> Trading Account and Profit & Loss Account
> Balance Sheet and Trial Balance
> Profit & Loss Account and Balance Sheet

- Grouping and Marshalling (Arrangement) of Assets and Liabilities
- Classification of Assets and Liabilities

FINANCIAL STATEMENTS

Meaning

Financial Statements show the financial performance (profit) and position of the enterprise.

Financial Statements (Final Accounts) are the statements prepared at the end of the accounting period to determine the financial performance, *i.e.*, profit earned or loss incurred during the accounting period and also the financial position of the business as on the date. A complete set of Financial Statements or Final Accounts include:

(*i*) Trading and Profit & Loss Account; and

(*ii*) Balance Sheet.

Financial Statements are the end-product of the accounting process prepared from the Trial Balance. They are prepared to ascertain:

(i) profit earned or loss incurred by the business for an accounting period. It is known from the Trading and Profit & Loss Account.

(ii) assets owned and liabilities owed as on the date, *i.e.*, financial position, by preparing the Balance Sheet.

Objectives or Need or Importance of Financial Statements

The objectives or need or importance of the Financial Statements are:

1. Trading and Profit & Loss Account (Also known as Income Statement)

(i) Determine Gross Profit or Gross Loss

Trading Account is prepared to determine gross profit earned or gross loss incurred by the business during the accounting period.

(ii) Determine Net Profit or Net Loss

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

(iii) Comparison with the Previous Years' Profits

Gross Profit and Net Profit for the accounting period can be compared with that of the previous years' profits. It helps in determining whether the business is progressing as planned or not.

(iv) Details of Expenses and Income

Trading and Profit & Loss Account provide details of all expenses (direct and indirect) and income of the business. It helps in determining how expenses can be controlled and sources of income can be increased.

(v) Reserves

Reserves are created out (set aside) of profits to meet future uncertainties and to strengthen financial position of the firm. The amount set aside as reserves depends upon net profit earned.

(vi) Accounting Ratios

For financial analysis, ratios are calculated from the contents of Trading and Profit & Loss Account. For example, Gross Profit Ratio, Net Profit Ratio, Operating Ratio, Return on Capital Employed, etc.

2. Balance Sheet (Also known as Position Statement)

(i) Ascertaining Financial Position

Balance Sheet shows the financial position of the business on a particular date by showing its assets (*i.e.*, what it owns) and liabilities (*i.e.*, what it owes).

(ii) Comparison with Previous Year

The amounts under various heads of Balance Sheet can be compared with that of previous year to assess the change in financial position.

(iii) Determining Solvency Position

Short-term solvency of the business (*i.e.*, ability to meet its short-term liabilities) by computing Current Ratio and Liquid Ratio. Likewise long-term solvency can be ascertained by computing Debt to Equity Ratio, Proprietary Ratio, etc. These ratios are computed from the Balance Sheet.

Financial Statements are prepared from the Trial Balance. Accounts in the Trial Balance are transferred either to the Trading Account or to the Profit & Loss Account or to the Balance Sheet. *Entries (items) in the Trial Balance which are of revenue nature are transferred either to Trading Account or to Profit & Loss Account while entries of capital nature are transferred to the Balance Sheet.*

If an item of capital nature is transferred to Trading Account or Profit & Loss Account, *i.e.*, treating it as of revenue nature or *vice versa*, then neither Profit & Loss Account will show correct profit or loss for the year nor the Balance Sheet will show true and fair financial position of the business.

It is, therefore, necessary to understand and classify correctly whether an entry (item) in the Trial Balance is of revenue nature or of capital nature. Thereafter, the item should be transferred to the final accounts accordingly.

Going Concern Assumption allows classifying Expenses and Receipts as Capital Expenditure, Revenue Expenditure, Capital Receipts and Revenue Receipts.

There are certain rules for classification of expenditure and receipts as revenue and capital. Let us discuss these rules or basis.

Capital Expenditure

Capital Expenditure is the expenditure that gives benefit of *enduring nature, i.e.*, the benefit from the expenditure will be for period or periods beyond the accounting period. Capital expenditure *increases the earning capacity* or *reduces the operating expenses* of a business.

Capital Expenditure is the amount incurred by an enterprise normally on purchase of fixed assets. Fixed assets are used in the business to earn income and are not intended for resale. Fixed assets purchased may be tangible or intangible.

Following types of expenditures are usually accounted as Capital Expenditure:

(i) *Expenditure incurred for purchase of fixed assets such as land, building, machinery, furniture, motor vehicle, etc.*

(ii) *Expenditure for the extension of or improvement of fixed assets which will improve the earning capacity or quality of the product:* Such as increasing the seating capacity of a theatre.

