= ₹ 1,25,000 – ₹ 1,00,000 = ₹ 25,000.

PROFIT & LOSS ACCOUNT

It is an account prepared to ascertain Net Profit.

"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." —**Prof. Carter**

Profit & Loss Account is prepared after preparing the Trading Account. It is prepared to determine net profit earned or net loss incurred by the business during an accounting period.

Profit & Loss Account starts with Gross Profit (transferred from Trading Account) on the credit side. In case of Gross Loss, it starts with Gross Loss (transferred from Trading Account) on the debit side. Thereafter, all indirect expenses and losses are transferred to the debit side of the Profit & Loss Account.

Indirect incomes and gains are transferred to the credit of Profit & Loss Account. It means those expenses or incomes which have not been debited or credited to Trading Account are debited or credited in the Profit & Loss Account.

The difference in totals of the two sides of this account is net profit, if the total of credit side is more than the total of debit side. In the reverse situation, difference means net loss. The difference (*i.e.*, net profit or net loss) is transferred to the Capital Account of the proprietor. Net profit increases the capital and net loss decreases it.

Indirect Expenses are those expenses which are not directly associated with manufacturing or sale of goods. They include administrative, selling and distribution expenses such as salaries, rent and taxes, postage and stationery, insurance, depreciation, interest paid, electricity expenses, advertising, packing, carriage outwards, etc. Losses include items like loss by fire, loss by theft, etc.

Indirect Incomes are those incomes which are not directly associated with revenue, *i.e.*, sale of goods, such as interest, dividends, profit on sale of fixed assets or investments.

Features of Profit & Loss Account

1. It is the second stage in the preparation of the final accounts.
2. It relates to a particular accounting period and is prepared at the end of that period.
3. It shows the financial performance of an enterprise during an accounting period.
4. Accrual basis of accounting is followed in the preparation of this account.
5. It is credited by the gross profit and income from other sources and debited with indirect expenses and losses.
6. Balance of this account is either Net Profit or Net Loss.
7. Net Profit or Net Loss directly affects the capital. Net Profit increases the capital, while Net Loss decreases it.

Purpose (Need) of Profit & Loss Account

1. *Determine Net Profit or Net Loss*

The main purpose of preparing Profit & Loss Account is to ascertain net profit earned or net loss incurred by the business during the accounting period.

2. *Comparison with the Previous Year's Profit*

Profit determined by the Profit & Loss Account for the accounting period can be compared with that of the earlier years' profit. It helps in ascertaining whether the business is being conducted efficiently or not.

3. *Finding Details of Indirect Expenses*

Indirect expenses are shown in the Profit & Loss Account. These expenses can be compared over the period and suitable steps can be taken for controlling these expenses.

4. *Helps in Preparing Balance Sheet*

A Balance Sheet can be prepared only after ascertaining Net Profit or Net Loss through the preparation of Profit & Loss Account.

5. *Basis for Profitability Ratios*

Profit & Loss Account is the basis for calculating various profitability ratios such as Gross Profit Ratio, Net Profit Ratio, Operating Ratio or Return on Capital Employed Ratio, etc., which are of immense use to users of financial statements.

Format of Profit & Loss Account

Dr. PROFIT & LOSS ACCOUNT for the year ended ... Cr.

Particulars	₹	Particulars	₹
To Gross Loss transferred from Trading A/c*	...	By Gross Profit transferred from Trading A/c*	...
To Salaries	...	By Rent Received	...
To Rent	...	By Discount Received	...
To Printing and Stationery	...	By Commission Earned	...
To Postage and Courier	...	By Interest Received	...
To Telephone and Internet Expenses	...	By Bad Debts Recovered	...
To Insurance Expenses	...	By Income from Investment	...
To Business Promotion Expenses	...	By Miscellaneous Income	...
To Repairs	...	By Net Loss transferred to Capital A/c**	...
To Depreciation	...		
To Interest	...		
To Bank Charges	...		
To General Expenses	...		
To Electricity Expenses	...		
To Loss by Fire or Theft or Damage	...		
To Commission	...		
To Advertisement	...		
To Freight Outwards	...		
To Discount Allowed	...		
To Travelling Expenses	...		
To Bad Debts	...		
To Net Profit transferred to Capital A/c**	...		
	...		...

*Either of the two will appear. **Either of the two will appear.

Heads of accounts given are imaginary. They may vary from question to question.

Contents or Items of Profit & Loss Account

Indirect expenses or losses, *i.e.*, expenses that have not been transferred to the debit of Trading Account are transferred to the debit of Profit & Loss Account. Similarly, Indirect incomes, *i.e.*, incomes that have not been transferred to the credit of Trading Account are transferred to the credit of Profit & Loss Account.

