**Financial Statements**

Financial statements serves as a means of communicating information about the profitability (income statement) and the financial position (Balance Sheet) of the business in a concise and understandable manner at the end of accounting period.

**Financial statements include these statements:**

**(i)** Income statement (Trading and Profit and Loss Account)—prepared to ascertain gross profit and net profit/loss during an accounting period.

**(ii)** Statement of Financial Position (Balance Sheet)—prepared to ascertain position (assets, liabilities and capital) of an enterprise at a particular point of time.

**(iii)** Schedules and notes forming part of Balance sheet and Income statement —to give detail of various items shown in both the statements.

**Capital Expenditure**

The non-recurring expenditure whose benefit is derived by the business for more than a year is called Capital Expenditure.

It includes amount spent or liabilities incurred to acquire or improve any fixed assets or acquiring any legal rights or first-time expenses incurred to make fixed assets workable e.g. purchase of machinery/building/furniture etc., expenses incurred to acquired Patents, Trade-mark etc. and expenditure incurred for getting an asset ready to use (like installation exp., carriage, first time expenses incurred on second hand fixed asset for making it ready to use).

Capital expenditures are recorded on the assets side of the Balance sheet.

**Revenue Expenditure**

The recurring and routine nature expenditures which are incurred for operating the business smoothly and which help to maintain business’s earning capacity, are called Revenue expenditure e.g. expenses incurred for producing finished goods such as direct expenses, purchase of raw material and other expenses as rent, salary, repairs etc.

The benefit of these expenses last in one year (give benefit up to one year). These expenses are shown in Debit side of income statement (trading and profit and loss account).

**Deferred Revenue Expenditure**

The expenditure which is revenue in nature, but the heavy amount spent and benefits likely to be derived over a number of years called deferred revenue expenditure e.g. heavy expenses on advertising on launching of a new product and hence it is capitalized like any fixed asset.

**Accounting treatment of Deferred Revenue Expenditure**

As per matching principle, expenses incurred in an accounting period are matched with the revenue recognized in that accounting period. So the whole deferred revenue expenditure should be spread over the number of years over which benefit is likely to be derived.

During the current accounting year (a) Only that portion of the expenditure should be charged to the profit and loss account which has facilitate the enterprise to earn revenue during current year (b) Remaining amount of expenditure be carried forward to the next year and shown in the assets side of balance sheet (It is also called a fictitious asset).

**Capital Receipt**

Capital receipts are those irregular receipts that don’t affect profit or loss of business; it either increases the liabilities (raising of loan) or reduces the fixed assets (by sale of fixed assets), so it will be shown in balance sheet.

Capital receipts are not made available for distribution of profit to the owner.

**Revenue Receipt**

Revenue receipts are received in the normal and regular course of business like Receipts from sale of goods and rendering services to customers. Income from non-operating business activities (like income from investment i.e. interest and dividend received and rent received, Commission and other fees received for non-operating business etc. These receipts increases profit and shown in the credit side of the Trading and Profit and Loss account.

**Types of Expenses**

**Direct Expenses:** Those expenses which are incurred on purchasing of goods and for converting raw material into the finished goods e.g.

Manufacturing wages, Expenses on purchases (including all duty and tax paid on purchases), Carriage/Freight/Cartage inwards, Production expenses (such as power and fuel, water etc.), factory expenses (e.g. lighting, rent and rates), Royalty based on Production etc.

Note: All direct expenses are debited to Trading account.

**Indirect Expenses:** Those expenses which are not directly related to production or purchase of the goods are called indirect expenses. It includes those expenses which are related to office and administration, selling and distribution of goods and financial expenses etc.

These expenses are shown in the debit side of the Profit and Loss A/c.

Calculation of Gross Profit

Gross Profit = Net Sales – Cost of Goods Sold

Cost of goods sold = Opening Stock + Net Purchases + Direct Expenses – Closing Stock.

Calculation of Operating Profit

Operating profit = Net sales – Operating cost

**OR**

= Gross Profit – (Office and Administrative Expenses + selling and distribution exp.)

Operating Cost = Cost of Goods Sold + Office and Administrative Expenses + Selling and distribution exp.

