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Financial Statements

LEARNING OBJECTIVES

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

- Meaning of Financial Statements
- Users of Financial Statements
- Meaning, Need and Preparation of Trading Account
- Meaning, Need and Preparation of Profit & Loss Account
- Operating Profit and Net Profit
- Meaning, Need and Preparation of Balance Sheet
- Grouping and Marshalling of Assets and Liabilities
- Classification of Assets and Liabilities
- Distinction between Tangible and Intangible Assets
- Distinction between Trial Balance and Balance Sheet

Meaning of Financial Statements

Financial Statements refer to such statements which report the profitability and the financial position of the business at the end of accounting period. The term financial statements includes atleast two basic statements which are as under :

(*i*) Income Statement (or Trading and Profit and Loss Account) which shows results of business operations during an accounting period, and

(*ii*) Statement of Financial Position (or Balance Sheet) which shows financial position of an enterprise at a specified point of time.

In the words of **John N. Myer**, "The financial statements provide a summary of the accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period."

These two financial statements are termed as 'Final Accounts'.

In modern times, in addition to the aforesaid two basic financial statements, two other statements namely a Statement of Retained Earnings and a Cash Flow Statement are also generally included in financial statements.

Objectives of Preparing Financial Statements :

(*i*) To present a true and fair view of the financial performance (*i.e.* profit/loss) of the business;

(*ii*) To present a true and fair view of the financial position (*i.e.* Assets/Liabilities) of the business.

Users of Financial Statements : Information provided by financial statements is used by the management, investors, creditors, employees, government etc. The utility of financial statements to different parties is as follows :

(1) **Management :** The financial statements help the management in assessing the profitability of various activities and various departments. On their basis, the management can review the progress of the business and take decisions for controlling the non-profitable activities.

(2) **Investors :** They can assess the short-term and long-term financial soundness and earning capacity of the business with the help of financial statements. They can also study the trend of sales, trend of profits, shortcomings and the prospects of future growth of the enterprise.

(3) **Short-term Creditors :** On the basis of financial statements they assess whether the enterprise will be able to pay their debts when they fall due and may decide to extend, maintain or restrict the credit allowed to the enterprise.

(4) **Long-term Creditors :** On the basis of financial statements they may determine (*i*) whether the enterprise will be able to pay the interest consistently, and (*ii*) whether the company will be able to pay their debts when due. On this basis they may also decide to extend, maintain or restrict the loans extended to the enterprise.

(5) **Employees and Trade Unions :** On the basis of financial statements they can judge as to how much bonus and increase in their wages is possible from the profits of the enterprise.

(6) **Government :** Government uses the financial statements to study the profit margins of various industries to announce or withdraw various concessions and to increase or decrease the excise duty.

(7) **Taxation Authorities :** They use the financial statements for the purpose of assessment of income tax, sales tax etc.

(8) **Other Users :** Such as trade associations, consumer organisations, researchers etc.

INCOME STATEMENT

It is divided into two parts :

(*i*) The first part is called 'Trading Account'. It shows the gross profit or gross loss,

(*ii*) The second part is called 'Profit & Loss Account'. It shows the net profit or net loss.

TRADING ACCOUNT

Trading account is prepared for calculating the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, it is prepared to show the result of manufacturing, buying and selling of goods. If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the difference is termed as gross profit. On the contrary, if the purchases, and direct expenses exceed the sales, the difference is called gross loss. A Trading

Account records the amount of purchases of goods and also the expenses which are incurred in bringing that commodity to a saleable state. In other words, all expenses which relate to either purchase of raw material or manufacturing of goods are recorded in the Trading Account. All such expenses are called 'Direct Expenses'. According to J. R. Batliboi :—

"The Trading Account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included."

Sometimes, a Trading Account is also called 'Goods A/c' because all the transactions relating to goods are recorded in it. Such as I. Opening Stock, II. Purchases, III. Purchases Returns, IV. Sales, V. Sales Returns, VI. Closing Stock, VII. Expenses incurred on manufacturing of goods, and VIII. Expenses incurred on purchasing and bringing the goods to the trading place. All such expenses are summarised and recorded in the Trading Account at the end of the year.

Need and Importance of Trading Account

Preparation of Trading Account serves the following objectives :—

(1) **It provides information about Gross Profit and Gross Loss** :— It informs of the gross profit or gross loss as a result of buying and selling the goods during the year. The percentage of Current Year's gross profit on the amount of sales can be calculated and compared with those of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.

(2) **It provides information about the direct expenses** :— All the expenses incurred on the purchase and manufacturing of goods are recorded in the trading account in a summarised form. Percentage of such expenses on sales can be calculated and compared with those of the previous years. In this way it enables the management to control and rationalise the expenses.

(3) **Comparison of closing stock with those of the previous years** :— Closing stock has to be valued and recorded in a trading account. This stock can be compared with the closing stock of the previous years and if the stock shows an increasing trend, the reasons may be inquired into.

(4) **It provides safety against possible losses** : If the ratio of gross profit has decreased in comparison to the preceding year, the businessman can take effective measures to safeguard himself against future losses. For example, he may increase the sale price of his goods or may proceed to analyse and control the direct expenses.

Preparation of Trading Account

Trading Account is a Nominal Account and all expenses which relate to either purchase or manufacturing of goods are written on the Dr. side of the Trading Account.