Entries (Items) transferred to the Debit of Profit & Loss Account:

(i) Salaries

Salaries are paid for the services of the employees and are transferred to the debit of Profit & Loss Account being indirect expenses. Sometimes, an account titled 'Salaries and Wages Account' is maintained in the books. Salaries and Wages Account is transferred to the debit of Profit & Loss Account considering it to be an indirect expense. On the other hand, if the account maintained is 'Wages and Salaries Account', it is transferred to Trading Account considering it to be direct expense being paid to manufacturing and/or trading staff.

(ii) Office Rent

Office Rent is an indirect expense being not related to manufacturing or trading but incurred for the purposes of administration and sale.

(iii) Office Electricity

Office Electricity expenses like office rent are not related to manufacturing or trading but are incurred for the purposes of administration and sale.

(iv) Printing and Stationery

Expenses on printing and stationery are related more with administration and sale rather than manufacturing or trading.

(v) Postage, Courier, Telephone and Internet

Expenses on postage, courier, telephone and Internet, etc., are related more with administration and sale rather than manufacturing or trading.

(vi) Administrative Expenses

Expenses such as legal expenses, audit fee and general expenses are also indirect expenses and debited to Profit & Loss Account. We may categorise them as Administrative and Office Expenses.

(vii) Salesmen Commission

Salesmen commission is like salary being paid to salesmen. This expense is an indirect expense being directly related to sales.

(viii) Freight on Sales or Freight Outwards

Freight paid on sales is an indirect expense.

(ix) Delivery Vehicle Expenses

Expenses incurred on delivery vehicle are expenses for delivering the goods sold. It is an indirect expense.

(x) Insurance Expenses

Insurance premium paid for insuring the assets, finished goods, stock, etc., are indirect expenses. It is an indirect expense.

(xi) Advertising Expenses

Expenses incurred towards advertisement is an indirect expense being expense to advertise the products or possibly to recruit staff.

(xii) Selling and Distribution Expenses

Expenses such as Godown Charges, Packing Charges, etc., are also indirect expenses and debited to Profit & Loss Account.

(xiii) Interest on Loan

Loan is taken by the firm to make up the deficiency of capital. Interest paid on loan is an expense to service the loan taken by the firm. It is an indirect expense being not related to manufacturing or trading.

(xiv) Discount Allowed

Discount Allowed means cash discount allowed to the debtors. It is an indirect expense being discount allowed on timely payments by the debtors.

(xv) Bad Debt

Bad Debt is the amount that has become irrecoverable from a debtor. It is an indirect expense.

(xvi) *Depreciation*

Depreciation is the cost of fixed asset written off over its estimated useful life. It is a fall in the value of the asset due to its wear and tear, use or lapse of time. Depreciation is a cost and it being indirect expense.

(xvii) *Loss of Goods by Fire or Theft or Damage*

Loss of goods by fire or theft or damage being a loss for the business is debited to Profit and Loss.

Loss of Goods by Fire or Theft or Damage Account is debited and Purchases Account is credited by the purchase cost.

In case goods are insured, Insurance Company is debited and if the goods are not insured Loss of Goods by Fire or Theft or Damage Account is debited.

(xviii) *Insurance Premium*

Assets are normally insured to cover the risk of loss. Insurance premium is an expense and is debited to Profit & Loss Account.

(xix) *Miscellaneous or Sundry or General Expenses*

Miscellaneous Sundry or General Expenses are expenses involving small amounts and being not material are clubbed together into one account.

Besides the above there are other payments say drawings of cash or goods by the proprietor. Personal income tax or life insurance premium of the proprietor paid from the firm's cash or bank are not accounted as expense of the firm. They are drawings and are deducted from capital.

Entries (Items) transferred to the Credit of Profit & Loss Account:

Profit & Loss Account starts with the Gross Profit, brought down from the Trading Account, in the credit side. In case of Gross Loss, it is brought down in the debit side. Further Other Incomes, *i.e.*, income earned from the use of firm's resources other than the main business of the firm are transferred to the credit of Profit & Loss Account. It includes:

(*a*) Interest on fixed deposits;

(*b*) Rent Received;

(*c*) Cash discount received;

(*d*) Gain (Profit) on sale of fixed assets;

(*e*) Interest on Drawings; and

(*f*) Bad Debts Recovered. The amount of bad debts earlier written off, if recovered is an income for the firm.

Balancing of Profit & Loss Account

Balance in the Profit & Loss Account means **Net Profit or Net Loss**. If total of credit side is more than the total of debit side, it is net profit. If total of debit side is more than the total of credit side, it is net loss. Net Profit or Net Loss is transferred to Capital Account of the proprietor.