Net Profit = Operating Profit + Non-operating Income – Non-operating expenses.

**Operating expenses:** The expenses which are related to the main or normal activities of the business e.g. office and Administrative expenses, selling and distribution expenses Operating profit is also called EBIT (Earnings before interest and taxes).

**FORM OF TRADING ACCOUNT**

**TRADING PROFIT AND LOSS ACCOUNT**

**For the year ended………**

|  |  |  |  |
| --- | --- | --- | --- |
| *Particulars* | *Rs.* | *Particulars* | *Rs.* |
| To Opening Stock  To Purchases  **Less:** Purchases Returns  To Wages/Wages and Salaries  To Carriage Inwards To Freight Inwards To Gas & Fuel  To Power & Water  To Factory Rent & Rates  To manufacturing Expenses To Import and Customs Duty To Royalties on Production  To Gross Profit (balance figure] |  | By Sales  Less: Return Inwards/SalesReturns  By Closing Stock  By Gross Loss[balance figure]  (Transferred to Profit & Loss  Account) |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Particulars** | **Rs.** | **Particulars** | **Rs.** |
| **To Gross Loss**  **(Transferred from Trading A/c)**  **Office & Admin. Expenses**  **To Salaries**  **To Rent Rates Taxes**  **To Printing and Stationery**  **To Salaries & Wages**  **To Postages and Telephones**  **To Office Lighting**  **To Insurance Premium**  **To Legal Expenses**  **To Audit Fees**  **To Travelling Expenses**  **Selling & Distribution Exp.**  **To Carriage and Freight Outwards** |  | By Gross Profit  (Transferred from Trading A/c)  By Rent Received  By Discount Received  By Rebates  By Commission Received  By Interest Received  By Dividend Received  By Bad Debts Recovered  By Apprentice fees or premium  By Gain on Sale of Fixed Asset  By Miscellaneous Receipts  By Net Loss (If Dr. side> Cr. side) (Transferred to capital Account) |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Particulars** | **Rs.** | **Particulars** | **Rs.** |
| **To Commission**  **To Brokerage**  **To Advertisement**  **To Publicity**  **To Bad Debts**  **To Export Duty**  **To Packing Expenses**  **To Salaries of Salesman**  **To Delivery Van Expenses**  **Financial Exp.**  **To Interest paid on loans**  **To Discounts Allowed**  **To Rebate Allowed To Bank Charges Miscellaneous Exp.**  **To Repairs**  **To Depreciation on Fixed Assets**  **To Entertainment Expenses**  **To Donations & Charity**  **To Loss on Sale of Fixed Assets**  **To Stable Expenses**  **To Loss by Fire**  **To Loss by theft**  **To Unproductive Expenses**  **To Net Profit Transferred to Capital Account**  **(If Cr. side > Dr, side)** |  |  |  |

**GROUPING AND MARSHALLING OF ASSETS AND LIABILITIES**

**Grouping:** The term ‘Grouping’ means putting together items of a similar nature under a common heading. For example, under the heading ‘trade Creditors’ the balances of the ledger accounts of all the suppliers from whom goods have been purchased on credit, will be shown.

**Marshalling:** It refers to the order in which the various assets and liabilities are shown in the Balance Sheet. The assets and liabilities can be shown either in the order of liquidity or in the order of permanence.

**Order of Liquidity**

**1.**The assets are arranged in the order of their liquidity i.e., the most liquid asset (e.g., cash-in-hand), is shown first. The least liquid asset (e.g., goodwill) is shown last.

**2.**The liabilities are arranged in the order of timing i.e., the liabilities which are to be paid immediately {e.g., Creditors) are shown first and which are to be paid later are shown at last (long-term loans).