Items written on the Dr. side of the Trading Account :—

(1) **Opening Stock** :— The stock of goods remaining unsold at the end of the previous year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. Opening Stock will include the following :—

I. Opening Stock of Raw Material,

II. Opening Stock of Semi-finished goods, and

III. Opening Stock of Finished goods.

(2) **Purchases and Purchases Returns** :— Goods which have been bought for resale are termed as Purchases and goods which are returned to suppliers are termed as purchase returns or returns outwards. Purchase Account will be given on the debit side of the trial balance and Purchase Return Account on the credit side of the trial balance. Purchase returns will be shown as a deduction from Purchases on the debit side of the trading account. Purchases include cash as well as credit purchases.

(3) **Direct Expenses** :— All expenses incurred in purchasing the goods, bringing them to the godown and manufacture of goods are called direct expenses. Direct expenses include the following :—

(I) **Wages** :— Wages are paid to workers who are directly engaged in the loading, unloading and production of goods and as such are debited to the trading account. It should be noted that :—

(*i*) If the item 'Wages and Salaries' is given in the question it will be shown on the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown on the Profit & Loss Account.

(*ii*) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence will not be shown in the trading account.

(II) **Carriage or Carriage Inwards or Freight** :— These expenses should be debited to trading account because these are generally paid for bringing the goods to the factory or place of the business. However, if any carriage or freight is paid on bringing an asset, the amount should be added to the asset account and must not be debited to trading account.

(III) **Manufacturing Expenses** :— All expenses incurred in the manufacture of goods are shown on the debit side of the trading account such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc.

(IV) **Dock Charges** :— These are the charges levied on ships and their cargo while entering or leaving docks. If dock charges are paid on import of goods they are shown on the debit side of Trading Account. In the absence of specific instructions, these are debited to Trading Account.

(V) **Import Duty or Custom Duty** :— Custom duty is paid on import as well as on export of goods. Custom duty when paid on the purchase of goods is charged to Trading Account. In the absence of specific instructions, these are debited to trading account.

(VI) **Octroi** :— This is levied by the Municipal Committee when the goods enter the city and hence debited to Trading Account.

(VII) **Royalty** :— This is the amount paid to the owner of a mine or patent for using his right or patent. Royalty is usually charged to Trading Account because it increases the cost of production. However, if it is specifically stated in the question that the Royalty is based on sales, it will be charged to Profit and Loss Account.

Items written on the Cr. side of the Trading Account :—

(1) **Sales and Sales Returns** :— Both Cash and Credit sales will be included in sales. The sales account will be a credit balance whereas, the sales return account or

returns inwards account will be a debit balance. Sales return will be deducted out of Sales on the credit side of the trading account.

(2) **Closing Stock** :— The goods remaining unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the closing stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods.

Normally, the Closing Stock is given outside the Trial Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry :—

Closing Stock A/c Dr.
    To Trading A/c
(Closing Stock transferred to Trading A/c)

When the above entry is passed, the Closing Stock Account is opened. On the one hand, it will be posted to the credit side of the trading account and on the other hand, will be shown on the Assets side of the Balance Sheet, in order to complete the double entry. **Sometimes, the Closing Stock is given inside the Trial Balance. This will mean that the entry to incorporate the closing stock in the books has already been passed. It would imply that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear on the Assets side of the Balance Sheet only.**

Closing Entries Relating to Trading Account

The preparation of the Trading Account requires that the balances of all such accounts which are due to appear in the Trading Account are transferred to it. The entries required for such transfer are termed as Closing Entries. These will be as follows :—

(1) Purchases Returns Account is closed by transferring its balance to Purchases Account. Following entry is recorded for this purpose :

Purchases Return A/c Dr.
    To Purchases A/c
(Transfer of purchases returns account to purchases account)

(2) Similarly, the Sales Returns Account is closed by transferring its balance to the Sales Account as :

Sales A/c Dr.
    To Sales Return A/c
(Transfer of Sales Return Account to Sales Account)

(3) Closing Entry for those accounts which are to be transferred to the Dr. side of the Trading Account :

Trading A/c Dr.
    To Opening Stock A/c
    To Purchases A/c
    To Wages A/c
    To Direct Expenses A/c
    To Carriage A/c

To Gas, Fuel & Power A/c
To Freight, Octroi & Cartage A/c
To Manufacturing exp. A/c
To Factory Rent & Lighting A/c
To Custom Duty A/c
To Royalty A/c
(The Transfer of above accounts to the Dr. side of the Trading A/c)

(4) Closing Entry for those accounts which are to be transferred to the Cr. side of the Trading Account :

Sales A/c	Dr.
Closing Stock A/c	Dr.
To Trading A/c	

(The Transfer of above accounts to the Cr. side of the Trading A/c)

(5) Another Closing Entry is needed to close the Trading Account itself. If the credit side of the Trading Account exceeds the debit, the difference will be Gross Profit. The Gross Profit will be transferred to the credit of a newly opened account called Profit and Loss Account :—

Trading A/c	Dr.
To Profit & Loss A/c	

(The Transfer of Gross Profit to the Credit side of P & L A/c)

(6) If the debit side of the Trading Account exceeds the credit, the difference will be Gross Loss. It will be transferred to the debit of P & L A/c by means of the following entry :—

Profit & Loss A/c	Dr.
To Trading A/c	

(The Transfer of Gross Loss to the Debit side of P & L A/c)

Format of a Trading Account

TRADING A/C

Dr. *for the year ending......................* Cr.