(iii) *Expenditure incurred to bring the fixed assets to the place of their use and expenditure incurred on their installation or erection:* Such as freight on fixed assets, wages paid for the installation. Expense incurred up to the time the asset is ready for use is added to the cost of the asset.

(iv) *Expenditure incurred for reconditioning of old fixed assets:* Such as expenditure incurred on repairing or overhauling of second hand machinery to increase its life or to make it ready.

(v) *Expenditure incurred to take right to do business:* Expenses necessary for obtaining licence or patents, etc., are capital expenditure. Only the initial expenditure is capital expenditure, renewal fee is revenue expenditure.

(vi) *Expenditure incurred for purchase of intangible assets* such as goodwill, patents, trademarks, copyrights, etc.

(vii) *Legal Expenses Incurred for purchasing/owning a fixed asset,* rights, etc., are also capital expenditure.

Accounting Treatment of Capital Expenditure

Capital Expenditure is added to the cost of the fixed asset, *i.e.,* debited to relevant Fixed Asset Account and is shown in the Balance Sheet.

Revenue Expenditure

Revenue Expenditure is an expenditure the benefit of which is consumed or exhausted within the accounting period. Stating differently, an expenditure which is not capital expenditure is revenue expenditure. Examples of such expenses are:

(i) *Expenses incurred in day-to-day running of the business* such as rent, salaries, wages, power, fuel, etc.

(ii) Expenses incurred for repairs and maintenance of fixed assets.

(iii) *Expenses incurred on purchase of stock of materials and goods* to the extent that they are used (consumed) during the year; balance of unused raw material and unsold goods are shown as an asset.

(iv) *Depreciation* on fixed assets.

Revenue expenditure is accounted as an expense and is matched against revenues of the period to determine profit or loss of that period. It also includes that part of capital expenditure which expires or is consumed within an accounting year. For example, depreciation on fixed assets.

We have discussed the basis for distinguishing Capital Expenditure from Revenue Expenditure. However, the distinction is not simple.

Following expenses appear to be revenue expenses but they are capital expenses:

1. Expenses incurred on the repairs and whitewashing for the first time on the purchase of an old building, since these expenses are necessary to make the building usable.
2. Wages paid to workers to produce a tool to be used in the factory itself or to install a machine.
3. Expenses incurred for purchase of land or building such as fees paid to lawyer or registration expenses.
4. Interest on borrowing to purchase an asset up to the point of time it is ready for use.

Accounting Treatment of Revenue Expenditure

Revenue expenditure is shown on the debit side of Trading Account or Profit & Loss Account.

Difference between Capital Expenditure and Revenue Expenditure

Basis	Capital Expenditure	Revenue Expenditure
1. **Purpose**	It is incurred for purchase of fixed assets for use in business.	It is incurred for running of business.
2. **Capacity**	It increases earning capacity of the business.	It is incurred for earning profits.
3. **Period**	Its benefit extends to more than one year.	Its benefit is exhausted within the year.
4. **Recording**	It is debited to related Asset Account.	It is debited to related Expense Account.
5. **Nature of Account**	It is an Asset Account.	It is an Expense Account.
6. **Depiction**	It is shown in the Balance Sheet.	It is shown in the Trading or Profit & Loss Account.
7. **Examples**	(a) Cost of Plant and Machinery. (b) Cost of Land and Building.	(a) Depreciation on Plant and Machinery. (b) Rent.

Improper Considerations of Capital Expenditure and Revenue Expenditure

Whether an expenditure is capital or revenue in nature is determined after considering nature of the expenditure. *If revenue expenditure is accounted as capital expenditure, it will overstate profit and also value of the asset. On the other hand, if capital expenditure is debited to Profit & Loss Account, it will understate profit and also value of the asset.*

As a result, financial statements will not give true and fair view of profit earned and financial position of the enterprise.

Important Points to Categorise an Expenditure as Capital or Revenue Expenditure

(i) Amount of Expenditure

Capital expenditure is normally larger than revenue expenditure. But it does not mean that if the amount is small, it is always revenue expenditure and if the amount is large, it is always capital Expenditure.

(ii) Payment—Periodic or Lump Sum

Capital expenditure is normally not frequent and is made at a time, in lump sum. For example, purchase of land. On the other hand, revenue expenditure is paid periodically such as salary. It should not be concluded that if payment is made frequently, it is revenue expenditure. It is possible that payment for an asset purchased (which is a capital expenditure), is made in instalments.

(iii) Source of Payment

Mostly payment of capital expenditure is made out of the capital while revenue expenditure is paid out of revenue receipts. But it should not be considered as a general rule that expenses paid out of the capital are always capital expenditure and expenses paid out of revenue receipts are always revenue expenditure.