Difference between Trading Account and Profit & Loss Account

Basis	Trading Account	Profit & Loss Account
1. **Relation**	Trading Account is a part of Profit & Loss Account.	Profit & Loss Account is the main account.
2. **Nature**	Gross Profit or Gross Loss is determined from Trading Account.	Profit & Loss Account is prepared to ascertain net profit or net loss of the business.
3. **Transfer of Balance**	Balance of the Trading Account is transferred to Profit & Loss Account.	Balance of the Profit & Loss Account is transferred to Capital Account of the proprietor.
4. **Items**	Items shown in the Trading Account are purchases, sales, opening and closing stocks, direct expenses, etc.	Items like indirect expenses related to sales, distribution, administration, finance, etc., are shown in the Profit & Loss Account.

Closing Entries related to Profit & Loss Account

Following entries are to be passed in the Journal Proper for preparing the Profit & Loss Account:

1. Items of indirect expenses and losses are closed by transferring their balances to the debit of Profit & Loss Account. The entry passed is:

   Profit & Loss A/c ...Dr.
   To Salaries A/c
   To Rent A/c
   To Interest A/c
   To Advertising A/c
   To Bank Interest A/c
   To Bank Charges A/c
   To Miscellaneous Expenses A/c

2. Items of income or gain are closed by transferring their balances to the credit of Profit & Loss Account. The entry passed is:

   Interest Received A/c ...Dr.
   Discount Received A/c ...Dr.
   Bad Debts Recovered A/c ...Dr.
   Miscellaneous Income A/c ...Dr.
   To Profit & Loss A/c

These two entries close all the Expense and Income Accounts.

3. At this stage the Profit & Loss Account shows either net profit or net loss. Both are transferred to Capital Account. In case of net profit, *i.e.*, when the credit side of Profit & Loss Account is bigger than the total of debit side, the entry is:

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

   In the case of net loss, *i.e.*, when the total of debit side of Profit & Loss Account is bigger than the total of credit side, the entry is:

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

Illustration 17.

From the following Trial Balance of Venkat, pass closing entries and prepare Trading and Profit & Loss Account for the year ended 31st March, 2022:

TRIAL BALANCE
as at 31st March, 2022

Heads of Accounts	L.F.	Dr. (₹)	Cr. (₹)
Capital A/c		–	10,00,000
Stock A/c (1st April, 2021)		2,00,000	–
Cash at Bank		1,00,000	–
Cash in Hand		44,000	–
Machinery A/c		6,00,000	–
Furniture and Fittings A/c		1,36,000	–
Purchases A/c		15,00,000	–
Wages A/c		10,00,000	–
Power and Fuel A/c		3,00,000	–
Factory Lighting A/c		20,000	–
Salaries A/c		7,00,000	–
Discount Allowed A/c		50,000	–
Discount Received A/c		...	30,000
Advertising A/c		5,00,000	–
General Expenses A/c		4,00,000	–
Sales A/c		–	50,00,000
Sundry Debtors		11,00,000	–
Sundry Creditors		–	6,20,000
Total		66,50,000	66,50,000

Value of Closing Stock as on 31st March, 2022 was ₹ 2,70,000.

Solution:

In the Books of Venkat

CLOSING ENTRIES

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2022				
March 31	Trading A/c ...Dr.		30,20,000	
	To Opening Stock A/c			2,00,000
	To Purchases A/c			15,00,000
	To Wages A/c			10,00,000
	To Power and Fuel A/c			3,00,000
	To Factory Lighting A/c			20,000
	(Opening stock, purchases account and direct expenses transferred to the Trading Account)			
March 31	Sales A/c ...Dr.		50,00,000	
	To Trading A/c			50,00,000
	(Amount of sales transferred to the credit of Trading Account)			
March 31	Closing Stock A/c ...Dr.		2,70,000	
	To Trading A/c			2,70,000
	(Value of stock on hand on 31st March, 2022)			
March 31	Trading A/c ...Dr.		22,50,000	
	To Profit & Loss A/c			22,50,000
	(Transfer of gross profit to Profit & Loss Account)			
March 31	Profit & Loss A/c ...Dr.		16,50,000	
	To Discount Allowed A/c			50,000
	To Salaries A/c			7,00,000
	To Advertising A/c			5,00,000
	To General Expenses A/c			4,00,000
	(Indirect expenses transferred to the debit of Profit & Loss Account)			
March 31	Discount Received A/c ...Dr.		30,000	
	To Profit & Loss A/c			30,000
	(Balance of discount received transferred to Profit & Loss Account)			
March 31	Profit & Loss A/c ...Dr.		6,30,000	
	To Capital A/c			6,30,000
	(Transfer of Net Profit to the Capital Account)			

Dr. **TRADING ACCOUNT** *for the year ended 31st March, 2022* Cr.

