11 Financial Statements of Proprietary Concern

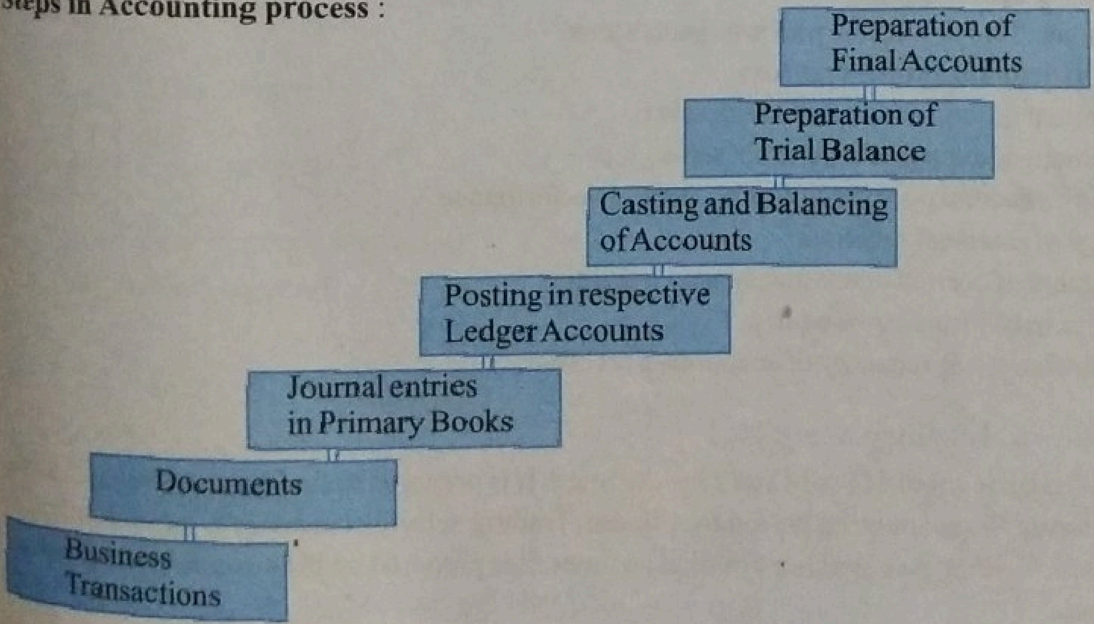
Contents :

Learning Objectives : - After studying this unit, student will be able to

- know the meaning, definition and importance of financial statements of a proprietary concern
- understand the method of preparing financial statements
- learn basic concept of ' Trading Account', Profit and Loss Account and Balance sheet
- understand Journal entries required to prepare final accounts
- understand Journal entries and effects of various adjustments.
- know the financial position i.e. Assets, Liabilities and Capital(Net worth) as on a Particular day/date

Introduction :- Accounting is systematic and scientific process of maintaining records of business transactions. A businessman records all the business transactions in journal or Sub-journals (Subsidiary books). The journalised entries are posted to the respective ledger accounts in the ledger. At the end of a particular accounting period these ledger accounts are balanced and a Trial Balance is prepared to check the arithmetical accuracy of the books of accounts On the basis of Trial Balance the Final Accounts are prepared.

Steps in Accounting process :



Meaning : Journalising, posting, casting balancing and preparation of Trial Balance is not a final stage of accounting.

Every businessman is interested to know whether he has earned a Profit or suffered a Loss during the accounting year. The Profit or Loss should be determined by preparing a Trading and Profit and Loss Account. While financial position is judged by preparing Balance Sheet of a business.

Final accounts are the accounts which are prepared at the end of an accounting year. It is a group of two accounts i.e. Trading Account and Profit and Loss Account and one statement i.e. Balance Sheet. Trading and Profit and Loss account is prepared to find out whether Profit is earned or Loss is suffered. And Balance sheet is prepared to know the financial position of the business on a particular date.

Definition : - The concept of Final Accounts is defined as "Final Accounts are the financial statements prepared at the end of an accounting year to disclose the financial position and performance of a business concern" It includes 1) Trading Account 2) Profit and Loss Account 3) Balance Sheet

Objectives and Importance of Final Accounts : - The primary objective of final account is to enable a trader to know the following information

1) The amount of Profit earned or Loss suffered during the accounting period.
2) The amount of assets and liabilities in the business on a particular date.
3) The amount of his capital in the business (equity).

