indirect expenses and revenues from sources other than sales are presented. This account when balanced shows net profit (or net loss). This account is termed as Profit and Loss Account. The profit shown by this account is called ‘net profit’ and if it shows loss it is known as ‘net loss’.

FORMAT OF PROFIT AND LOSS ACCOUNT

Profit and Loss A/c of M/s

for the year ended

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Gross loss b/d; if any	—	Gross Profit b/d	—
Salaries	—	Discount Received	—
Rent, Rates & taxes	—	Commission Received	—
Insurance Premium	—	Dividend Received	—



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Advertising	—	Interest on Investment	—
Commission paid	—	Rent Received	—
Discount Allowed	—	Net Loss transferred	
Repairs & Renewals	—	to capital account; if any	—
Bad Debts	—		
Establishment charges	—		
Travelling Expenses	—		
Bank Charges	—		
Sales Tax/Value added Tax	—		
Depreciation on fixed assets	—		
Net Profit transferred to			
Capital Account	—		

Some important items of Profit and Loss Account

As stated earlier indirect expense are shown on the debit side of Profit and Loss A/c. These can be classified under the following heads :

Debit Items

- 1. Selling and Distribution Expenses :** To materialise sales, the expenses incurred are called selling and distribution expenses. Examples are :
Carriage on sales/carriage outwards, advertisement, selling expenses, travelling expenses and salesman commission, depreciation of delivery van, salary of driver of the delivery van, etc.
- 2. Office and Administration Expenses :** These are the expenses incurred on establishment and maintenance of office. Some of the expenses that may be under this head are: rent, rates and taxes, postage, printing and stationery, insurance, legal charges, audit fees, office salaries, etc.
- 3. Financial Expenses :** Finances are to be arranged for carrying on business. Expenses that are incurred in this connection are called financial expenses. Some of the financial expenses are: interest on loan, interest on capital, discount on bills, etc.
- 4. Depreciation and Maintenance Charges :** The total value of a fixed asset like machinery, building, furniture, etc. is not charged to profit and loss account in the year in which it is purchased. Such assets help running business for a number of

years to come. Therefore, only a part of the value of such assets is treated as an expense and is charged to Profit and Loss A/c as depreciation. Depreciation means decline in the value of fixed asset due to wear and tear, lapse of time, obsolescence, etc. Expense incurred on repairs and renewals and maintenance of assets are expenses other than depreciation under this category.

- 5. Other Expenses :** These are the expenses which are not included under the above mentioned heads of expenses for example, losses and expenses due to fire, theft etc.

Credit Items

On the credit side of Profit and Loss Account, items of revenue and incomes are written. The first item on this side of Profit and Loss Account is the gross profit transferred from trading account. Other items of the credit side are : Interest on investment, interest on fixed deposits etc. rent received, commission received, discount received, dividend on shares received etc.

Need of preparing Profit and Loss Account

Need of preparing profit and loss account by a business concern may be stated as follows :

- (i) To know the net profit or net loss of a business for an accounting year.
- (ii) Net profit of one year can be compared with net profits of previous year or years. It helps in ascertaining whether the business is being conducted efficiently or not.
- (iii) Different expenses which are taken to Profit & Loss A/c in one year can be compared with the amounts incurred in previous year or years. This helps in ascertaining the need of applying control over such expenses.



INTEXT QUESTIONS 16.4

- I. Following are the items of expenditure and income to be taken to Profit and Loss Account. Write 'E' for expenses and 'I' for income against each item.**

- (i) Interest on Fixed Deposit
- (ii) Advertisement
- (iii) Insurance Premium
- (iv) Discount allowed by creditors
- (v) Carriage on sales



Notes



Notes

II. State whether the following statements are 'true or false'. Write true for true statements and 'false' for false statements.

- (i) Profit and Loss Account is prepared to ascertain the Gross Profit of a business unit.
- (ii) Items of income are written on the credit side of Profit and Loss Account.
- (iii) Net Profit calculated by preparing Profit and Loss Account is transferred to Trading Account.
- (iv) Profit and Loss Account is prepared for an accounting year.