Particulars	₹	Particulars	₹
To Stock	2,00,000	By Sales	50,00,000
To Purchases	15,00,000	By Closing Stock	2,70,000
To Wages	10,00,000		
To Power and Fuel	3,00,000		
To Factory Lighting	20,000		
To Gross Profit c/d	22,50,000		
(Transferred to Profit & Loss A/c)			
	52,70,000		52,70,000

PROFIT & LOSS ACCOUNT
for the year ended 31st March, 2022

Dr. Particulars	₹	Particulars	Cr. ₹
To Salaries	7,00,000	By Gross Profit b/d	22,50,000
To Discount Allowed	50,000	By Discount Received	30,000
To Advertising	5,00,000		
To Sundry Office Expenses	4,00,000		
To Net Profit transferred to Capital A/c	6,30,000		
	22,80,000		22,80,000

Difference between Gross Profit and Net Profit

Gross Profit	Net Profit
1. Gross Profit = Sales – Cost of Goods Sold.	Net Profit = Gross Profit + All other Incomes – Indirect Expenses and Losses.
2. It is determined from the Trading Account.	It is determined from the Profit & Loss Account.
3. Gross Profit is transferred to Profit & Loss Account.	Net Profit is transferred to Capital Account.
4. It does not include any income from other sources.	It may include income from other sources.
5. It does not depend on the amount of net profit.	It depends on the amount of gross profit.

OPERATING PROFIT AND NET PROFIT

Profit may be divided into:

(*i*) Operating Profit; and

(*ii*) Net Profit.

Operating Profit is the profit earned by the enterprise from its operating activities. It is calculated by deducting the Operating Expenses from the Gross Profit.

Operating Profit = Gross Profit – Operating Expenses

Net Profit is the profit earned through operating and non-operating activities of the business.

Operating Expenses are the expenses incurred by an enterprise that are associated (incurred) with its operating activities. For example, a retail store's main or operating activities are buying and selling of goods. Therefore, cost of goods sold, salaries paid to staff, electricity expenses, rent, repairs, depreciation and amortisation are operating expenses because without incurring these expenses, the enterprise cannot carry its operating activities.

Non-Operating Expenses are the expenses which do not relate to the main activity of the enterprise such as interest on loan, charity, donation, loss on sale of fixed assets and loss by fire or theft or damage, etc.

Expenses, Operating and Non-Operating, are debited to Profit & Loss Account.

Operating Incomes are the incomes earned by an enterprise that are earned from its operating activities. For example, a retail store's main or operating activity is buying or selling of goods. Incomes earned in carrying the operating activities such as income from renting of space in the showroom, renting of show window, etc., are operating incomes. Besides the above, it includes cash discount received and commission received, etc.

Non-Operating Incomes are incomes earned and which do not relate to the operating activity of the enterprise such as interest received on investments, gain (profit) on sale of fixed assets, etc.

Incomes, Operating and Non-Operating, are credited to Profit & Loss Account.

Operating Profit = Gross Profit – Operating Expenses

Or

Operating Profit = Net Sales – Cost of Goods Sold – Operating Expenses

Or

Operating Profit = Net Profit + Non-Operating Expenses – Non-Operating Incomes

Operating Profit = Net Sales – Operating Cost*

*Operating Cost = Cost of Goods Sold + Operating Expenses

Difference between Net Profit and Operating Profit

The concept of Net Profit is different from the concept of Operating Profit. Net Profit is calculated after considering non-operating incomes and non-operating expenses/losses, while ascertaining the operating profit, non-operating items are not considered.

Net Profit = Gross Profit – Operating Expenses – Non-Operating Expenses
+ Non-Operating Incomes

Net Profit = Operating Profit – Non-Operating Expenses + Non-Operating Incomes.

Illustration 18

Donation		
Loss by Fire	20,000	82,100
Net Profit		1,34,000

BALANCE SHEET

A statement of firm's assets, liabilities and capital of proprietor at a specific point of time.

Balance Sheet is the statement prepared after preparing Trading and Profit & Loss Account. Balance Sheet is *"a statement which sets out the assets and liabilities of an entity as at a certain date."* It is a statement which reports the assets owned by the enterprise and the claims of the creditors and owners against these assets. *It shows the financial position of the business as at a given time.* It is prepared from **Real Accounts** and **Personal Accounts**. In other words, *the debit and credit balances of those ledger accounts which have not been closed by transfer to Trading and Profit & Loss Account are shown in the Balance Sheet. Debit balances are shown on the 'Assets side' and credit balances on the 'Liabilities side'.*

The purpose of preparing Balance Sheet is to determine the financial position of a business on a specific date. This is why the Balance Sheet has the heading: **Balance Sheet as at ...** as against the heading of Trading Account and Profit & Loss Account which usually is for a year. Since, even a single transaction will make a difference to one of the assets or liabilities, the Balance Sheet is true only at a particular point of time. That is the significance of the words 'as at'.