(iv) Its Nature in the Hands of Recipient

Whether an expenditure is a capital expenditure or revenue expenditure, nature of payment in the hands of recipient is not material. It may be possible that an item, which is of revenue nature for the payee, is of capital nature for the payer. For example, for a car manufacturer, amount received from sale of car is a revenue receipt but for the purchaser, it is a capital expenditure.

Illustration 1.

State whether following are capital or revenue expenditures:

(i) Second-hand car was purchased for ₹ 1,00,000. ₹ 10,000 were spent on its overhauling.

(ii) ₹ 25,000 paid for the installation of a new machine.

(iii) Repairs for ₹ 5,000 necessitated by negligence.

(iv) Cost of annual taxes paid and the annual insurance premium paid on the car.

(v) Cost of air-conditioning of the office of the General Manager.

Solution:

(i) Total expenditure of ₹ 1,10,000 is *Capital Expenditure*. ₹ 1,00,000 was paid for a capital asset while ₹ 10,000 was spent to make the car ready for use.

(ii) Cost of installing the new machine is a *Capital Expenditure* because the amount spent is up to the point when the asset is ready for use.

(iii) Repair charges are *Revenue Expenditure* since they are for maintaining an asset and not for improving the asset.

(iv) Annual taxes and insurance premium paid on the car are *Revenue Expenditure* because they do not add to the value of the car and their benefit will be exhausted within the year.

(v) It is *Capital Expenditure* because the benefit of this expenditure will be available for a number of years.

Illustration 2.

State with reasons whether following are Capital or Revenue Expenditures:

(i) Custom duty paid on import of a machine.

(ii) Wages paid for installation of a new machine.

(iii) ₹ 5,000 spent on repainting the factory.

(iv) Repairs for ₹ 2,000 necessitated by negligence of an operator of machine.

(v) ₹ 10,000 paid for electricity bill.

Solution:

(i) Custom duty paid on import of a machine is a *Capital Expenditure* because it is incurred for acquiring a new asset.

(ii) Wages paid for installation of a new machine is *Capital Expenditure* because it is in connection with the acquisition of new asset.

(iii) ₹ 5,000 spent on repainting the factory is *Revenue Expenditure* because it has been incurred to maintain the factory building.

(iv) Repairs for ₹ 2,000 necessitated by negligence of an operator of machine is *Revenue Expenditure* since it has not improved the asset (machine) in any way.

(v) ₹ 10,000 paid for electricity bill is *Revenue Expenditure* because it is a part of operating expense.

Deferred Revenue Expenditure

Deferred Revenue Expenditure is a revenue expenditure that is incurred during an accounting period but it is estimated that its benefit will extend beyond that accounting period, i.e., will not be exhausted within the accounting period. Such an expenditure is usually larger than the normal expenditure under the head. An example of this is large expense, say on advertising a new product. The expenditure so incurred will give benefit in the periods beyond the accounting period in which the expenditure was incurred. It will thus, be proper to spread the expenditure over a period and not debit the total amount to Profit & Loss Account for the year in which the expense is incurred.

The amount which is not transferred to the debit of Profit & Loss Account is shown in the Balance Sheet in the asset side.

It should be noted that deferred revenue expenditure and prepaid expenses are two different terms. In case of deferred revenue expenditure, benefits available cannot be precisely known but in case of prepaid expenses, like payment of rent in advance, benefits available are precisely known.

Accounting of Deferred Revenue Expenditure

Amount to be written off in the current year is debited to the Profit & Loss Account and amount not written off in the current year is shown on the assets side of Balance Sheet as fictitious asset.

Deferred Revenue Expenditure is a Fictitious Asset: Although it is shown in the assets side of the Balance Sheet, it is not really an asset of the business.

CAPITAL RECEIPTS AND REVENUE RECEIPTS

Difference between capital receipts and revenue receipts is also necessary as is in the case of expenditure.

Capital Receipts

Capital Receipts are the amounts received by the enterprise that are not revenue. They are the receipts or amounts receivable from sources other than its operating, *i.e.*, business activities.

Examples of capital receipts are capital contribution by the proprietor, borrowings and sale proceeds of fixed assets. Capital and borrowings increase the liability of the enterprise thus, is not an income. Sale of fixed asset reduces fixed assets, thus, the amount received is not revenue earned in the normal course of business.

Capital receipts do not affect profit or loss of the business. They either increase liabilities or reduce assets. Hence, these are shown in the Balance Sheet.

Revenue Receipts

These are the amounts received in the normal course of business, mainly from sale of goods and/or services. Cash sales, cash received from debtors, bad debts recovered are examples of revenue receipts. In other words, revenue receipts arise from operating activities in the normal course of business. An important feature of revenue receipts is that such receipts are incomes. Hence, these are shown on credit side of the Trading Account or Profit & Loss Account.