16.5 TRANSFERRING ENTRIES OF PROFIT AND LOSS ACCOUNT

Before preparing Profit and Loss Account as per the format given in the previous section, closing entries are made in the journal proper of the enterprise. Following journal entries are made :

- (i) For transferring the indirect expense accounts :

Profit & Loss A/c	Dr.
To Salaries A/c	
To Insurance Premium A/c	
To Bad Debts A/c	
To Discount Allowed A/c	
(Transfer of indirect expenses)	

- (ii) For transfer of items of incomes and gain

Interest on investment A/c	Dr.
Rent Received A/c	Dr.
Discount Received A/c	Dr.
To Profit & Loss A/c	
(Transfer of items of income)	

- (iii) For transferring Net Profit :

Profit & Loss A/c	Dr.
To Capital A/c	
(Transferring of Net Profit to Capital A/c)	

(iv) For transferring Net Loss

Capital A/c	Dr.
To Profit & Loss A/c	
(Transfer of Net Loss to Capital Account)	

Illustration 6

The following balances were extracted from the books of Maya Gupta & Sons at the end of March 31, 2014. Make necessary closing entries as on that date:

<i>Items</i>	<i>Dr. Balance (₹)</i>	<i>Cr. Balance (₹)</i>
Gross Profit	65,000	
Salaries	11,500	
Audit fees	400	
Insurance Premium	800	
Interest received		1,600
Discount (Cr)		460
Advertisement	1,200	
Bad Debts	150	
Discount Allowed	340	
Depreciation	460	
Rent from tenants	—	1,800

Solution :

Journal Entries

(i) Trading A/c	Dr.	65,000	
To P&L A/c			65,000
(Gross profit transferred to P&L A/c)			
(ii) Profit & Loss A/c	Dr.	14850	
To Salaries A/c			11500
To Audit Fees A/c			400



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	To Insurance Premium A/c		800
	To Advertisement A/c		1200
	To Bad Debts A/c		150
	To Discount Allowed A/c		340
	To Depreciation A/c		460
	(Transfer of items of expenses to profit & Loss A/c)		
(iii)	Interest A/c	Dr.	1600
	Discount Received A/c	Dr.	460
	Rent A/c	Dr.	1800
	To Profit & Loss A/c		3860
	(Transfer of items of income to Profit & Loss A/c)		
(iv)	Profit & Loss A/c	Dr.	54010
	To Capital A/c		54010
	(Transfer of Net Profit to Capital Account)		

Illustration 7

The following ledger balances were extracted from the books of Rabina & Brothers at the end of accounting year 31st March, 2014. Make journal entries to transfer these balances to prepare Profit & Loss A/c for the year ending 31st March, 2014.

	₹
Gross Profit	65800
Salaries	8400
Rent paid	2400
Discount allowed	500
Interest on investments	3100
Advertisement	1800
Trading expenses	1600
Bad Debts	500
Depreciation	600
Insurance Premium	800
Commission received	2700

Solution :

Trading A/c	Dr.	65,800	
To P & L A/c			65,800
(Gross profit transferring to P&L A/c)			

Journal

<i>Date 2014</i>	<i>Particulars</i>	<i>LF</i>	<i>Dr Amount</i>	<i>Cr Amount</i>
March 31	Profit & Loss A/c Dr		16600	
	To Salaries A/c			8400
	To Rent A/c			2400
	To Discount allowed A/c			500
	To Advertisement A/c			1800
	To Trading expenses A/c			1600
	To Bad Debts A/c			500
	To Depreciation A/c			600
	To Insurance Premium A/c			800
	(Transfer of indirect expenses to profit & Loss A/c)			
March 31	Commision A/c Dr		2700	
	Interest A/c Dr		3100	
	To Profit & Loss A/c			5800
	(Transfer of incomes other than sales to Profit & Loss A/c)			
March 31	Profit & Loss A/c Dr		55000	
	To Capital A/c			55000
	(Transfer of net profit to capital A/c)			



Notes

Operating Profit

Operating profit is the excess of gross profit over operating expenses. Gross Profit is the excess of net sales revenue over cost of goods sold. Operating expenses includes office and administration expenses, selling and distribution expenses, cash discount allowed, interest on bills payable and other short term debt, bad debts and so on. Net sales means cash sales + credit sales - sales returns.



Notes

$$\begin{aligned} \text{Operating Profit} &= \text{Net Sales} - \text{Operating Cost} \\ &= \text{Net Sales} - (\text{Cost of goods sold} + \text{administration and office exp.} + \text{Selling and Distribution expenses}) \end{aligned}$$

$$\text{Operating Profit} = \text{Net Profit} + \text{Non-operating exp.} - \text{Non-Operating Income}$$

Illustration 8

Compute Operating profit from the following particular.