Purpose (Need) of Balance Sheet

The need or purposes for which Balance Sheet is prepared are:

1. To ascertain the financial position of the business at a particular point of time.
2. To know the amount of assets it owns under various heads say, debtors, fixed assets etc.
3. To know the amount of liabilities it owes to outsiders and the proprietor.
4. It shows the opening capital of the proprietor, drawings made by him during the year and capital introduced by him during the year.
5. It is a base for the Opening Entry for the next accounting year.
6. It helps in determining whether the firm is solvent or not.

Preparation of Balance Sheet

Debit and credit balances of Asset Accounts, Liability Accounts and Capital Account are shown in the Balance Sheet. Asset Accounts have debit balances and thus are shown in the Assets side of the Balance Sheet. Liability Accounts have credit balances, *i.e.*, amounts payable. Thus, they are shown in the Liabilities side of the Balance Sheet.

Capital Account normally has credit balance, meaning the amount payable to the proprietor. Thus, it is shown in the liabilities side of the Balance Sheet. However, it is possible that Capital Account has debit balance meaning the amount receivable from the proprietor. It is shown in the Assets side of the Balance Sheet.

Format of Balance Sheet

BALANCE SHEET OF ... as at ...

Liabilities			₹	Assets	₹
Capital		...		Goodwill	...
Add: Interest on Capital	...			Plant and Machinery	...
Net Profit for the year	...	...		Land and Building	...
		...		Patents and Trademarks, etc.	...
Less: Drawings	...			Furniture and Fittings	...
Income Tax	...			Investments	...
Interest on Drawings	...			Bills Receivable	...
Net Loss	...	...	...	Sundry Debtors	...
Reserves			...	Loans and Advances (Dr.)	...
Loans			...	Closing Stock	...
Bank Overdraft			...	Loose Tools	...
Employees' Provident Fund			...	Cash at Bank	...
Sundry Creditors			...	Cash in Hand	...
Bills Payable			...		
			...		...

Characteristics of Balance Sheet

1. *It is prepared as at a particular date.*
2. *It is prepared after the preparation of Trading and Profit & Loss Account.* This is the reason why the Profit & Loss Account (including the Trading Account) and the Balance Sheet are together called the **Final Accounts**.
3. *It shows financial position* of a business as a going concern.
4. *Balance Sheet is not an account but only a statement of assets and liabilities.* On the left-hand side, the liabilities of business are shown whereas on the right-hand side assets of the business are shown.
5. Totals of assets side and liabilities side should match, *i.e.*, totals of two sides of the Balance Sheet should be equal. If totals of two sides do not match, it means there is an error.

Difference between Balance Sheet and Trial Balance

Basis	*Balance Sheet*	*Trial Balance*
1. **Purpose**	The purpose is to portray financial position.	The purpose is to establish arithmetical accuracy of the books of account.
2. **Information about Profits**	It provides information as to profitability and financial position of the firm.	No such information is possible from Trial Balance.
3. **Necessity**	It is essential to prepare Balance Sheet to complete the accounting process.	Though desirable, it may be possible to dispense with its preparation.
4. **Headings**	The two sides are headed as assets and liabilities.	The two columns are headed as debit and credit.
5. **Coverage**	Only personal and real accounts appear in the Balance Sheet.	In the Trial Balance all accounts must be written, no account can be left out.
6. **Closing Stock**	This account appears in the Balance Sheet.	Normally, a closing stock does not appear in the Trial Balance.
7. **Period**	Normally, it is prepared only at the end of the accounting period.	A Trial Balance can be prepared at any time, even monthly or whenever required.
8. **Adjustments**	A Balance Sheet cannot be prepared without making adjustments for outstanding and prepaid items and without taking into account all events and transactions for the year.	A Trial Balance can be prepared at any stage, without even making such adjustments.
9. **Accounts**	Only Asset, Liability and Capital Accounts are shown.	All accounts, i.e., Asset, Liability, Capital, Income and Expense Accounts are shown.

Grouping and Marshalling (Arrangement) of Assets and Liabilities

Assets and liabilities are shown in either in order of permanence or liquidity in the Balance Sheet. Therefore, they are arranged in that particular order. This is known as **Grouping** and **Marshalling** of the Balance Sheet.

'Grouping' *means putting items of a similar nature under a common accounting head. The arrangement of assets and liabilities in a particular order in the Balance Sheet is called* ***Marshalling****.*

Let us understand the meaning of assets and liabilities at this stage. The term 'assets' means economic resources (property) of the business and includes all current and fixed assets. The term 'liabilities' means claims against the assets of the business and includes those of the outsiders (creditors) and those of the owners of the business (capital).

(i) In Order of Permanence

Assets, which are to be used permanently in the business are written first followed by the liquid assets and assets that are most liquid such as cash in hand are written last. Liabilities also be shown according to their permanency in the business. In this method, capital is shown first, then long-term liabilities and short-term liabilities, like amounts due to suppliers of goods or bills payable in the last. The form of a Balance Sheet under such an arrangement is as follows:

BALANCE SHEET OF ... *as at* ...