Particulars	*Amount*	*Particulars*	*Amount*
	₹		₹
To Opening Stock		By Sales	
To Purchases		*Less :* Sales Returns	
Less : Purchase Returns		or	
or		Returns inwards	
Returns outward		By Closing Stock	
To Wages		By Gross loss	
To Wages & Salaries		(if any) transferred to Profit	
To Direct Expenses		and Loss A/c	
To Carriage, or		(Balancing figure)	
To Carriage inwards, or			
To Carriage on Purchase			
To Gas, Fuel and Power			

To Freight, octroi and cartage To Manufacturing Expenses, or Productive Expenses To Factory Expenses, such as : Factory Lighting Factory Rent etc. To Dock charges and Clearing charges To Import Duty or Custom Duty To Royalty To Gross Profit Transferred to P & L A/c (Balancing Figure)			

Notes : (1) In the heading of the Trading Account the words 'For the year ended........' are used. Because it discloses the position of the business for the full accounting year and not at a particular point of time.

(2) No separate column for date is prepared in the Final Accounts because the date will be already mentioned in the heading itself.

(3) No column for L.F. is prepared in Final Accounts because these are prepared from trial balance and not from ledger accounts directly.

ILLUSTRATION 1.

Prepare a Trading Account for the year ended 31st March, 2012 from the following balances :—

	₹		₹
Opening Stock	2,00,000	Purchases Return	60,000
Purchases	10,00,000	Sales Return	1,00,000
Sales	25,00,000	Carriage on Purchase	40,000
Freight and Octroi	32,500	Carriage on sales	50,000
Wages	1,50,000	Factory Rent	60,000
Factory Lighting	54,000	Office Rent	37,500
Coal, Gas and Water	11,000	Import Duty	1,60,000

Closing Stock is valued at ₹3,00,000.

ILLUSTRATION 10.

Calculate closing stock from the following details :

	₹
Opening Stock	20,000
Cash Sales	60,000
Credit Sales	40,000
Purchase	70,000

Rate of Gross profit on cost $33\frac{1}{3}\%$. *(KVS 2011)*

SOLUTION :

Total Sales = Cash Sales + Credit Sales = ₹1,00,000

Goods Costing 100 must have been sold for $133\frac{1}{3}$

Hence, If Sales $133\frac{1}{3}$ then Gross Profit $= 33\frac{1}{3}$.

If Sales 1,00,000 then Gross Profit $= \frac{100}{3} \times \frac{3}{400} \times 1,00,000$

= ₹25,000

Cost of Goods Sold = Sales – Gross Profit

= 1,00,000 – 25,000 = 75,000

Cost of Goods Sold = Opening Stock + Purchases – Closing Stock

₹75,000 = ₹20,000 + ₹70,000 – Closing Stock

Closing Stock = ₹20,000 + ₹70,000 – ₹75,000 = ₹15,000

ILLUSTRATION 11.

Calculate Net Sales and Gross Profit from the following information :

Cost of Goods Sold ₹1,00,000

Gross Profit 20% on Sales *(KVS 2012)*

SOLUTION :

If Sale is ₹100, G.P. will be ₹20 and Cost = 100 – 20 = ₹80

Hence, if Cost of Goods Sold is ₹80, Sale will be ₹100

if Cost of Goods Sold is ₹1,00,000,

Sale will be ₹$\frac{100}{80} \times 1,00,000$ = ₹1,25,000

G.P. = Sales – Cost of Goods Sold

= ₹1,25,000 A ₹1,00,000 = ₹25,000

PROFIT AND LOSS ACCOUNT

Trading account only discloses the gross profit earned as a result of buying and selling of goods. However, a businessman has to incur a number of expenses which are not taken to trading account. Hence, a businessman is more interested in knowing the net profit earned or net loss incurred during the year. As such, a Profit & Loss Account is prepared which contains all the items of losses and gains pertaining to the accounting period. According to Prof. Carter :—

"A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or *vice-versa*".

Need and Importance of Profit & Loss A/c

(1) **To ascertain the Net Profit or Net Loss** :— A Trading Account only discloses the Gross Profit earned as a result of trading activities, whereas the Profit & Loss Account discloses the net profit (or net loss) available to the proprietor and credited to his capital account.

(2) **Comparison with previous years' profits** :— The net profit of the current year can be compared with that of the previous years. It enables the businessman to know whether the business is being conducted efficiently or not.

(3) **Control on Expenses** :— Profit & Loss Account helps in comparing various expenses with the expenses of the previous year. Also the percentage of each individual expenses to net profit is calculated and compared with the similar ratio of previous years. Such comparison will be helpful in taking concrete steps for controlling the unnecessary expenses.

(4) **Helpful in the preparation of Balance Sheet** :— A Balance Sheet can only be prepared after ascertaining the Net Profit through the preparation of Profit and Loss Account.

Preparation of Profit and Loss Account

A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account are now debited to Profit & Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

Items Written on the Dr. Side of Profit & Loss Account :—

(1) **Gross Loss** :— If trading account discloses Gross Loss, it is shown on the debit side first of all.

(2) **Office and Administrative Expenses** :— Such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee etc.

(3) **Selling and Distribution Expenses** :— Such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc.

(4) **Miscellaneous Expenses** :— Such as interest on loan, interest on capital, repair charges, depreciation, charity etc.