A general format of a Balance Sheet in order of liquidity is shown below:

**Balance Sheet of ……….**

As at………….

|  |  |  |  |
| --- | --- | --- | --- |
| **Liabilities** | **Rs.** | **Assets** | **Rs.** |
| **Current Liabilities:**  **Bank Overdraft**  **Bills Payable**  **Outstanding**  **Expenses**  **Sundry Creditors**  **Income received-in-advance**  **Long-term Liabilities:**  **Loan Capital:**  **Opening balance xxxx**  **Add: Net Profit xxxx**  **(Less: Net Loss)**  **Less: Drawing (xxxx)** |  | Current Assets:  Cash-in hand  Cash at Bank  Bills Receivable  Sundry Debtors  Prepaid Expenses  Accrued Income  Closing Stock  Investment:  Fixed Assets:  Furniture an Fixture  Plant & Machinery  Building  Land  Goodwill |  |

**Order of Permanence:** This order is exactly reverse of the liquidity order

**1.**The assets are arranged in the order of their permanence i.e., the least liquid asset (e.g., goodwill) is shown first and the most liquid asset (e.g., Cash-in-hand) is shown last.

**2.**The least urgent payment to be made (e.g., short-term creditors) is shown last.

**3.**A company is required to prepare the balance sheet in order of permanence.

A general format of a Balance Sheet in the order of performance is shown below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Liabilities** | **Rs.** | **Assets** | **Rs.** |
| **Capital:**  **Opening Balance xxx**  **Add: Net Profit xxxx**  **(Less: Net Loss)**  **Less: Drawings xxxx**  **Long-term Liabilities:**  **Loan**  **Current liabilities:**  **Income received-in-advance**  **Sundry Creditors**  **Outstanding Expenses**  **Bills Payable**  **Bank Overdraft** |  | Fixed Assets:  Good will  Land  Building  Plant & Machinery  Furniture & Fixtures  Investment:  Current Assets:  Closing stock  Accrued income  Prepaid expenses  Sundry Debtors  Bills Receivable  Cash at Bank  Cash in Hand |  |

**Balance Sheet of ………… As at………….**

**Adjustment in preparation of financial statements of Sole-proprietor**

**Meaning of Adjustment entries:** Those entries which need to be passed at the end of the accounting year to show the accurate profit or loss and fair financial position of the business.

**Need of Adjustment:** There are number of transactions that may not find the place in the Trial Balance due to any reason such as Closing Stock (because it is valued at the end of the year), Manager’s Commission based on Net profits (because its calculation requires preparation of Income Statement first). These transactions can only be taken into account by passing Adjustment entries so that their impact on the profitability and financial position can be shown.

**Closing Stock:** the closing stock represents the cost of unsold goods lying in the stores at the end of the accounting period.

**Outstanding Expenses:** When expenses of an accounting period remain unpaid at the end of an accounting period, they are termed as outstanding expenses.

As they relate to the earning of revenue during the current accounting year, it is logical that they should be duly charged against the revenue for computation of the correct amount of profit or loss.

**Prepaid Expenses:** At the end of the accounting year, it is found that the benefits of some expenses have not yet been fully received; a portion of its benefit would be received in the next accounting year. This portion of expenses, is carried forward to the next year and is termed as prepaid expenses.

**Accrued Income:** It may sometime happen that certain items of income such as a interest on loan, commission, rent, etc. are earned during the current ac- counting year but have not been actually received by the end of the same year. Such incomes are known as accrued income. .

**Income Received in Advance:** Sometimes, a certain income is received but the whole amount of it does not belong to the current period. The portion of the income which belongs to the next accounting period is termed as income received in advance or an Unearned Income.