Liabilities		₹	Assets	₹
Capital			Goodwill	–
Opening Balance	–		Land and Building	–
Add: Net Profit	–		Plant and Machinery	–
	–		Furniture	–
Less: Drawings	–	–	Investment	–
Loans		–	Closing Stock	–
Bank Overdraft		–	Debtors	–
Sundry Creditors		–	Bills Receivable	–
Bills Payable		–	Cash at Bank	–
			Cash in Hand	–
		–		–

(ii) In Order of Liquidity

Assets that are most liquid are written first followed by less liquid assets and fixed assets in the last. Liabilities first shown are short-term liabilities and then long-term liabilities and capital in the last. According to this arrangement, the format of a Balance Sheet is as follows:

BALANCE SHEET OF ... *as at* ...

Liabilities		₹	Assets	₹
Bills Payable		–	Cash in Hand	–
Sundry Creditors		–	Cash at Bank	–
Bank Overdraft		–	Bills Receivable	–
Loans		–	Debtors	–
Capital			Closing Stock	–
Opening Balance	–		Investment	–
Add: Net Profit	–		Furniture	–
	–		Plant and Machinery	–
Less: Drawings	–	–	Land and Building	–
			Goodwill	–
		–		–

Difference between Order of Permanence and Order of Liquidity

Basis	Order of Permanence	Order of Liquidity
1. **Order of Assets**	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.	The assets are arranged in the order of their liquidity, i.e., the most liquid asset (e.g., cash in hand), is shown first and the least liquid asset (e.g., goodwill) is shown last.
2. **Order of Liabilities**	The liabilities are arranged in the order of their permanence, i.e., the least urgent payment to be made (e.g., capital) is shown first and the most urgent payment to be made (e.g., short-term creditors) is shown last.	The liabilities are arranged in the order of their urgency of payment, i.e., the most urgent payment to be made (e.g., short-term creditors) is shown first. The least urgent payment to be made (e.g., capital) is shown last.

Illustration 19.

Prepare the Balance Sheet of R. Kumar as at 31st March, 2022 from the following information in the order of permanence:

Cash in Hand ₹ 11,200; Sundry Creditors ₹ 28,800; Bills Payable ₹ 3,500; Bills Receivable ₹ 5,300; Sundry Debtors ₹ 18,000.

Machinery as on 1st April, 2021 ₹ 85,000 and Depreciation provided for the year ₹ 8,500; Furniture and Fixtures as on 1st April, 2021 ₹ 21,000 and Depreciation provided for the year ₹ 2,100; Closing Stock ₹ 15,400.

Proprietor's Capital Account ₹ 90,000; His drawings during the year ₹ 8,000. Net Profit as per Profit & Loss Account ₹ 31,000. *(Delhi, Modified)*

Solution:

BALANCE SHEET OF R. KUMAR *as at 31st March, 2022*

Liabilities		₹	Assets		₹
Capital	90,000		**Fixed Assets**		
Add: Net Profit	31,000		Machinery	85,000	
	1,21,000		*Less:* Depreciation	8,500	76,500
Less: Drawings	8,000	1,13,000	Furniture and Fixtures	21,000	
Current Liabilities			*Less:* Depreciation	2,100	18,900
Sundry Creditors		28,800	**Current Assets**		
Bills Payable		3,500	Stock		15,400
			Bills Receivable		5,300
			Sundry Debtors		18,000
			Cash in Hand		11,200
		1,45,300			1,45,300

Classification of Assets

Assets in the Balance Sheet are divided in two parts as follows:

1. Fixed Assets

Fixed Assets are those assets that are purchased for long-term use, *i.e.*, are not purchased for resale. They may be tangible assets like land, building, plant and machinery, furniture and fixtures, etc., or intangible assets like goodwill, patents, etc.

(i) *Tangible Fixed Assets* are those fixed assets which have a physical existence, *i.e.*, can be seen and touched. Examples are: Land and Building, Plant and Machinery, Furniture and Fixtures, etc.

(*ii*) *Intangible Fixed Assets* are those fixed assets which do not have physical existence, *i.e.*, they can neither be seen nor touched. Examples are: goodwill, patents, trademarks, softwares, etc.

Note: Fixed assets (Tangible) are shown in the Balance Sheet at cost *less* depreciation while Fixed Assets (Intangible) are shown at cost *less* amortisation.