Items written on the Cr. side of Profit & Loss Account :—

(1) **Gross Profit** :— The starting point of the Cr. side of Profit and Loss Account is the gross profit brought down from the Trading Account.

(2) **Other Incomes and Gains** :— All items of incomes and gains are shown on the credit side of the Profit & Loss Account, such as income from investments, rent received, discount received, commission earned, interest received, dividend received etc.

If the credit side of the profit and loss account exceeds that of debit side, the difference is termed as net profit. On the other hand, the excess of the debit side over the credit side is termed as net loss. Net profit is added to the capital whereas net loss is deducted from the capital.

Closing Entries relating to Profit and Loss Account

The preparation of Profit and Loss Account requires that the balances of all concerned items are transferred to it by passing the following closing entries :—

(1) Accounts of various items of expenses and losses are transferred to the debit side of Profit and Loss Account by means of the following entry :—

Profit and Loss A/c Dr.
To Salaries A/c
To Rent, Rates and Taxes A/c
To Printing and Stationery A/c
To Postage and Telegrams A/c
To General Expenses etc.
(The transfer of nominal accounts showing Dr. balances to the Debit of P & L A/c)

(2) Balances of all the accounts of incomes and gains will be transferred to the credit side of Profit and Loss Account by means of the following entry :—

Interest Received A/c Dr.
Commission Received A/c Dr.
Rent Received A/c Dr.
To Profit and Loss A/c
(The transfer of nominal accounts showing Cr. balances to the Credit of P & L A/c)

(3) For the transfer of credit balance of Profit & Loss A/c, known as net profit :—

Profit and Loss A/c Dr.
To Capital A/c
(The transfer of net profit to Capital A/c)

(4) For the transfer of debit balance of Profit & Loss A/c, known as net loss :—

Capital A/c Dr.
To Profit and Loss A/c
(The transfer of net loss to Capital A/c)

Format of a Profit and Loss Account

PROFIT AND LOSS A/C

Dr. *for the year ending ....* Cr.

Particulars	*Amount*	*Particulars*	*Amount*
	₹		₹
To Gross Loss b/d (Transferred from Trading A/c)		By Gross Profit b/d (Transferred from Trading A/c)	
Office expenses :—		By Rent from Tenant	
To Salaries		By Rent (Cr.)	
To Salaries & Wages		By Discount received	

To Rent, Rates & Taxes		Or Discount (Cr.)	
To Printing & Stationery		By Commission Received	
To Postage & Telegram		By Interest on Investments	
To Lighting		By Dividend on Shares	
To Insurance Premium		By Bad-Debts Recovered	
To Telephone Charges		By Apprentice Premium*	
To Legal Charges		By Profit on sale of Assets	
To Audit Fees		By Income from other Sources	
To Travelling Expenses		By Miscellaneous Receipts	
To Establishment Expenses		By Net Loss (if any)	
To Trade Expenses		Transferred to Capital A/c	
To General Expenses			
Selling and Distribution Expenses:			
To Carriage Outwards, or Carriage on Sales			
To Advertisement			
To Commission			
To Brokerage			
To Bad-debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses			
To Stable expenses			
Miscellaneous expenses :—			
To Discount			
To Repairs			
To Depreciation			
To Interest (Dr.)			
To Bank Charges			
To Entertainment Expenses			
To Conveyance Expenses			
To Donation and Charity			
To Loss on Sale of Assets			
To Net Profit— Transferred to Capital A/c			

Notes :— (1) Those expenses which are not related to the business are not written in the Profit and Loss Account such as (I) Domestic and household expenses of the proprietor, (II) Income-Tax, and (III) Life Insurance Premium etc. These expenses are known as Drawings and deducted from Capital at the liabilities side of the Balance Sheet.

(2) Only those items of expenses and incomes are shown in the Profit & Loss Account which have not been shown in the Trading Account.

*Income received by providing training to someone is called 'Apprentice Premium'.

ILLUSTRATION 12.

From the following particulars, prepare a Profit & Loss Account for the year ending 31st March, 2012 :—

Particulars	₹	*Particulars*	₹
Gross Profit	10,52,500	Discount allowed	15,000
Trade Expenses	10,000	Lighting	3,900
Carriage on Sales	50,000	Commission Received	4,200
Office Salaries	79,000	Bad-debts	6,000
Postage and Telegram	3,600	Discount Cr.	3,000
Office Rent	37,500	Interest on Loan	11,000
Legal Charges	2,000	Stable Expenses	7,000
Audit fee	8,000	Export Duty	11,500
Donation	5,500	Miscellaneous Receipts	2,500
Sundry Expenses	1,800	Unproductive Expenses	20,500
Selling Expenses	26,600	Travelling Expenses	12,500

SOLUTION : PROFIT & LOSS ACCOUNT

Dr. *for the year ending on 31st March, 2012* Cr.

Particulars	*Amount*	*Particulars*	*Amount*
	₹		₹
To Trade expenses	10,000	By Gross Profit	10,52,500
To Carriage on sales	50,000	By Commission received	4,200
To Office Salaries	79,000	By Discount	3,000
To Postage & Telegram	3,600	By Miscellaneous Receipts	2,500
To Office Rent	37,500		
To Legal charges	2,000		
To Audit Fee	8,000		
To Donation	5,500		
To Sundry expenses	1,800		
To Selling expenses	26,600		
To Discount allowed	15,000		
To Lighting	3,900		
To Bad-Debts	6,000		
To Interest on Loan	11,000		
To Stable expenses	7,000		
To Export duty	11,500		
To Unproductive expenses	20,500		
To Travelling expenses	12,500		
To Net Profit transferred to Capital Account	7,50,800		
	10,62,200		10,62,200

Operating Profit and Net Profit

Profit may be of two types : (*i*) operating profit and (*ii*) net profit.