**Depreciation:** It is the decline in the value of assets on account of wear and tear and passage of time. It is treated as a business expense and is debited to profit and loss account.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Closing Stock** | **Closing Stock A/c**  **To Trading A/c** | | **Dr.** | | **(i) Credit side of Trading A/c.**  **(ii) Show on the assets side of BALANCE SHEET.** | | |
| **Outstanding/Unpaid**  **Expenses** | Expenses A/c Outstanding Expenses | | Dr. | | (i) Add to die concerned item on die Debit side of Trading/Profit & Loss A/c.  (ii) Shown on the liabilities side of BALANCE SHEET. | | |
| **Prepaid expenses/ Unexpired expenses** | Prepaid Expenses  A/c  To Expenses A/c | | Dr. | | (i) Deduct from the concerned expenses on the debit side of Profit & Loss A/c  (ii) Show on the assets side of BALANCE SHEET. | | |
| **Accrued income/ Income due but not received** | Accrued Income A/c  To Income A/c | | Dr. | | (i) Add to the concerned income on  Credit side of Profit and Loss A/c  (ii) Show on the assets side of  BALANCE SHEET. | | |
| **Unearned income/ Income received in Advance** | | **Income A/c**  **To Unearned**  **Income A/c** | | **Dr.** | | **(i) Deduct from the concerned income on the credit side of Profit & Loss A/c**  **(ii) Show on the liabilities side of Balance Sheet.** |  |
| **Depreciation** | | Depreciation A/c  To Asset A/c & | | Dr. | | (i) Show on the debit side of Profit Loss A/c (ii) Deduct from the concerned asset in the Balance Sheet. |  |
|  |  |  |  |  |  |  |  |

This, in effect, amounts to writing-off a portion of the cost of an asset which has been used in the business for the purpose of earning profits.

**Note:**Sometimes the opening and closing stock are adjusted through purchases account. In that case, the entry recorded is as follows:

Closing stock A/c Dr.

To Purchase A/c

This entry reduces the amount in the purchases account and is also known as adjusted purchases which is shown on the debit side of the trading and profit and loss account.

When the opening and closing stocks are adjusted through purchases, the trial balance does not show any opening stock. Instead, the closing stock shall appear in the trial balance (not as additional information or as an adjustment item) and so also the adjusted purchases.

|  |  |  |  |
| --- | --- | --- | --- |
| **To write off bad debts** | **Bad Debts A/c**  **To Debtors** | **Dr.** | **(i) Debit side of P&L A/c.**  **(ii) Deduct from debtors on the as- sets side of Balance Sheet.** |
| **Provision for bad and doubtful debts** | P & L A/c  To Debtors A/c | Dr. | (i) Debit side of P & L A/c.  (ii) Deduct from debtors on the assets side of Balance Sheet. |
| **Provision for discount on debtors** | P & L A/c  To Provision for Discount on Debtors Debtors A/c | Dr. | (i) Debit side of P & L A/c.  (ii) Deduct from debtors on the assets side of Balance Sheet. |

**Further Bad Debts:** These Bad debts is a loss that occurred after preparation of Trial Balance. Further bad debts be added in the bad debts already appearing in the Profit and Loss A/c and Debtors would be reduced with the same amount.

**Provision for Bad Debts:** In the balance sheet, debtors appears on the assets side of the Balance Sheet, which is their estimated realisable value during next year. It is quite possible that the whole of the amount may not be realized in future. However, it is not possible to accurately know the amount of such bad debts.

Hence, a reasonable estimate of such loss is provided in the book. Such provi- sion is called provision for bad debts. Provision for doubtful debts is shown as a deduction from the debtors on the asset side of the balance sheet.

**Note:** The provision for doubtful debts brought forward from the previous year is called the opening provision or old provision. When such a provision already exists, the loss due to bad debts during the current year are adjusted against the same and while making provision for doubtful debts required at the end of the current year is called new provision. The balance of old provision as given in trial balance should also be taken into account.

**Provision for discount on Debtors:** Discount is allowed to customers to en- courage them to make prompt payment. The discount likely to be allowed to customers in an accounting year can be estimated and provided for by creating a provision for Discount on debtors.

Provision for discount on debtors is made on good debtors which are arrived at by deducting further bad debts and provision for bad debts out of Debtors shown in the Balance sheet.

**Manager’s Commission**

The manager of the business is sometimes given the commission on the net profit of the company. The percentage of the commission is applied on the profit either before charging such commission or after charging such commission. In the absence of any such information, it is assumed that commission is allowed as a percentage of the net profit before charging such commission.