Difference between Tangible Assets and Intangible Assets

Basis	*Tangible Assets*	*Intangible Assets*
1. **Physical Existence**	Tangible Assets are assets having a physical existence. *Example:* Land and Building, Plant and Machinery, etc.	Intangible Assets are fixed assets that do not have physical existence. *Example:* Goodwill, Patents, Trademarks, etc.
2. **Fixed vs. Current**	Tangible Assets can be fixed or current, *e.g.*, stock.	Intangible Assets normally are fixed assets.
3. **Depreciation or Amortisation**	Tangible Assets are depreciated.	Intangible Assets are amortised.
4. **Risk of Loss**	These assets may be lost in an accident.	These assets cannot be lost in an accident.
5. **Acceptance as Security**	Lenders accept such assets as security for providing loan.	Lenders usually do not accept these assets as security for providing loan.

Investments*: Investments are capital expenditure normally incurred on purchase of securities, *i.e.*, shares, debentures, bonds, etc., to earn dividend, interest and other returns.
*Investment is shown separately in the Balance Sheet.

There is another category of assets called **Fictitious Assets**. In the real sense, they are losses yet to be written off. Examples of fictitious assets are Advertisement Suspense Account, Profit & Loss Account (Debit Balance), etc.

2. *Current Assets*

These are the assets of business which are held for resale or for converting into cash. These are the assets which are either in the form of cash or are held to be realised at the earliest. A business earns profit by sale of these assets but not by keeping them in hand. Examples are: unsold goods, debtors, bills receivable, bank balance, cash in hand, etc. These assets are temporary in nature and may change from time to time. These are sometimes referred to as floating or circulating assets.

Difference between Fixed Assets and Current Assets

Basis	*Fixed Assets*	*Current Assets*
1. **Nature**	These are long-term resources of a business.	These are short-term resources of a business.
2. **Purpose of Holding**	These assets are held to be used in operating the business and to earn profits.	These assets are realised in cash or consumed in business operations.
3. **Valuation**	These assets are valued at cost *less* depreciation.	These assets are valued at cost or net realisable value (market price), whichever is less.
4. **Sources of Finance**	These assets are purchased using long-term funds of the business.	These assets are purchased using short-term funds of the business.
5. **Subject to Change**	These assets usually do not change their form.	These assets usually change their form.
6. **Profit on Sale**	Profit on sale of these assets is capital profit.	Profit on sale of these assets is revenue profit.

Classification of Liabilities

Liabilities are shown in the Balance Sheet on the left-hand side. They may be divided as follows:

(i) Non-Current Liabilities

These liabilities are those liabilities which are not payable by the business within a period of one year from the end of the year. They mainly include long-term loans, borrowings or debentures, etc. Funds from this source are used for purchasing fixed assets.

(ii) Current Liabilities

These liabilities are payable by the business within a period of one year from the end of the year. Examples are creditors, bills payable, outstanding expenses, bank overdraft, etc.

(iii) Owner's Capital

The amount owing to the proprietors as capital is a separate class of liabilities. It includes undistributed profits and reserves besides capital. It is equal to the net assets of the business, *i.e.*, difference between assets and liabilities.

Contingent Liabilities

Contingent Liability is a liability that becomes payable on the happening of an event. In case, the event does not happen, no amount is payable. Such liabilities are not accounted and are not shown in the Balance Sheet; they are disclosed as a note. Examples of contingent liabilities are:

(i) Liabilities in Respect of Bills Discounted

If the firm has discounted its bills receivable, the primary liability will be that of the drawee. If the drawee does not pay, then it becomes a liability of the firm.

(ii) Guarantee for Loan

If the firm has stood surety for a loan, it will be liable to pay the amount if the other person does not meet his obligation.

(iii) Disputed Claims

If some other party has lodged a claim against the firm, the firm will be liable to pay if the claimant succeeds.

Difference between Profit & Loss Account and Balance Sheet

Basis	Profit & Loss Account	Balance Sheet
1. **Nature**	It is an account.	It is a statement.
2. **Period**	It is prepared for an accounting period.	It is prepared on the last day of the accounting period.
3. **Recording**	It records incomes and expenses.	It records assets and liabilities.
4. **Profit/ Financial Position**	It shows performance of the business, *i.e.*, profit earned or loss incurred by the business.	It shows the financial position of the business.
5. **Accounts**	Accounts that are transferred to the Profit & Loss Account are closed.	Accounts that are transferred to Balance Sheet are not closed but carried forward to next year.
6. **Balance**	Balance of this account is transferred to the Capital Account in the Balance Sheet.	Balances of this statement become the opening balances for the next period.

(vi) It should be determined whether entries (items) on the *debit side* of the Trial Balance are direct expenses or indirect expenses or assets. Direct expenses are transferred to the debit of Trading Account, Indirect expenses to Profit & Loss Account whereas Assets are shown in the assets side of the Balance Sheet.

Remember that the total of two sides of the Balance Sheet should match.

Illustration 20.