Operating Profit is the profit earned through normal operating activities of the business. It is arrived at by deducting the operating expenses from gross profit.

Expenses which are related to the main or normal activities of the business are called operating expenses. They include office and administrative expenses and selling and distribution expenses, discount, bad-debts etc. Operating Profit is also called 'Earning Before Interest & Tax or EBIT'.

Net Profit is arrived at by deducting operating as well as non-operating expenses from the gross profit. Expenses which are incidental or indirect to the main operations of the business are called non-operating expenses. They include interest on loan, charities and donations, loss on sale of fixed assets, extraordinary losses due to theft, loss by fire and so on. Similarly, non-operating incomes are added while calculating the net profit. Non-operating incomes include receipt of interest, rent and dividend, gain on sale of fixed assets etc.

ILLUSTRATION 13.

Calculate Gross Profit, Operating Profit and Net Profit from the following :

Particulars	₹	*Particulars*	₹
Opening Stock	2,00,000	Commission Paid	2,400
Purchases	19,00,000	Commission Received	6,000
Sales	25,00,000	Travelling Expenses	4,800
Purchase Returns	70,000	Office Expenses	3,500
Sales Returns	1,00,000	Interest on Long Term Loans	22,000
Wages	80,000	Dividend on Investments	2,800
Advertising	12,000	Printing & Stationery	3,600
Salaries	1,78,000	Loss on sale of Machinery	35,000
Rent & Taxes	62,000	Carriage Outwards	1,400
Lighting	15,000	Loss by Theft	25,100
		Gain on Sale of Building	50,000

Closing Stock was valued at ₹2,50,000

BALANCE SHEET

After ascertaining the net profit or loss of the business enterprise, the businessman would also like to know the exact financial position of his business. For this purpose a statement is prepared which contains all the Assets and Liabilities of the business enterprise. The statement so prepared is called a Balance Sheet because it is a sheet of balances of ledger accounts which are still open after the transfer of all nominal acounts to the Trading and Profit & Loss Account. Balances of all the personal and real accounts are grouped as assets and liabilities. Liabilities are shown on the left hand side of the Balance Sheet and Assets on the right hand side.

Definitions : A Balance Sheet has been defined as follows :—

In the words of Karlson :—

"A business form showing what is owed and what the proprietor is worth, is called a Balance Sheet."

According to A. Palmer :—

"The Balance Sheet is a statement at a particular date showing on one side the trader's property and possessions and on the other hand the liabilities."

According to J.R. Batliboi :

"A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date."

Need and Importance of Preparing a Balance Sheet

The purposes of preparing a Balance Sheet are as follows :—

(1) The main purpose of preparing a Balance Sheet is to ascertain the true financial position of the business at a particular point of time.

(2) It helps in ascertaining the nature and cost of various assets of the business such as the amount of Closing Stock, amount owing from Debtors, amount of fictitious assets etc.

(3) It helps in determining the nature and amount of various liabilities of the business.

(4) It gives information about the exact amount of capital at the end of the year and the addition or deduction made into it in the current year.

(5) It helps in finding out whether the firm is solvent or not. The firm is solvent if the assets exceed the external liabilities. It would be insolvent if opposite is the case.

(6) It helps in preparing the Opening Entries at the beginning of the next year.

Drafting a Balance Sheet

Characteristics of Balance Sheet :—

(1) A Balance Sheet is a part of the Final Accounts. This is the reason that the Trading and Profit and Loss Account and the Balance Sheet are together called 'Final Accounts'. However, the Balance Sheet is a statement and not an account. It has no debit or credit side and as such the words 'To' and 'By' are not used before the names of the accounts written therein.

(2) A Balance Sheet is a summary of the Personal and Real Accounts, which are still open and have not been closed by transfer to the Trading and Profit & Loss Account. Debit balances of all Personal and Real Accounts are put on the right hand side known as Assets side, whereas the credit balances are put on the left hand side known as Liabilities side.

(3) The totals of the two sides of the Balance Sheet must be equal. If the totals are not equal, there will be an errror somewhere.

(4) Balance Sheet is prepared on a particular date and not for a fixed period. As such, it discloses the financial position of a business on a particular date and not for a period. It is True only for the date on which it is prepared because even a single transaction would cause a change in the assets and liabilities.

(5) It shows the financial position of the business according to the going concern concept.

Grouping and Marshalling of Assets and Liabilities in Balance Sheet

The Assets and Liabilities shown in the Balance Sheet are properly grouped and presented in a particular order. The term 'grouping' means showing the items of similar nature under a common heading. For example, the amount owing from various customers will be shown under the heading 'Sundry Debtors'. Similary, under the heading 'Current Assets', the balance of cash, bank, debtors, stock etc. will be shown.

'Marshalling' is the arrangement of various assets and liabilities in a proper order. Marshalling can be done in any of the following two ways :—

(1) **In the Order of Liquidity** :— According to this method, an asset which is most easily convertible into Cash such as Cash in hand is written first and then will follow those assets which are comparatively less easily convertible, so that the least liquid asset such as goodwill, is shown last.