Difference between Capital Receipt and Revenue Receipt

Capital Receipt	Revenue Receipt
1. It is the amount realised by sale of fixed assets or receipt as capital or loans taken.	It is the amount realised by sale of goods and/or rendering services.
2. It is shown in Balance Sheet.	It is shown in Trading Account or Profit & Loss Account.
3. Capital Receipts are normally of non-recurring nature.	Revenue Receipts are normally of recurring nature.
4. Capital Receipts are the receipts which are not received in the normal course of business.	Revenue Receipts are received in the course of normal trading operations.
5. Capital Receipts are normally not available for payment as profit to the owner of the business.	Revenue Receipts, i.e., net of revenue expenses and expired portion of Capital Expenditure/Deferred Revenue Expenditure are available for distribution to the owner of the business.

FINANCIAL STATEMENTS OR FINAL ACCOUNTS

Financial Statements or Final Accounts are prepared at the end of the accounting period to ascertain profit earned or loss incurred for the accounting period and the financial position as on a particular date. It includes:

1. Trading and Profit & Loss Account (Income Statement), and
2. Balance Sheet.

INCOME STATEMENT

Income Statement is a summary of accounts that affects the profit or loss of an enterprise. Accounts that increase the profit are shown on one (credit) side while accounts that decrease the profit, *i.e.*, losses and expenses are shown on the other (debit) side. The statement so prepared is known as an **Income Statement**. An Income Statement has two parts, namely,

1. *Trading Account*

   It shows Gross Profit or Gross Loss for the accounting period; and

2. *Profit & Loss Account*

   It shows Net Profit or Net Loss for the accounting period.

Let us discuss these in detail.

TRADING ACCOUNT

It is an account prepared to ascertain Gross Profit.

Meaning

Preparation of Trading Account is the first stage of preparing the financial statements (final accounts). It is the *financial statement which shows result of purchasing and selling of goods and/or services during an accounting period*. It is prepared following the Matching Concept of Accounting. Revenue from sales of goods and/or services rendered and closing stock or inventory are transferred to the credit while opening stock or inventory, net purchases and other direct expenses are transferred to the debit of Trading Account. The difference in the balances of two sides is either *Gross Profit* or *Gross Loss*.

Net Purchases = Purchases – Purchase Return

Features of Trading Account

1. It is the first stage in the preparation of financial statements (final accounts) of an enterprise.
2. Net Sales and Cost of Goods Sold are transferred to the account.
3. Balance of this account is either Gross Profit or Gross Loss.
4. Gross Profit or Gross Loss is transferred to Profit & Loss Account.

Purpose (Need) of Preparing Trading Account

1. Determine Gross Profit or Gross Loss for the accounting period.
2. Determine whether Gross Profit is adequate to meet indirect expenses.
3. Decide whether sale price of products needs to be increased or not. Alternatively, whether Cost of Goods Sold, *i.e.*, purchase cost and direct expenses need to be controlled.
4. Comparison of current year's data with that of earlier years.

Cost of Goods Sold = Opening Stock or Inventory + Purchases (Net) + Direct Expenses – Closing Stock or Inventory.

Contents or Items of Trading Account

Entries (Items) transferred to the Debit of Trading Account:

1. Opening Stock or Inventory

It is Closing Stock or Inventory of the previous year, which is recorded as Opening Stock of the new financial year in the books of account through an opening entry. Therefore, it is shown in the Trial Balance. This entry (item) is placed as the first item on the debit side of the Trading Account. It should be noted that in the first year of a business there will be no Opening Stock. In case of a trading concern, Opening Stock is of different types of finished goods and in a manufacturing concern, Opening Stock is of raw materials, work-in-progress and finished goods.

2. Purchases and Purchases Return

Purchases means purchase of goods and materials for the purpose of resale or to be used in manufacturing. Purchases Account has a *debit* balance and includes both cash and credit purchases. It should be kept in mind that purchase of assets which are meant for use in business such as machinery, furniture, etc., are not included in purchases.

Purchases Return Account has a *credit* balance showing the returns of goods or materials to the suppliers from whom these goods were purchased.

Purchases is shown on the debit side of Trading Account after deducting the amount of Purchases Return as follows (amounts are imaginary):

To Purchases	₹ 3,00,000
Less: Purchases Return	₹ 10,000
	₹ 2,90,000

Besides Purchases Return, following are also deducted from Purchases:

(a) Goods taken by the proprietor for his personal use;

(b) Goods given as charity; and

(c) Goods given as samples.

Let us discuss some issues relating to Purchases for more clarity.