	₹		₹
Gross Profit	44,000	Interest on loan	2200
Carriage outward	480	Interest on investment	280
Advertising	1200	Printing and Stationery	360
Salaries	17,800	Loss on Sale of furniture	3,500
Rent & Taxes	6,200	General expenses	140
Lighting	1,500	Donation	510
Insurance charge	240	Rent Received	600
Bad Debts	150	Loss by fire	2,000
Audit fees	200	Gain on sale of machine	5,000

Solution

Computation of Operating Profit

	₹	₹
Gross Profit		44,000
<i>Less :</i> Selling and Distribution expenses :		
Carriage outward	480	
Advertising	1,200	
Bad Debts	150	
	1,830	
<i>Less :</i> Office and Administrative Expenses		
Salaries	17,800	
Rent & Taxes	6,200	
Lighting	1,500	
Insurance	240	
Audit fees	200	
Printing & Stationery	360	
General expense	140	
	26,440	
Operating Profit		15,730

Position Statement/Balance Sheet

Position Statement or Balance Sheet is another financial statement that a business enterprise prepares. Balance Sheet is a statement prepared on a particular date, generally at the end of accounting year to ascertain the financial position of the business entity. It consists of assets on the one hand and liabilities on the other.

In the words of Francis R Steal, “Balance Sheet is a screen picture of the financial position of a going business at a certain moment.” In the words of Freeman, “A Balance Sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain date.”

Financial position of a business is the list of assets owned by the business and the claims of various parties against these assets. The statement prepared to show the financial position is termed as Balance Sheet.

In the next lesson we shall discuss Balance Sheet in detail.

**INTEXT QUESTIONS 16.5**

I. Write ‘debit’ if Profit and Loss Account is to be debited and ‘credit’ if profit and loss account is to be credited of the following items :

- (a) Legal charges (b) Net Loss (c) Rent Received
(d) Discount Allowed (e) Salaries

II. (a) Name the financial statement which is prepared in addition to income statement.

- (b) Why it is prepared?
(c) When it is prepared?
(d) Name its two elements.

III. (a) Operating Profit = Net Sales - _____

(b) Operating Profit = Net Profit + Non-Operating Expenses - _____

(c) If Net Sales = ₹ 2,00,000 and Operating cost = ₹ 1,50,000 than calculate Operating profit.

**WHAT YOU HAVE LEARNT**

- Financial statements are of two types :
 - (a) Income Statement i.e. Trading Account and Profit and Loss Account.



Notes



Notes

(b) Position Statement i.e. Balance Sheet.

- Trading Account is prepared to ascertain the results of the trading activities of the business.
- Trading Account may show profit (i.e. the excess of sales to cost of goods sold or excess of credit side over debit side), which is termed as Gross Profit.

Trading Account may show loss (i.e. Cost of goods sold exceeds sales or total of debit side exceeds total of credit side). This is called Gross Loss.

- Profit and Loss Account is prepared to find out Net Profit/Net Loss.

Net Profit = Gross Profit + other incomes – Indirect expenses.

It may also show a net loss.

All indirect expenses are shown on the debit side of Profit & Loss Account.

All incomes and gains are shown on the credit side of Profit & Loss Account.

- Balance Sheet is prepared to ascertain the financial position of a firm on a particular date.



TERMINAL EXERCISE

1. State the meaning of financial statements.
2. Explain in brief the various objectives of financial statements.
3. Explain in brief the following terms with two examples of each :
 - (a) Revenue expenditure.
 - (b) Revenue Receipts
 - (c) Capital expenditure
 - (d) Capital Receipts
4. Distinguish between capital expenditure and Revenue expenditure on the basis of:
 - (a) Earning capacity
 - (b) Placement in financial statements
 - (c) Occurrence of expenditure
5. Distinguish between capital receipts and revenue receipts.
6. How is cost of goods sold calculated?