From the following Trial Balance, prepare Trading and Profit & Loss Account for the year ended 31st March, 2022 and Balance Sheet as at that date:

Particulars	₹	Particulars	₹
Debit Balances		Rent	8,000
Sundry Debtors	15,000	Salaries	20,000
Stock on 1st April, 2021	50,000	Drawings	20,000
Land and Building	1,00,000	Purchases	1,00,000
Cash in Hand	16,000	General Expenses	25,000
Cash at Bank	40,000	Plant and Machinery	57,000
Wages	30,000	**Credit Balances**	
Bills Receivable	20,000	Capital	2,50,000
Interest	2,000	Interest	6,000
Bad Debts	5,000	Sundry Creditors	70,000
Repairs	3,000	Sales	1,70,000
Furniture and Fixtures	15,000	Bills Payable	40,000
Depreciation	10,000		

On 31st March, 2022, the stock was valued at ₹ 1,00,000.

Solution:

TRADING AND PROFIT & LOSS ACCOUNT
for the year ended 31st March, 2022

Dr. Cr.

Particulars	₹	Particulars	₹
To Opening Stock	50,000	By Sales	1,70,000
To Purchases	1,00,000	By Closing Stock	1,00,000
To Wages	30,000		
To Gross Profit c/d (Transferred to Profit & Loss A/c)	90,000		
	2,70,000		2,70,000
To Interest	2,000	By Gross Profit b/d	90,000
To Bad Debts	5,000	By Interest	6,000
To Repairs	3,000		
To Depreciation	10,000		
To Rent	8,000		
To Salaries	20,000		
To Office Expenses	25,000		
To Net Profit transferred to Capital A/c	23,000		
	96,000		96,000

BALANCE SHEET *as at 31st March, 2022*

Liabilities		₹	Assets		₹
Current Liabilities			**Current Assets**		
Sundry Creditors	70,000		Cash in Hand	16,000	
Bills Payable	40,000	1,10,000	Cash at Bank	40,000	
Capital			Bills Receivable	20,000	
Opening Balance	2,50,000		Sundry Debtors	15,000	
Less: Drawings	20,000		Closing Stock	1,00,000	1,91,000
	2,30,000		**Fixed Assets**		
Add: Net Profit	23,000	2,53,000	Furniture and Fixtures	15,000	
			Plant and Machinery	57,000	
			Land and Building	1,00,000	1,72,000
		3,63,000			3,63,000

Illustration 21.

From the following Trial Balance of Chandan on 31st March, 2022, prepare Trading and Profit & Loss Account and Balance Sheet:

TRIAL BALANCE *as on 31st March, 2022*

Heads of Accounts	L.F.	Dr. (₹)	Cr. (₹)
Capital		—	1,50,000
Stock on 1st April, 2021		30,000	—
Cash at Bank		10,000	—
Cash in Hand		5,000	—
Machinery		1,00,000	—
Furniture		13,000	—

Purchases	2,00,000	–
Wages	50,000	–
Carriage Inwards	33,000	–
Salaries	70,000	–
Discount Allowed	4,000	–
Discount Received	–	5,000
Advertising	50,000	–
General Expenses	40,000	–
Sales	–	5,00,000
Sundry Debtors	90,000	–
Sundry Creditors	–	40,000
Total	6,95,000	6,95,000

Value of Closing Stock at cost as on 31st March, 2022 was ₹ 50,000. Its Net Realisable Value (Market Value) is ₹ 51,500.

Solution:

TRADING AND PROFIT & LOSS ACCOUNT OF CHANDAN

for the year ended 31st March, 2022

Dr. Cr.

Particulars	₹	Particulars	₹
To Opening Stock	30,000	By Sales	5,00,000
To Purchases	2,00,000	By Closing Stock	50,000
To Wages	50,000		
To Carriage Inwards	33,000		
To Gross Profit *c/d*	2,37,000		
	5,50,000		5,50,000
To Salaries	70,000	By Gross Profit *b/d*	2,37,000
To Discount Allowed	4,000	By Discount Received	5,000
To Advertising	50,000		
To Office Expenses	40,000		
To Net Profit transferred to Capital A/c	78,000		
	2,42,000		2,42,000

BALANCE SHEET OF CHANDAN

as at 31st March, 2022

Liabilities		₹	Assets	₹
Current Liabilities			**Current Assets**	
Sundry Creditors		40,000	Cash in Hand	5,000
Capital			Cash at Bank	10,000
Opening Balance	1,50,000		Sundry Debtors	90,000
Add: Net Profit	78,000	2,28,000	Closing Stock	50,000
			Fixed Assets	
			Furniture	13,000
			Machinery	1,00,000
		2,68,000		2,68,000

Note: Closing Stock is taken at cost (₹ 50,000), it being *less* than its net realisable value (market value) (₹ 51,500) because stock is valued at lower of cost or net realisable value (market value) due to Prudence Concept.