1. Purchases includes both credit and cash purchases of goods and not assets.
2. Purchase means goods purchased for resale or manufacturing of goods.
3. Purchase of assets such as plant, furniture, stationery, etc., are not debited to Purchases Account but are debited to respective Asset Account because these are not the goods traded in by the firm.
4. Goods taken by Proprietor for personal use are not sales but drawings. Hence, his Drawings Account is debited by purchase cost of the goods taken by the proprietor for personal use. The Journal entry is:

   Drawings A/c ...Dr.
   To Purchases A/c [With Cost of Goods]

5. 'Goods given as charity' is not sale but donation. Hence, the cost of goods given as charity is transferred to Donation/Charity Account. The Journal entry is:

   Donation/Charity A/c ...Dr.
   To Purchases A/c

6. Similarly, goods given as samples are not sale but advertisement. Hence, the cost of goods given as samples is transferred to Samples Account or Advertisement Account. The Journal entry is:

   Sample/Advertisement A/c ...Dr.
   To Purchases A/c

7. When goods purchased are in transit, it is necessary to account them also. Since these

assets side.

8. Purchases are shown in the Trading Account as follows:

	₹	₹
Purchases		...
Less: Purchases Return	...	
Drawings	...	
Donation/Charity	...	
Sales Promotion (Samples)	...	...
		...
Add: Goods in Transit		...
Net Purchases		...

9. *Adjusted Purchases:* Closing Stock or Inventory is normally given outside the Trial Balance, therefore, adjustment for closing stock or inventory is made. It is also possible that adjustment entry for closing stock is passed in the books of account. As a result, closing stock stands adjusted against Opening Stock and Purchases. The Journal entries passed are:

(a) *For adjustment of Opening Stock:*

Purchases A/c	...Dr.
To Opening Stock A/c	

(b) *For adjustment of Purchases Returns:*

Purchases Return A/c	...Dr.
To Purchases A/c	

(c) *For adjustment of Closing Stock:*

Closing Stock A/c	...Dr.
To Purchases A/c	

After passing the above entries, Opening Stock, Purchases and Purchases Return accounts will not have balances and hence, will not be shown in the Trial Balance. Instead 'Adjusted Purchases Account' and 'Closing Stock' will be shown in the Trial Balance.

Adjusted Purchases = Opening Stock + Purchases (Net) – Closing Stock

The amount of 'Adjusted Purchases Account' is shown in the Trading Account and the amount of Closing Stock is shown in the assets side of the Balance Sheet.

3. Direct Expenses

Direct Expenses are the expenses *incurred on the goods purchased, till they are brought to the place of business.* Examples of such expenses are freight inwards, insurance, customs (import) duty, cartage, loading and unloading charges, etc. In a manufacturing concern, besides the above, expenses incurred for purposes of production such as wages, power and fuel, factory rent, etc., are also Direct Expenses.

Let us discuss few direct expenses individually.

(i) Carriage or Freight or Cartage Inwards

It is the cost of bringing raw materials or goods traded in to the firm's godown. If any freight or carriage is paid on any asset, like machinery, it is added to the cost of the asset and is not transferred to the debit of Trading Account.

(ii) Wages

Wages paid to workers in the factory, including stores, are debited to the Trading Account; if any amount is outstanding it is accounted for so that the total wages for the period are transferred to the debit of Trading Account.

If wages are paid for installation of machinery, it is debited to Machinery Account. If any amount is spent on wages for installation of an asset (say machinery), the amount of wages, to that extent, is added to the asset and reduced from wages in the debit of Trading Account.

If the Trial Balance includes a single amount for *'Wages and Salaries'*, it is assumed that the item includes the salaries of the supervisory staff in the factory. Therefore, the amount is transferred to the Trading Account. But, if the item in the Trial Balance is shown as *'Salaries and Wages'*, it is transferred to the Profit & Loss Account.

(iii) Power (Electricity) and Fuel

Cost of Power (electricity) and fuel (coal) used in running the machines is included under this head of accounts. Expenses incurred including not paid, *i.e.*, outstanding expenses are transferred to the debit of Trading Account.

(iv) Factory Rent

Rent paid for the factory premises as well as the municipal taxes or charges for water, etc., are transferred to the debit of Trading Account. If the office and the factory are in the same premises, total rent have to be suitably apportioned.

(v) Consumable Stores

These are incurred to keep the machine in right condition and include engine oil, cotton waste, soft soap, oil grease and waste, consumed in a factory.

Stores consumed during the year = Opening Balance in Stores + Net Purchases of Stores – Closing Balance of Stores.

Entries (Items) transferred to the Credit of Trading Account:

I. Sales and Sales Return

Sales Account has a credit balance, showing sales of the goods (both cash and credit) during the year. Sales Return Account has a debit balance, showing total of the amount of goods returned by customers. **Net Sales**, *i.e.*, Sales – Sales Return is transferred to the credit of Trading Account.