In the same way, those liabilities which are to be paid at the earliest will be written first. In other words, current liabilities are written first of all, then fixed or long-term liabilities and lastly, the proprietor's capital.

Generally, sole proprietors and partnership firms prepare their Balance Sheet in the order of liquidity. Proforma of a Balance Sheet in the order of liquidity will be as follows :—

BALANCE SHEET

as at.............................

Liabilities	*Amount*	*Assets*	*Amount*
	₹		₹
Current Liabilities :—		**Current Assets** :—	
Bank Overdraft		Cash in Hand	
Bills Payable		Cash at Bank	
Sundry Creditors		Bills Receivable	
Outstanding expenses		Short Term Investments	
Unearned Income		Sundry Debtors	
Fixed Liabilities :—		Closing Stock	
Long term loans		Prepaid Expenses(3)	
Reserves		Accrued Income	
Capital		**Long Term Investments**	
Add : Net Profit		**Fixed Assets** :—	
Less : Drawings		Furniture	
Less : Income Tax		Loose Tools	
Less : Life Insurance Premium		Motor Vehicle	
		Plant and Machinery	
		Land and Buildings	
		Patents	
		Goodwill	

Notes : (1) The words 'As at' or 'As on' are used in the heading of the Balance Sheet, because it is true only for the date on which it is prepared.

(2) The total of both the sides of the Balance Sheet is always equal.

(3) Prepaid expenses are treated as current assets. Though Cash cannot be realised from prepaid expenses, the service will be available against these without further payment.

(2) **In the Order of Permanence** :— This method is exactly the reverse of the first method discussed above. Assets which are most difficult to be converted into cash such as Goodwill are written first and the assets which are most liquid such as Cash in hand are written last. Similarly, those liabilities which are to be paid last, will be written first. In other words, the proprietor's capital is written first of all, then fixed or long term liabilities and lastly, the current liabilities. Joint stock companies are required under the Companies Act to prepare their Balance Sheet in the order of permanence.

It is essential to understand the classification of various Assets and Liabilities before preparing a Balance Sheet.

Classification of Assets

According to the nature of assets, these may be classified into the following :—

(1) **Fixed Assets** :— Fixed Assets are those which are acquired for continuous use and last for many years such as Land and Building, Plant and Machinery, Motor Vehicles, Furniture etc. According to Finney and Miller :—

"Fixed Assets are assets of a relatively permanent nature used in the operations of business and not intended for sale".

As the purpose of keeping such assets is not to sell but use them, changes in their market values are ignored and these are always shown in the Balance Sheet at cost less depreciation.

(2) **Current Assets** :— Current Assets are those which are either in the form of cash or can be easily converted into cash within one year of the date of Balance Sheet. In the words of Hovard & Upton :—

"The Current Assets are usually defined as those assets which are convertible into cash through the normal course of business within a short time ordinarily in a year."

Current Assets include Cash, Bills Receivable, Short Term Investments, Debtors, Prepaid Expenses, Accrued Income, Closing Stock etc. While valuing these assets, Closing Stock is valued at cost or realisable value whichever is less and a reasonable provision for doubtful debts is deducted out of Sundry Debtors.

(3) **Liquid Assets** :— Liquid Assets are those which are either in the form of Cash or can be quickly converted into cash, such as Cash, Bills Receivable, Short Term Investments, Debtors, Accrued Income etc. In other words, if Prepaid Expenses and Closing Stock are excluded from Current Assets, the balance will be Liquid Assets.

(4) **Fictitious or Nominal Assets** :— These are the Assets which cannot be realised in Cash or no further benefit can be derived from these assets. Such assets include Debit balance of P & L A/c and the expenditure not yet written off such as Advertisement Expenses etc. These assets are not really assets but are shown on the Assets side only for the purpose of transferring them to the Profit & Loss Account gradually over a period of time.

(5) **Wasting Assets** :— These are the Assets which are exhausted or consumed over a period of time such as mines and oil-wells. Their value reduces through being worked. These also include Patents and the properties taken on lease for a definite period of time.

(6) **Tangible and Intangible Assets** :— Tangible Assets are those which have a physical existence or which can be seen and felt like Plant and Machinery, Building, Furniture, Stock, Cash etc. Intangible Assets are those which do not have any physical existence or which cannot be seen or felt such as the Goodwill, Trade Marks, Patents etc. Intangible Assets are as much valuable as Tangible Assets because they also help the firm in earning profits. For example, Goodwill helps in attracting customers and patents are actually the know-how which help in producing the goods.

Distinction between Tangible Assets and Intangible Assets

S. No.	Basis of Distinction	Tangible Assets	Intangible Assets
1.	**Physical Existence**	These assets have physical existence. Examples of these assets are Plant and Machinery, Furniture etc.	These assets do not have physical existence. Examples of these assets are Goodwill, Patents, Trade Marks etc.
2.	**Fixed V/s Current**	These assets can be fixed assets or current assets.	These assets usually fall in the category of fixed assets.
3.	**Depreciation or Amortisation**	Depreciation is charged on fixed tangible assets.	Intangible assets are amortised.
4.	**Acceptance as Security**	Lenders accept these assets as security for providing loan.	Lenders usually do not accept intangible assets as security for providing loan.
5.	**Risk of loss due to fire**	Tangible assets may be lost due to fire.	Intangible assets cannot be lost due to fire.