Apart from the above main objectives the following are also the objectives of final accounts

a) To know the amount due to creditors and amount due from debtors.
b) To know the Trading Profit, Operating Profit and abnormal gains and losses.
c) To compare his business with that of other similar concerns.
d) To ascertain the amount of Tax liability payable to Government e.g. Income tax, Sales tax, wealth tax. etc.
e) To calculate various ratios for the purpose of financial analysis.
f) To take necessary policy decisions regarding future business activities.

Importance : - Final accounts are prepared for the following purposes.

1) Ascertainment of gross profit or gross loss.
2) Calculation of cost of goods sold.
3) Comparisons of stock with the previous years stock.
4) Ascertainment of net profit or net loss.
5) Ascertainment of ratio of net profit with sales.
6) Ascertainment of expenses ratio to net sales.
7) Comparison of actual performance with desired performance.
8) Knowledge of financial position.
9) Ascertainment of current assets and current liabilities.
10) Ascertainment of Proprietor's equity.
11) To check arithmetical accuracy of accounting records.

11.1 Preparation of Trading Account :

Trading Account is a part of Profit and Loss Account. It is prepared to find out the result of trading activities done during the accounting period by a trader. Trading activities means buying and selling of goods and services. Trading Account is a nominal account. It is prepared on the basis of direct expenses and direct income.

The main objective of preparation of Trading Account is to find out Gross Profit or Gross Loss i.e. trading result. Trading Account is prepared by passing the closing entries of nominal accounts (direct incomes and direct expenses only). Gross Profit or Gross Loss is the difference between net sales and cost of goods sold.

Equation of Gross Profit / Gross Loss

Gross Profit = Net Sales - Cost of goods sold

If amount of net sales is less than cost of goods sold the result is Gross Loss. The equations for these are as follows.

Gross Loss = Cost of goods sold - Net sales

* **Net Sales** = Total Sales - Sales return (Return Inward)
  Total sales includes Cash sales and credit sales during the year.
* **Cost of Goods Sold** = Opening stock + Net purchases + Direct expenses - Unsold goods.
* **Net purchases** = Total purchases (cash and credit) - purchase return (return outward)
* Unsold Goods refers to the closing stock of goods at the end of the year, goods distributed as free sample, goods taken over by owner for personal use and goods destroyed by fire or in accident or stolen.

Illustration No 1 : Find out Gross Profit / Loss from the following information of Mr. Omkar for the year ended 31st March 2011.

	₹		₹		₹
Opening Stock	15,000	Royalty	1,500	Purchases	48,200
Closing Stock	10,000	Sales Return	1,400	Sales	95,400
Wages	4,500	Purchase Return	1,200	Carriage Inward	1,000
Octroi duty	500				

Solution: 1

In the Books of Mr. Omkar
Statement of Gross Profit / Loss
for the year ended 31st March 2011

Particulars			Amount ₹	Amount ₹
Total Sales			95,400	
Less : Sales Return			1,400	
Net Sales				94,000
Less : Opening stock			15,000	
Less : Purchases (Total Purchases)		48,200		
Less Purchase Return		1,200	47,000	
Less : Direct expenses :	Wages	4,500		
	Carriage	1,000		
	Octroi duty	500		
	Royalty	1,500	7,500	
Cost of Purchase			69,500	
Less : Closing Stock			10,000	59,500
Cost of goods sold				
Gross Profit				34,500
If cost of goods sold is more than net sales it is Gross Loss				

Specimen of Trading Account

In the Books of M/s -------
Trading Account
for the year ended 31st March -------

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Opening Stock		xx	By Sales	xx	
To Purchases	xx		Less: Sales Return	xx	xx
Less: Purchase Return	xx	xx	By Goods distributed		xx
To Carriage/ Freight			as free sample		
To Cartage		xx	By Goods withdrawn by		
To Octroi / Custom duty		xx	Proprietor for personal use		xx
To Import duty		xx	By Goods destroyed by		
To Wages		xx	fire/loss by theft		xx
To Factory rent		xx	By closing stock		xx
To Factory expenses		xx	By Gross Loss c/d		xx
To Motive power fuel			(transferred to Profit &		
gas, coal		xx	Loss A/c)		xx
To Factory lighting					
and heating		xx			
To Royalties		xx			
To Gross Profit c/d		xx			
(transferred to P & L A/c)					
Total		**xx**	**Total**		**xx**

The balancing figure of Trading Account may show either Gross Profit or Gross Loss. Credit balance of Trading A/c indicates Gross Profit. It is transferred to the credit side of Profit and Loss account. Debit balance of Trading account indicates Gross Loss it is transferred on debit side of Profit and Loss account.