**1. Commission on net profits before charging such commission**

Commission

http://media.mycbseguide.com/images/static/revise/11/acc/ch09/image001.png

**2. Commission on net profits after charging such commission**

Commission

http://media.mycbseguide.com/images/static/revise/11/acc/ch09/image002.png

|  |  |  |  |
| --- | --- | --- | --- |
| **Interest on Capital** | **Interest on Capital A/c To Capital A/c** | **Dr.** | **(i) Debit side of P & L A/c. (ii) Add to capital on the liabilities side of Balance Sheet.** |
| **Interest on drawings** | Capital/Drawings A/c To Interest on Drawings A/c | Dr. | (i) Credit side of P & L A/c. (ii) Deduct from capital on the liabilities side of Balance Sheet. |
| **Interest payable on loan (borrowed)** | Interest on Loan A/c To Loan A/c | Dr. | (i) Debit side of P & L A/c. (ii) Add to loan on the liabilities side of Balance Sheet. |
| **Commission payable to manager** | P&L A/c To Comm. Payable to | Dr. | (i) Debit side of P & L A/c. (ii) Show on the liabilities side of Balance Sheet. |

**Abnormal loss of goods by fire, theft, accident, etc.**

|  |  |  |  |
| --- | --- | --- | --- |
| **For gross loss (Total loss)** | **Loss by …… A/c To Trading A/c (or) To Purchases A/c** | **Dr.** | **(i) Gross Loss: Deduct from Purchases or show on the credit side of Trading A/c.** |
| **For insurance claim accepted, if any To For net loss** | Insurance Claim Loss by ………. A/c | Dr. | (ii) Net Loss: Debit side of P & L A/c. |
| **(Total loss-Claim accepted by Ins.Co.)** | ‘P & L A/c to Loss by …. A/c | Dr. | (iii) Insurance claim: Assets side of  Balance Sheet |
| **Goods taken by the proprietor for his personal use** | Drawings A/c  To Purchases A/c | Dr. | (i) Deduct the amount of goods from the purchases in Trading A/c. (ii) Deduct the amount from the capital on the liabilities side of Balance Sheet. |
| **Goods given as charity** | Charity A/c To Purchases a/c | Dr. | (i) Deduct the amount from the purchases on the debit side of Trading A/c. (ii) Show on the debit side of P & L A/c. |
| **Goods distributed as free samples** | Advertising A/c To Purchases A/c | Dr. | (i) Deduct the amount of goods from the purchases in Trading A/c. (ii) Show on the debit side of P & L A/c. |

**Note:**

**1.** If closing stock shown in Trial Balance then it will be shown in balance sheet only. It is assumed that purchases amount already get adjusted in trial balance.

**2.** Salary and wages will be shown in profit and loss A/c debit side (assuming that salary is prominent) while wages and salary will be shown in trading A/c debit side, (wages are prominent).

**3.** Freight, carriage, cartage will be shown in Dr. side of trading A/c. if inward word attached with these then it also debited to trading A/c, if outward word attached with these item then it will be debited to profit and loss account.

**4.**Any expenses related to factory are debited to trading account like factory lighting, factory rent if factory word is not given then lighting and rent will be debited to profit and loss account.

**5.** Trade expenses always debited to profit and loss A/c not as name indicate trading A/c.

**6.** Packaging material: cost of packaging material used in product are direct expenses as it refers to small containers which form part sold, it will debited to trading A/c.

**7.** **Packing:** the packing refers to the big containers that are used for transporting the goods and regarded as indirect expenses and debited to profit and loss account.

**8.** Adjusted purchases mean the amount of purchases is adjusted by way of adding opening stock and reduced by the amount of closing stock, e.g., purchases Rs. 1,00,000; opening stock Rs. 12,000, closing stock Rs. 8,000. Calculate adjusted purchases.

Adjusted purchases = purchases + opening stock – closing stock = Rs. 1,00,000 + Rs. 12,000 – Rs. 8,000 = Rs. 1,04,000

When adjusted purchases is given in trail balance, then there is no need of debiting opening stock and crediting closing stock in trading A/c.

In this case closing stock will be shown in balance sheet only.

**Remember**

While preparing Final Account the items which are given inside the Trial Bal- ance are written only once either in Income Statement or in the Balance Sheet. (Assuming that they have been already adjusted in the respective account). On the other hand, the items which are given outside the Trial Balance (known as adjustment) are to be written twice because the double entry in respect of all adjustments is to be completed in the final accounts itself.