Classification of Liabilities

According to their nature, the liabilities may be classified as follows :—

(1) **Fixed or Long-term Liabilities** :— Those liabilities which are to be repaid after one year or more are termed as long-term liabilities. These include Public Deposits, Long-term Loans, Debentures etc.

(2) **Current or Short-term Liabilities** :— Those liabilities which are expected to be paid within one year of the date of the Balance Sheet are termed as current or short-term liabilities. These include Bank Overdraft, Creditors, Bills Payable, Outstanding expenses etc.

(3) **Contingent Liabilities** :— These are the liabilities which will become payable only on the happening of some specific event, otherwise not. Such as :—

(I) ***Liabilities for bill discounted*** :— In case a bill discounted from the bank is dishonoured by the acceptor on the due date, the firm will become liable to the bank.

(II) ***Liability in respect of a suit pending in a court of law*** :— This would become an actual liability if the suit is decided against the firm.

Following points should be noted for preparing Final Accounts :—

(1) If a Trial Balance is not given in the question, it is better to prepare a Trial Balance first of all. If there is a difference in the Trial Balance, the difference is placed to a 'Suspense A/c' and shown in the Balance Sheet.

(2) It should be remembered that all items which appear in the Trial Balance should be shown only once whereas items which appear outside the Trial Balance, known as adjustments, have to be shown at two places.

(3) The items which appear on the debit side of the Trial Balance should be shown either on the debit side of the Trading or Profit and Loss A/c or on the Assets side of the Balance Sheet.

(4) The items which appear on the credit side of the Trial Balance should be shown either on the credit side of the Trading or Profit & Loss A/c or on the Liabilities side of the Balance Sheet.

(5) All accounts relating to Goods such as Purchases, Sales, Purchase Returns and Sales Returns are written in the Trading Account. In addition to these, the Trading Account will also be debited with all expenses which are directly related to either purchase or manufacturing of goods. All the remaining expenses or the balances of the Nominal Accounts are shown in the Profit & Loss Account.

(6) The balances of Personal and Real Accounts are always shown in the Balance Sheet.

(7) If the expenses in respect of 'Rent' and 'Lighting' are clearly stated as having been incurred in respect of factory, these will be shown in the Trading Account, otherwise these will be shown in Profit & Loss Account. For example, if 'Factory Rent' is given in the question, it will be shown in Trading Account. Instead, if 'Rent' is given, it will be shown in Profit & Loss Account.

(8) If a trial balance is not given in the question, and it is not clearly stated whether a particular item is expense or income, it will be treated as expense such as Discount, Commission, Brokerage or Rent etc.

(9) The total of both sides of the Balance Sheet will always be equal.

ILLUSTRATION 17.

Given below is the Trial Balance of Sh. Gopi Chand as at 31st March, 2010. You are required to prepare a Trading and Profit & Loss A/c for the year ended 31st March, 2010 and Balance Sheet as at that date :—

Debit Balances	₹	*Credit Balances*	₹
Opening Stock	45,000	Sundry Creditors	22,100
Purchases	1,20,000	Return outwards	2,500
Return inwards	3,200	Sales	3,50,000
Carriage inwards	2,400	Capital	2,00,000
Carriage outwards	1,500	Loan from Bank	24,000

Office furniture	8,000	Discount Received	2,000
Sundry Debtors	68,000	Commission	1,600
Dock Charges	5,000		
Electric Power	10,000		
Fuel, Gas and Water	12,000		
Bad-debts	1,100		
Advertisement	25,000		
Salary	36,000		
Cash in hand	8,100		
Cash at Bank	30,000		
Motor Vehicles	58,000		
Motor Repairs	3,000		
Interest on Bank Loan	2,400		
Rent and Insurance	24,500		
Business Premises	1,06,000		
Household expenses	33,000		
	6,02,200		6,02,200

Stock at the end ₹75,000.

ILLUSTRATION 18.

From the following balances taken from the books of Sh. Murli Manohar, prepare Trading and Profit & Loss Account for the year ended 31st March, 2010 and a Balance Sheet as at that date. Stock in hand on 31st March, 2010 was ₹56,000.

Name of Accounts	*Dr. Balances*	*Cr. Balances*
	₹	₹
Stock at Commencement	15,320	
Purchases and Sales	1,00,000	1,20,000
Returns	2,200	3,000
Drawings and Capital	10,000	1,30,000
Cartage	2,200	
Factory heating and lighting	6,600	
Works expenses	15,200	
Rent Received		7,300
Cash at Shop	800	
Accounts Receivable		
Kapil	8,000	
Jadeja	5,000	
Yadav	1,500	
Accounts Payable		
Parbhakar		16,000
Tendulkar		7,540
Horses and Carts	25,000	
B/R and B/P	10,000	2,120
Rent paid	15,000	
Fire Insurance Premium	4,800	
Life Insurance Premium	6,000	
Bank overdraft		67,000
Bank Interest	2,400	
Telephone Expenses	3,000	

ILLUSTRATION 19.

From the following balances prepare a Trading, Profit & Loss Account and Balance Sheet.