Explanation of items of Trading Account

On debit side of Trading Account

1) **Opening Stock :** - Opening stock refers to the stock of goods in hand at the beginning of the year. The amount of opening stock appears in Trial Balance. It is debited to Trading Account. In case of newly started business there will be no opening stock of goods. In case of manufacturing concern opening stock will be in three forms Viz a) Stock of raw material b) Stock of work in process c) Stock of finished goods.

2) **Purchases :** The term purchases means goods purchased during the year for sale. It includes both cash purchases and credit purchases. Total amount of purchases of goods is debited to Trading Account.

If there is a balance of purchases return i.e. return outward on credit column of Trial Balance it should be deducted from purchases in Trading Account.

Purchases of capital assets or stationery, spare parts should not be added with the purchases.

3) **Direct Expenses**: The expenses which are incurred for purchasing or manufacturing of the goods and also the Expenses incurred on goods to bring them in the safest condition are called Direct Expenses. In other words expenses which are directly related to purchases or production of goods are directly related to purchases or production of goods increases the cost of purchase. These are as follows.

a) **Productive wages / wages**: wages refer to the remuneration paid to labourers who are engaged in manufacturing of goods in a factory. Hence it is treated as direct expenses and debited to Trading Account.

b) **Carriage Inward / Freight / Cartage / Demurrage** : These expenses are incurred for bringing the goods or raw material purchased from the place of purchase to our factory shop or godown. It is debited to Trading Account. Demurrage is a penalty given to Railway authority.

c) **Octroi duty / Custom duty**: When goods are brought within municipal area the octroi duty is to be paid on it. In case of goods are imported from other countries import duty, customs duty, dock charges have to be paid. Hence these expenses are related to purchases of goods and treated as direct expenses and debited to Trading Account.

d) **Factory Rent, Rates and Factory Expenses:** These expenses are related to manufacturing of goods, which includes factory rent, municipal taxes of factory premises, work expenses, works managers salary etc. It is treated as direct expenses and debited to Trading Account.

e) **Motive power / fuel/ coal / gas / water**: Electricity power or coal gas or fuel utilised for manufacturing of goods are expenses related to manufacturing of goods. Therefore it is treated as direct expenses and debited to Trading Account.

f) **Royalty**: Royalty is the amount paid to the owner for using his rights. e.g. amount paid to the owner of coal-mine for taking out the coal from coal-mine. It is direct expenses and debited to Trading Account.

g) **Trade expenses** : Trade expenses are indirect expenses and debited to Profit and Loss Account. But if Trade expenses appears in trial balance along with sundry expenses, general expenses or office expenses, miscellaneous expense then it is treated as direct expenses and debited to Trading Account.

On credit side of Trading Account

1) **Sales:** Net sales of goods is shown in the credit side of Trading Account. When the goods sold are returned, it is called as sales return. It is deducted from total sales to arrive at net sales.

2) **Closing Stock** : Closing Stock of goods means the value of goods which remain unsold at the end of financial year. The amount of closing stock is credited to Trading Account. Closing stock is valued on the basis of " Cost Price or Market Price which ever is less" The amount of closing stock is given in the adjustments.

Closing Stock is valued at Cost price or Market price whichever is less. Why?

Journal entries for preparing Trading Account :

At the end of accounting year, accounts of direct expenses and direct incomes are closed and the balance of those accounts are transferred to trading account. For this purpose some Journal entries are passed which are known as ' closing entries'

The following closing and transferring entries are passed while preparing trading account.

1) **Transferring of Direct Expenses and Opening Stock**

Trading Account-----------Dr.	xx	
To Opening Stock Account		xx
To Purchases Account		xx
To Sales Return Account		xx
To Direct Expenses Account		xx

(Being Opening Stock, Purchases and Direct expenses transferred to Trading Account)

2) **Transferring of sales and purchase return**

Note: Purchase returns and sales return are transferred to Trading Account by making Journal entries, but while preparing the Trading Account purchase returns are deducted from purchase and sale reruns are deducted from sales.

After above stated journal entries the Trading Account is prepared. If the total of credit side of Trading Account is more than the debit side, it represents Gross Profit and if the debit side total is more than credit side then the difference is called as Gross Loss.