Let us discuss some issues relating to sales for more clarity.

(i) Sales means sale of goods dealt in by the firm in cash or credit.

(ii) Sale of fixed assets (say building) is not credited to Sales Account because they are not held for sale.

(iii) Sales Return means return of goods sold.

(*iv*) Gross Sales is shown in the inner column from which Sales Return is deducted and the balance (Net Sales) is shown in the outer column as follows:

	₹	₹
Sales	...	
Less: Sales Return	...	...

2. Closing Stock or Inventory

Closing Stock or Inventory means stock of unsold goods, *i.e.*, raw materials, semi-finished goods, finished goods or goods traded in at the end of the current accounting period. Closing Stock is taken and valued at the year end and is shown in Trading Account on the credit side.

Valuation of Closing Stock

According to the *Convention of Conservatism (Prudence Concept), stock is valued at cost or net realisable value (market value), whichever is less.*

For example, if Closing Stock is ₹ 1,00,000 but its net realisable value (market value) is ₹ 90,000, closing stock will be taken at ₹ 90,000. The reason being to provide for anticipated losses as is guided by the Prudence Concept.

Accounting Treatment

Closing Stock is usually given outside the Trial Balance. It is recorded in the books by passing the following entry:

Closing Stock A/c ...Dr.
To Trading A/c
(Closing Stock brought into books)

As a result, Closing Stock is shown both on the credit side of the Trading Account and also on the assets side of the Balance Sheet.

Closing Stock if shown in the Trial Balance means it has been adjusted by debiting Closing Stock and crediting Purchases Account. Stating it differently, entry for Closing Stock has been passed as follows:

Closing Stock A/c ...Dr.
To Purchases A/c
(Closing Stock brought into books)

The effect of this entry is to reduce the debit balance in Purchases Account; Closing Stock is then not shown in the Trading Account but *is shown as a Current Asset on the assets side of the Balance Sheet.*

In case of a trading business, Closing Stock is of finished goods. In case of a manufacturing concern, Closing Stock is of raw materials, work-in-progress and finished goods.

Balancing of Trading Account

After transferring the above entries (items) in respective sides of the Trading Account, balance is calculated to determine **Gross Profit or Gross Loss**. If total of the credit side is more than the total of debit side, excess is *Gross Profit*. If total of the debit side is more than the total of credit side, excess is *Gross Loss*.

Gross Profit is transferred to the credit side of the Profit & Loss Account and if it is Gross Loss it is transferred to the debit side of the Profit & Loss Account.

Closing Entries related to Trading Account

While preparing a Trading Account, it should be kept in mind that closing Journal entries are passed in Journal Proper. The closing entries passed are as follows:

(i) *For entries (items) in the debit side:*

Trading A/c ...Dr.
  To Opening Stock A/c
  To Purchases A/c
  To Returns Inward (Sales Return) A/c
  To Direct Expenses A/c

(ii) *For entries (items) in the credit side:*

Sales A/c ...Dr.
Returns Outward (Purchases Return) A/c ...Dr.
Closing Stock A/c ...Dr.
  To Trading A/c

(iii) *For transferring Gross Profit:*

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

(iv) *For transferring Gross Loss:*

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

Format of a Trading Account

Dr. TRADING ACCOUNT *for the year ended...* Cr.

Particulars		₹	Particulars		₹
To Opening Stock		...	By Sales	...	
To Purchases	...		Less: Returns Inward	...	...
Less: Returns Outward	...		By Scrap Sales		...
Loss of Stock	...	...	By Closing Stock		...
To Wages and Salaries		...	By Gross Loss c/d* (Transferred to Profit & Loss A/c)		...
To Direct Expenses		...			
To Carriage Inwards		...			
To Freight and Cartage Inwards		...			
To Factory Power (Electricity) and Fuel		...			
To Gross Profit c/d* (Transferred to Profit & Loss A/c)		...			
		...			...

*Either Gross Profit or Gross Loss will appear.

(iii) *For transferring Gross Profit:*

Trading A/c ...Dr.

To Profit & Loss A/c

(iv) *For transferring Gross Loss:*

Profit & Loss A/c ...Dr.

To Trading A/c

Format of a Trading Account

TRADING ACCOUNT *for the year ended ...*

Dr. | | Cr.