Notes

7. What is Trading Account? Why is it prepared?
8. How is Gross Profit calculated?
9. What is meant by Profit and Loss Account? Why is it prepared?
10. When does Profit and Loss Account show Net Profit?
11. What are direct expenses? Give two examples of such expenses.
12. State the meaning of Balance Sheet.
13. From the following balances of Sabana calculate Gross Profit or Gross Loss by subtracting cost of goods sold from sales for the year ended 31st December, 2014

	₹
Stock (1.1.2014)	26500
Purchases	64600
Sales	86800
Purchases Returns	2600
Sales Returns	1800
Freight inward	750
Wages	1850
Closing Stock	31100

14. From the following balances extracted from the books of Seth Brothers. Pass journal entries to prepare a Trading Account and Profit and Loss Account for the year ended 31st March, 2014.

	₹		₹
Stock (1.4.2013)	20000	Electric Power	5000
Purchases	95000	Wages	14000
Return Inwards	2000	Selling Commission	5500
Carriage Inwards	1850	Repair & Renewals	2000
Carriage Outwards	1200	General Expenses	8000
Custom duty	3000	Insurance	2200
Return outwards	5000	Stock (31.3.2014)	45000
Sales	165000		
Discount Received	1500		



Notes

15. The balances from the books of Parimal Ghosh are given below. Pass journal entries to prepare Trading and Profit & Loss Account for the year ended 31st March, 2014

	₹		₹
Stock as on 1.4.2013	9480	Purchase Returns	1800
Purchases	50800	Advertising	1500
Wages	1200	Commission (Cr.)	3200
Salaries	3400	Rent from tenant	2800
Octroi	1320	Sales	72000
Rent & Taxes	850	Stock (31.3.2014)	10700
Bad Debts	250		
Discount (Dr.)	360		
Interest on capital	760		

16. From the following information calculate cost of goods sold for the year ending 31st March, 2014

	₹		₹
Opening Stock	14800	Factory expenses	7200
Purchases	65700	Closing stock	28400
Returns outward	1700		
Wages	12500		
Carriage Inward	2400		
Custom Duty	3200		
Rent paid	4500		
Establishment expenses	650		

17. From the following balances extracted from the books of Jai Bhagwan & Sons as on 31st March, 2014. Pass journal entries to prepare Trading A/c and Profits & Loss A/c

	₹		₹
Opening Stock	16000	Rent	3600
Purchases	76000	Office expenses	1600
Machinery	28000	Carriage Inward	1200

Debtors	21600	Sales Returns	5400
Drawings	7200	Credit Balance	
Wages	1500	Capital	70000
Bank	12000	Creditors	14000
Depreciaton	2800	Sales	108000
Closing stock	24000	Purchase Returns	2600



Notes



ANSWERS TO INTEXT QUESTIONS

- 16.1** I. (i) Capital (ii) Revenue
 (iii) Deferred Revenue (iv) Capital
- II. (a) Ascertaining the financial position
 (b) Source of information
 (c) Helps in managerial decision making
 (d) An index of the solvency of the concern.
- 16.2** I. 1. Two 2. Trading and Profit & Loss
 3. Gross Profit 4. Success
- II. (a) Net sales (b) Net purchases (c) Gross profit
 (d) Gross Loss (e) Gross Loss
- 16.3** (i) Credit (ii) Debit (iii) Credit (iv) Debit
- 16.4** I. (i) I (ii) E (iii) E (iv) I (v) E
 II. (i) F (ii) T (iii) F (iv) T
- 16.5** I. (a) debit (b) debit (c) Credit (d) debit (e) debit
 II. (a) Balance sheet
 (b) to show the financial position of the concern
 (c) At the end of an accounting year
 (d) assets; liabilities
- III. (a) Operating Cost (b) Non-operating income
 (c) ₹ 50,000



ANSWERS TO TERMINAL EXERCISE

- 13. Gross Profit : ₹ 25000
- 14. Gross Profit : ₹ 74150 Net Profit : ₹ 56750
- 15. Gross Profit : ₹ 21700 Net Profit : ₹ 20580
- 16. Cost of goods sold : ₹ 75700
- 17. Gross Profit : ₹ 21000 Net Profit : ₹ 13000



Notes



ACTIVITY

Procure trial balance of at least four business concerns and classify the items into :

- (a) Revenue expenditure (b) Revenue receipts
- (c) Capital expenditure (d) Capital Receipts

<i>Name of organisation</i>	<i>Item of expenditure</i>	<i>Revenue expenditure</i>	<i>Revenue receipts</i>	<i>Capital expenditure</i>	<i>Capital Receipts</i>