Sales Account-----------------------------------Dr.	xx	
Purchase Return Account-----------------------Dr.	xx	
To Trading Account		xx

(Being Sales and purchase return transferred to Trading Account)

3) **Transfer entry of closing stock to Trading Account**

Closing Stock Account -------------------------Dr.	xx	
To Trading Account		xx

(Being closing stock transferred to Trading Account)

4) **For Gross Profit transferred to Profit and Loss Account.**

Trading Account ----------------------------- Dr.	xx	
To Profit and Loss Account		xx

(Being Gross Profit transferred to P & L Account)

Gross Profit is credited to Profit and Loss account

5) **For Gross Loss transferred to Profit and Loss Account.**

Profit and Loss Account ------------------------Dr.   xx

To Trading Account   xx

(Being gross loss transferred to Profit and Loss Account)

Gross Loss is debited to Profit and Loss Account

Give closing entries of purchase return and sales return.

11.2 Profit and Loss Account

After preparing Trading Account, the next step is to prepare Profit and Loss Account. Profit and Loss Account is prepared to ascertain net profit or net loss It is a nominal account and prepared on the basis of indirect expenses and indirect incomes.

Trading Account shows the amount of gross profit or gross loss which is transferred to Profit and Loss Account. Profit and Loss Account is opened with Gross Profit or Gross Loss.

All the indirect expenses are debited and indirect incomes are credited to Profit and Loss Account.

Indirect expenses are the expenses incurred after production of goods These are related to office and administration expenses, selling and distribution expenses and financial expenses.

Indirect income includes other sources of income and non-trading incomes such as commission received, discount received, rent, interest on investment and deposit received.

Specimen of Profit and Loss Account

In the Books of M/S---

Profit and Loss Account

for the year ended 31st March, 2011

Dr. Cr.

Particulars	Amt. ₹	Amt. ₹	Particulars	Amt. ₹	Amt. ₹
To Gross Loss b/d		xx	By Gross Profit b/d		xx
To Office Salaries		xx	By Interest on Investment		xx
To Office Rent		xx	By Commission received		xx
To Printing and stationery		xx	By Discount received		xx
To Postage, Telephone		xx	By Dividend on shares		xx
To Audit Fees		xx	By R.D.D. Account		
To Electricity		xx	Old R.D.D.	xx	
To Commission paid		xx	Less: Bad debts (Old)	xx	
To Discount allowed		xx	Less: New Bad debts	xx	
To Carriage outward		xx	Less: New R.D.D.	xx	xx
To Advertisement		xx	By Net Loss transferred to Capital Account		xx
To R.D.D Account					
Add: Bad debts (old)	xx				
Add: New Bad debts	xx				
Add: New R.D.D	xx				
	xx				
Less: Old R.D.D	xx	xx			
To Travelling and conveyance		xx			
To Bank charges and Interest on Bank Loan		xx			
To Depreciation		xx			
To Abnormal losses e.g. Loss: by fire, theft		xx			
To Loss on sale of assets		xx			
To Net Profit transferred to Capital Account		xx			
Total		xx	Total		xx

Explanation of some Important items in Profit and Loss Account

1) **Office and Administration expenses :** These are the expenses which are incurred for maintenance of office, management and administration of the organisation. It includes salary to office staff, printing and stationery, postage, telephone, telegram, office rent, insurance, audit fees, office expenses and office electricity charges, etc.

2) **Selling and Distribution expenses :** These expenses are incurred for promoting sale and distribution of sale of goods. These expenses include advertisement, salesmen commission, discount allowed, carriage outward, cost of after sales service, bad debts, godown rent, delivery van expenses, etc.

3) **Financial expenses :** These expenses are incurred for raising the funds which is required for running the business . These includes interest on loan, interest on capital, bank charges, discount on bills interest on bank overdraft etc.

4) **Depreciation and Maintenance charges :**Depreciation means gradual and continous decrease in the value of fixed assets due to its wear and tear. It is to be debited to Profit and Loss Account repair and maintenance expenses of various assets also come under this head.

5) **Abnormal losses :** Some abnormal losses may occur during the accounting period. For example Loss by fire, Loss by theft, Loss on sale of asset etc. These abnormal losses are debited to Profit and Loss Account.

6) **Indirect incomes and gains :** All other incomes other than sale of goods and gains are credited to Profit and Loss Account. These incomes and gains include interest on investment and deposits, commission received, discount received, dividend on shares, etc.