Particulars		₹	Particulars		₹
To Opening Stock		...	By Sales	...	
To Purchases	...		*Less:* Returns Inward	...	...
Less: Returns Outward	...		By Scrap Sales		...
Loss of Stock	...	...	By Closing Stock		...
To Wages and Salaries		...	By Gross Loss *c/d**		...
To Direct Expenses		...	(Transferred to Profit & Loss A/c)		
To Carriage Inwards		...			
To Freight and Cartage Inwards		...			
To Factory Power (Electricity) and Fuel		...			
To Gross Profit *c/d**		...			
(Transferred to Profit & Loss A/c)					
		...			...

*Either Gross Profit or Gross Loss will appear.

Illustration 3.

Prepare Trading Account for the year ended 31st March, 2022 from the following balances:

	₹		₹
Stock (1st April, 2021)	1,00,000	Purchases	10,00,000
Wages	50,000	Carriage Inwards	10,000
Sales	15,50,000	Returns Inward	50,000
Returns Outward	80,000		
Freight Inwards	5,000		

Closing Stock as on 31st March, 2022 was valued at ₹ 2,00,000.

Also, pass the Closing Entries.

Solution:

TRADING ACCOUNT
for the year ended 31st March, 2022

Dr. Cr.

Particulars		₹	Particulars		₹
To Opening Stock		1,00,000	By Sales	15,50,000	
To Purchases	10,00,000		*Less:* Returns Inward	50,000	15,00,000
Less: Returns Outward	80,000	9,20,000	By Closing Stock		2,00,000
To Wages		50,000			
To Carriage Inwards		10,000			
To Freight Inwards		5,000			
To Gross Profit c/d (Transferred to Profit & Loss A/c)		6,15,000			
		17,00,000			17,00,000

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Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2022 March 31	Trading A/c ...Dr.		12,15,000	
	To Opening Stock A/c			1,00,000
	To Purchases A/c			10,00,000
	To Returns Inward A/c			50,000
	To Wages A/c			50,000
	To Carriage Inwards A/c			10,000
	To Freight Inwards A/c			5,000
	(Transfer of accounts to the debit side of the Trading Account)			
March 31	Sales A/c ...Dr.		15,50,000	
	Returns Outward A/c ...Dr.		80,000	
	To Trading A/c			16,30,000
	(Transfer of sales and purchases return to Trading Account)			
March 31	Closing Stock A/c ...Dr.		2,00,000	
	To Trading A/c			2,00,000
	(Recording of Closing Stock)			
March 31	Trading A/c ...Dr.		6,15,000	
	To Profit & Loss A/c			6,15,000
	(Transfer of gross profit to the Profit & Loss Account)			

Illustration 4.

Prepare Trading Account as on 31st March, 2022 from the following balances:

	₹
Stock on 1st April, 2021	10,000
Sales Return	5,000
Sales	2,00,000
Wages	11,000
Purchases	2,00,000
Purchases Return	2,500
Carriage Inwards	1,500
Carriage Outwards	3,000
Freight Inwards	2,500

The Closing Stock of goods as on 31st March, 2022 is ₹ 20,000.

Solution:

TRADING ACCOUNT

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

Particulars		₹	Particulars		₹
To Opening Stock		10,000	By Sales	2,00,000	
To Purchases	2,00,000		*Less:* Sales Return	5,000	1,95,000
Less: Purchases Return	2,500	1,97,500	By Closing Stock		20,000
To Wages		11,000	By Gross Loss c/d		2,500
To Carriage Inwards		1,500	(Transferred to Profit & Loss A/c)		
To Freight Inwards		2,500			
		2,22,500			2,22,500

Note: Carriage Outwards is an indirect expense and, therefore, will be transferred to Profit & Loss Account.

Illustration 5.

From the following information, prepare Trading Account for the year ended 31st March, 2022:

Cash Purchases ₹ 1,50,000; Credit Purchases ₹ 9,00,000; Returns Inward ₹ 20,000; Cash Sales ₹ 1,60,000; Credit Sales ₹ 11,00,000; Returns Outward ₹ 10,000; Freight Inwards ₹ 3,000; Carriage Inwards ₹ 3,000; Wages and Salaries ₹ 4,000; Opening Stock ₹ 1,50,000; Closing Stock was ₹ 88,000 at cost but its net realisable value (market value) was ₹ 84,000.

Solution:

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

Dr. Particulars		₹	Particulars		Cr. ₹
To Opening Stock		1,50,000	By Sales:		
To Purchases:			Cash Sales	1,60,000	
Cash Purchases	1,50,000		Credit Sales	11,00,000	
Credit Purchases	9,00,000			12,60,000	
	10,50,000		*Less:* Returns Inward	20,000	12,40,000
Less: Returns Outward	10,000	10,40,000	By Closing Stock*		84,000
To Freight Inwards		3,000			
To Carriage Inwards		3,000			
To Wages and Salaries		4,000			
To Gross Profit c/d (Transferred to Profit & Loss A/c)		1,24,000			
		13,24,000			13,24,000

*As per Prudence Concept, Closing Stock is valued at cost or net realisable value (market value), whichever is less.