Particulars	₹	*Particulars*	₹
Carriage on Goods Purchased	8,000	Cash in Hand	2,500
Carriage on Goods Sold	3,500	Banker's A/c (Cr.)	30,000
Manufacturing Expenses	42,000	Motor Car	60,000
Advertisement	7,000	Drawings	8,000
Freight and Octroi	4,400	Audit Fees	2,700
Lighting	6,000	Plant	1,53,900
Customer's A/c	80,000	Repairs to Plant	2,200
Supplier's A/c	61,000	Stock at the end	76,000
Duty and Clearing Charges	5,200	Purchases Less Returns	1,60,000
Postage and Telegram	800	Commission on Purchases	2,000
Fire Insurance Premium	3,600	Incidental Trade Exp.	3,200
Patents	12,000	Investments	30,000
Income Tax	24,000	Interest on Investments	4,500
Office Expenses	7,200	Capital A/c	1,00,000
		Sales Less Returns	5,20,000
		Rent	12,000
		Discount Paid	2,700
		Discount on Purchases	3,400

ILLUSTRATION 20.

From the following balances prepare Final Accounts as at 31st March, 2012 :—

Particulars	₹	*Particulars*	₹
Opening Stock	15,310	Capital	2,50,000
Purchase	82,400	Drawings	48,000
Sales	2,56,000	Sundry Debtors	57,000
Returns (Dr.)	4,000	Sundry Creditors	14,000
Returns (Cr.)	2,400	Depreciation	4,200
Factory Rent	18,000	Charity	500
Custom Duty	11,500	Cash Balance	4,460
Coal, Gas and Power	6,000	Bank Balance	4,000
Wages & Salary	36,600	Bank Charges	180
Discount (Dr.)	7,500	Establishment Expenses	3,600
Commission (Cr.)	1,200	Plant	42,000
Bad-debts	5,850	Leasehold Building	1,50,000
Bad-debts Recovered	2,000	Goodwill	20,000
Apprentice Premium	4,800	Patents	10,000
Productive Expenses	2,600	Trade Marks	5,000
Unproductive Expenses	5,000	Loan Cr.	25,000
Carriage	8,700	Interest on Loan	3,000

The value of Closing Stock on 31st March, 2012 was ₹25,400.

Treatment of Various Adjustments

Adjustment	Adjustment Entry	Treatment in Trading A/c	Treatment in Profit & Loss A/c	Treatment in Balance Sheet
1. Closing Stock	Closing Stock A/c Dr. To Trading A/c	Shown on the credit side		Shown on the assets side
2. Outstanding Expenses	Expenses A/c Dr. To Outstanding Expenses A/c	Added to the respective expense on the debit side	Added to the respective expense on the debit side	Shown on the liabilities side
3. Prepaid or unexpired expenses	Prepaid Expenses A/c Dr. To Expenses A/c	Deducted from the respective expense on the debit side	Deducted from the respective expense on the debit side	Shown on the assets side
4. Depreciation	Depreciation A/c Dr. To Asset A/c		Shown on the debit side	Deducted from the concerned asset on the assets side
5. Accrued Income (Income earned but not received)	Accrued Income A/c Dr. To Income A/c		Added to the respective income on the credit side	Shown on the assets side
6. Unearned Income (Income received in advance)	Income A/c Dr. To Unearned Income A/c		Deducted from the respective income on the credit side	Shown on the liabilities side
7. Interest on capital	Interest on Capital A/c Dr. To Capital A/c		Shown on the debit side	Added to the capital on the liabilities side
8. Interest on Drawings	Drawings A/c Dr. To Interest on Drawings A/c		Shown on the credit side	Added to the drawings and then deducted from Capital
9. Interest on Loan (taken from someone)	Interest on Loan A/c Dr. To Loan A/c		Shown on the debit side	Added to the loan on the liabilities side
10. Further Bad-debts	Bad-debts A/c Dr. To Sundry Debtors A/c		Added to Bad-debts (given in Trial Balance) on the debit side.	Deducted from debtors on the assets side
11. Provision for Doubtful debts	Profit & Loss A/c Dr. To Provision for Doubtful Debts A/c		Added to Bad-debts on the debit side	Deducted from Debtors on the assets side
12. Provision for discount on Debtors	Profit & Loss A/c Dr. To Provision for Discount on Debtors A/c		Shown on the debit side as a separate item	Deducted from Debtors on the assets side
13. Abnormal loss of stock	Insurance Company A/c Dr. Profit & Loss A/c Dr. To Purchases A/c	Total amount of loss is deducted from purchases on the debit side	Amount not recovered from the insurance company is shown on the debit side	Amount recovered from the insurance company is shown on the assets side.
14. Charity in the form of goods	Charity A/c Dr. To Purchases A/c	Deducted from purchases on the debit side	Shown on the debit side	
15. Goods distributed as free samples	Free samples A/c Dr. To Purchases A/c	-do-	Shown on the debit side	
16. Drawings in goods	Drawings A/c Dr. To Purchases A/c	-do-		Deducted from capital on the liabilities side.
17. Manager's Commission	Manager's Commission A/c Dr. To Outstanding Commission A/c		Shown on the debit side	Shown on the liabilities side
18. Goods sold but omitted to be recorded	Debtors A/c Dr. To Sales A/c	Added to sales on the credit side		Added to Debtors on the assets side
19. Goods purchased but omitted to be recorded	Purchases A/c Dr. To Creditors A/c	Added to purchases on the debit side		Added to Creditors on the liabilities side
20. Sale of goods on approval basis	(*i*) Sales A/c Dr. To Debtors A/c (Sale value of goods) (*ii*) Closing Stock A/c Dr. To Trading A/c (Cost price of goods)	Deducted from sales on the credit side Added to closing stock on the credit side		Deducted from debtors on the assets side Added to closing stock on the assets side.