Operating Profit :

Operating profit means excess of operating revenue over operating expenses and losses, It is the result of operation and it excludes finance and investment income such as dividend, interest paid and received. Operating profit arises as a result of carrying out operating activities. Operating activities are the principal activities of business and non-operating activities are financial and investing activities. For e.g. buying and selling of furniture are principal activities of a furniture dealer but granting a loan or investing excess funds is non operating activities. Thus interest on investments is non operating income, profit or loss on sale of fixed asset, loss by fire these are abnormal losses and gains. Thus Operating profit = Net Profit + Non Operating Expenses and Losses - Non Operating Gains and Incomes

Closing Entries relating to Profit and Loss Account

1) **For transfer of expenses to debit side of Profit and Loss Account**

Profit and Loss A/c Dr.
 To Salaries A/c
 To Advertisement A/c
 To Audit fees A/c
 To Printing and stationery A/c
 To Rent A/c
(Being transfer of various expenses to Profit and Loss account)

2) **For transfer of incomes to credit side of Profit and Loss A/c**

Dividend A/c	Dr.		
Discount A/c	Dr.		
Interest A/c	Dr.		
To Profit and Loss A/c			
(Being transfer of various incomes to Profit and Loss A/c)			

Balancing of Profit and Loss Account:

After transferring the indirect expenses and losses and indirect incomes and gains to Profit and Loss Account, it is closed to find out Net Profit or Net Loss of the business. If the total of credit side of Profit and Loss Account is higher than debit side it shows Net Profit where as if debit side is higher than credit side of Profit and Loss Account it represents Net Loss and is transferred to Capital Account.

Journal entries for transferring Net profit or Net Loss

1) **Transferring Net Profit to Capital Account**

Profit and Loss Account -------------	Dr.	xx	
To Capital Account			xx
(Being Net Profit transferred to Capital Account)			

2) **Transferring Net Loss to Capital Account**

Capital Account-------	Dr.	xx	
To Profit and Loss Account			xx
(Being Net Loss transferred to Capital Account)			

Net profit is **added** to Capital Account where as Net Loss is **deducted** from Capital Account.

11.3 Preparation of Balance Sheet:

A Balance Sheet is a statement of the financial position of a business on a particular date. It is the mirror of the financial status of business. Balance Sheet is prepared after the preparation of the Trading and Profit and Loss Account. It is not an account. The word 'To' and 'By' are not used in the Balance Sheet because it is a statement and not an account. It is only a statement that shows Assets, Liabilities and Capital of the business. The total value of assets is always equal to the total of Capital and Liabilities. The excess of Assets over Liabilities of the business is known as Capital or Net worth. The following is the equation for returns or owner equity (capital)

Net Worth - Owner Equity = Capital or Owner Equity (Capital) = Total Equity (Assets) - Credit Equity (Liabilities)

Definition :

American Institute of Certified Public Accountant : defines Balance Sheet as "a list of balances of the assets and liabilities account. This list depicts the position of assets and liabilities of specific business at specific point of time."

According to Palmer : " The balance sheet is a statement at a given date showing on one side the traders property and possession and on the other side his liabilities."

Features:

1) A Balance Sheet is a statement and not an account.
2) It shows financial position of business.
3) It is prepared at a particular date.
4) It is summarised statement of ledger accounts which has not been transferred to Trading and Profit and Loss Account.
5) Balance of Real Accounts and Personal Accounts appear in Balance Sheet.

As stated above, Balance Sheet is a statement which is divided in to two sides. The left hand side of the Balance Sheet in known as Liabilities side and right hand side is known as Assets side. The balance of Real and Personal accounts are carried forward for next accounting year. A Balance Sheet is prepared as follows.

In the books of M/S

Balance Sheet as on 31st March.....

Liabilities	Amt. ₹	Amt. ₹	Assets	Amt. ₹	Amt. ₹
Capital (opening)	xx		Cash in hand		xx
Add: Net profit	xx		Cash at Bank		xx
Add: Interest on capital	xx		Bills Receivable		xx
	xx		Sundry Debtors		xx
Less: Drawings	xx		Goodwill		xx
Less: Interest on Drawings	xx		Furniture		xx
Less: Net Loss	xx	xx	Plant & Machinery		xx
Bank Loan		xx	Land & Building		xx
Bank Overdraft		xx	Prepaid expenses		xx
Sundry Creditors		xx	Outstanding Incomes		xx
Bills payable		xx	Closing Stock		xx
Outstanding expenses		xx			
Pre received Income		xx			
Total		**xx**	**Total**		**xx**
Contingent Liability		xx			

Classification of Assets :

Assets are classified as 1) Fixed Assets 2) Floating / Current Assets 3) Fictitious Assets.