Illustration 6.

From the following balances taken from the Trial Balance of a firm as on 31st March, 2022, prepare the Trading Account:

		₹
Opening Stock:	Raw Materials	40,000
	Finished Goods	70,000
Purchases		1,80,000
Sales		3,50,000
Returns:	Purchases	5,000
	Sales	3,000
Wages		65,000
Factory Expenses		45,000
Freight:	Inwards	10,000
	Outwards	15,000

At the end of the concerned period, the stocks at hand were:

Raw Materials	35,000
Work-in-Progress	10,000
Finished Goods	55,000

Solution:

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

Dr. Particulars		₹	Particulars		Cr. ₹
To Opening Stock:			By Sales	3,50,000	
Raw Materials		40,000	*Less:* Sales Return	3,000	3,47,000
Finished Goods		70,000	By Closing Stock:		
To Purchases	1,80,000		Raw Materials		35,000
Less: Purchases Return	5,000	1,75,000	Work-in-Progress		10,000
To Wages		65,000	Finished Goods		55,000
To Factory Expenses		45,000			
To Freight Inwards		10,000			
To Gross Profit c/d (Transferred to Profit & Loss A/c)		42,000			
		4,47,000			4,47,000

Note: Freight outwards, being indirect expense, is shown in Profit & Loss Account.

Illustration 7.

From the following information, prepare Trading Account for the year ended 31st March, 2022:

Adjusted Purchases ₹ 11,00,000; Sales ₹ 12,50,000; Freight and Carriage Inwards ₹ 6,000; Wages ₹ 14,000; Freight and Cartage Outwards ₹ 5,000; Closing Stock ₹ 1,00,000.

Solution:

TRADING ACCOUNT OF ...

for the year ended 31st March, 2022

Dr. Cr.

Particulars	₹	Particulars	₹
To Adjusted Purchases	11,00,000	By Sales	12,50,000
To Freight and Carriage Inwards	6,000		
To Wages	14,000		
To Gross Profit c/d (Transferred to Profit & Loss A/c)	1,30,000		
	12,50,000		12,50,000

Notes: 1. Adjusted Purchases = Opening Stock + Net Purchases − Closing Stock.

2. Closing Stock has not been shown on the credit side of the Trading Account because it has already been adjusted while calculating the Adjusted Purchases.

3. Freight and Cartage Outwards are indirect expenses and hence not debited to Trading Account.

Illustration 8.

Ascertain Cost of Goods Sold from the following:

	₹		₹
Indirect Expenses	15,200	Direct Expenses	18,600
Sales	1,20,000	Net Purchases	72,000
Return Inwards	12,000	Return Outwards	8,000
Opening Inventory	16,000	Closing Inventory	28,000

(*Delhi*)

Solution: Cost of Goods Sold = Opening Inventory + Purchases (Net) + Direct Expenses − Closing Inventory

= ₹ 16,000 + ₹ 72,000 + ₹ 18,600 − ₹ 28,000 = ₹ 78,600.

Illustration 9.

Calculate Gross Profit when Total Purchases during the year are ₹ 8,00,000; Returns

Points to Remember

1. Trading Account shows Gross Profit or Gross Loss.
2. Gross Profit can be presented in the form of an equation as follows:

   Gross Profit = Net Sales – Cost of Goods Sold

   where, (i) Net Sales = Total Sales – Sales Return

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

   (iii) Net Purchases = Total Purchases – Purchases Return.

   Gross Profit is usually determined by preparing Trading Account.
3. Carriage Inwards is debited to Trading Account while Carriage Outwards is debited to Profit & Loss Account.
4. Returns Inward (Sales Return) are deducted from Sales, whereas Returns Outward (Purchases Return) are deducted from Purchases in the Trading Account.

Illustration 10.

Opening Stock ₹ 30,000; Purchases ₹ 54,600; Expenses on Purchases ₹ 6,000; Sales ₹ 90,000; Expenses on Sales ₹ 3,000; Closing Stock ₹ 36,600.

Calculate Cost of Goods Sold and Gross Profit.

Solution:

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

= ₹ 30,000 + ₹ 54,600 + ₹ 6,000 – ₹ 36,600 = ₹ 54,000.

Gross Profit = Net Sales – Cost of Goods Sold

= ₹ 90,000 – ₹ 54,000 = ₹ 36,000.

Note: Expenses on sales being indirect expenses are not considered while computing Cost of Goods Sold.

Illustration 11.

Opening Stock ₹ 15,000; Sales ₹ 48,000; Carriage Inwards ₹ 3,000; Sales Return