1) **Fixed Assets :** Fixed assets are those assets which are acquired for relatively long period. These are permanent in nature. These assets are not meant for resale. They are used in business again & again for earning income. e.g. Plant & Machinery, Land & Building, Furniture etc.

2) **Floating / Current Assets :**-Current assets are those assets which are acquired with the intention of converting them in to cash during the Operating year. Current assets are also called circulating assets as their nature goes on changing continuously. The term "Current Assets" includes cash and bank balances, stock of goods, raw material and work in progress, bills receivable, debtors and short term investments.

3) **Fictitious Assets :-** These assets are not represented by tangible possession of property. They are imaginary assets but do not have exchange value. e.g. Preliminary expenses, Deferred revenue expenses like advertisement suspense, discount on issue of shares and debentures.

Classification of Liabilities:-

Liabilities are classified as 1) Fixed/ Long term Liabilities 2) Current Liabilities 3) Contingent Liabilities.

1) **Fixed/ Long term Liabilities:-** These are the liabilities which do not become due for payment in one year. In other words these liabilities are to be paid after a long period. e.g. Long term Loan, Debentures, Capital.

2) **Current Liabilities:** Current liabilities are to be paid within one year. e.g. Bills payable, Bank overdraft, Creditors, Outstanding expenses, Short term loans etc.

3) **Contingent Liabilities :** It is not actual liabilities. It may or may not be actual liability. It may occur after happening of any event e.g. Bill of exchange discounted, Workers Compensation claim in court. It should be written as a foot note below the Balance Sheet.

Summery Chart of Accounting Treatments in Final Accounts

Name of Adjustment	Journal Entries	Two Effects
a) Closing Stock	Closing Stock A/c Dr. To Trading A/c	1) Credit side of Trading A/c 2) Shown on Assets side of Balance sheet
b) Depreciation	1) Depreciation A/c Dr. To Asset A/c 2) Profit & Loss A/c--Dr. To Depreciation A/c	1) Debit side of Profit & Loss A/c 2) Deducted from particular Assets on Assets side of Balance Sheet
c) Bad debts	1) Bad debts A/c Dr. To Debtors A/c 2) Profit & Loss A/c Dr. To Bad debts A/c	1) Debit side of Profit Loss A/c (New R.D.D + Bad debts) 2) Deducted from Sundry debtors on assets side
d) R.D.D. (Reserve for doubtful debts	Profit & Loss A/c Dr. To R.D.D. A/c	1) Debit side of Profit and Loss A/c 2) Deducted from Sundry debtors on Assets side.
e) Outstanding or Unpaid Expenses	Expenses A/c Dr. To outstanding expenses A/c	1) Add to particular expenses on Trading or Profit and Loss A/c 2) Shown on Liabilities Side of Balance Sheet
f) Prepaid Expenses	Prepaid Expenses A/c Dr To Expenses A/c	1) Less from that particular expenses on Trading or Profit and Loss A/c 2) Shown on Assets side of Balance Sheet
g) Accrued Income / Outstanding Income	Accrued Income A/c Dr To Income A/c	1) Add to particular income on credit side of Profit & Loss A/c 2) Shown on Assets side of Balance Sheet
h) Pre-received Income	Income A/c Dr. To Pre-received Income A/c	1) Less from particular income on credit side of Profit & Loss A/c 2) Shown on Liabilities side of Balance Sheet
i) Provision for Discount on Debtors	Profit & Loss A/c Dr. To Provision for discount on debtors A/c	1) Debit side of Profit and Loss A/c 2) Deducted from Sundry debtors on for discount Assets Side
j) Provision for Discount on creditors	Provision for Discount on Creditors A/c Dr. To Profit & Loss A/c	1) Credit side of Profit & Loss A/c 2) Deducted from sundry creditors on Liabilities side of Balance Sheet
k) Goods taken for personal use	1) Drawing A/c Dr. To Trading A/c /To Purchase A/c 2) Proprietor's capital A/c Dr. To drawing A/c	1) Credit side of Trading or deduct from purchases A/c 2) Deducted from capital on Liability side
l) Goods distributed as free sample	1) Goods distributed as free sample A/c Dr. To Trading A/c /To Purchase A/c 2) Advertisement A/c Dr. To Goods distributed as free sample / To Purchase A/c	1) Credit side of Trading or deduct from purchases A/c 2) Debited to Profit & Loss A/c

Why are adjustments considered while preparing final accounts ?