2. Trading Account

Gross Profit = Sale Value of Goods Less Cost of Goods Sold. This Gross Profit is ascertained by preparing the Trading Account. The format of the Trading Account is as under –

Trading Account of ....for the year ended ... ...

Particulars	₹	Particulars	₹
To Opening Stock To Purchases (net of Returns) To Direct Expenses like Freight, Cartage Customs Duty, Insurance, etc. To Gross Profit c/d to P&L Account		By Sales (net of Returns) By Closing Stock By Abnormal Loss (if any, valued at cost) By Gross Loss, if any, c/d to P&L Account	
Total		**Total**	

Note: The Trading Account Format is slightly modified in respect of Manufacturing Entities, for whom a Manufacturing Account is also prepared. **See further discussion below.**

2.1 Items appearing in Trading Account

Item	Nature	Treatment
1. Opening Stock	Value of Closing Stock of last year is brought forward to the current year. In case of **first year** of operations, Opening Stock will be **Nil**.	**Debit** in Trading Account
2. Purchases	Gross Amount of Purchases made (Cash and Credit) during the year is recorded in the Trading Account.	**Debit** in Trading Account
3. Purchase Returns	Amount of Materials returned to the Suppliers is reduced from the Purchases Amount.	**Subtract** from Purchases on Dr. Side
4. Freight Inwards	These are the expenses incurred to bring the material to the Firm's godown and make them available for use. This expenditure may be known by different names like Transportation, Carriage Inwards, Cartage and Coolie, Loading & Unloading, etc.	**Debit** in Trading Account
5. Wages	Wages paid to workers in Godown / Stores, and identifiable as Revenue Expenditure, should be debited to Trading A/c.	**Debit** in Trading Account
6. Sales	Total Sales made (Cash and Credit) during the period, should be credited to the Trading Account.	**Credit** in Trading Account
7. Sales Returns	Amount of goods returned by the Customers is reduced from the Sales Amount.	**Subtract** from Sales on Cr. Side
8. Closing Stock	Goods that are unsold at the last day of the accounting period is posted to the credit of the Trading Account. [**Note:** Refer to alternative accounting treatments in respect of Closing Stock.]	**Credit** in Trading Account
9. Abnormal Loss	Value of Abnormal Loss of goods, if any, is credited to Trading Account. Net Loss (after deducting Insurance Claim receivable, if any) is debited to the Profit and Loss Account. **Note:** Abnormal Loss can also be credited / adjusted against Purchase A/c. In such case, it will not be separately credited in Trading A/c.	**Credit** in Trading Account
10. Goods and Services Tax (GST)	GST (on Sales) is an indirect tax, collected by the Seller from his customers on Sales made to them. The amount so collected is paid to the Government. There are two methods of recognizing GST in the Financial Statements, i.e. – (a) **Inclusive Method**, where Sales and Purchases are shown inclusive of GST thereon, and (b) **Exclusive Method**, where Sales and Purchases are shown net of GST thereon.	Considered under two alternative methods.
11. Gross Profit / Loss	It is the balancing figure in the Trading Account, which is transferred to the Profit and Loss Account.	GP on Dr. Side. Gross Loss, if any, on Cr. Side.

2.2 Closing Entries for Trading Account

	Transaction	Journal Entry	Remarks
1.	Transfer of Purchase Returns (i.e. Returns Outward) to Purchases A/c	Purchase Returns A/c Dr. To Purchases A/c	In the Trading Account, Purchases and Purchase Returns are shown in the inner column, and the net amount is taken to outer column.
2.	Transfer of Sales Returns (i.e. Returns Inward) to Sales A/c	Sales A/c Dr. To Sales Returns	In the Trading A/c, Sales & Sales Returns are shown in the inner column, and the net amount is taken to outer column.
3.	Transfer of Opening Stock, Purchases, Freight, Wages, etc. to Trading Account	Trading A/c Dr. To Opening Stock To Purchases A/c To Freight Inwards To Wages A/c, etc.	Each of these is shown as a separate Line Item in the Trading Account.
4.	Transfer of Sales	Sales A/c Dr. To Trading A/c	Sales Amount is shown in the Cr. Side of Trading Account.
5.	Recording of Closing Stock in Trading Account	Closing Stock A/c Dr. To Trading A/c	**See alternative treatments given below in separate Paragraph.**
6.	Transfer of Gross Profit from Trading A/c to P&L A/c	Trading A/c Dr. To Profit & Loss A/c	If Cr. Side Total > Dr. Side Total, the difference is called Gross Profit.
7.	Transfer of Gross Loss, if any, from Trading A/c to P&L A/c	Profit & Loss A/c Dr. To Trading A/c	If Dr. Side Total > Cr. Side Total, the difference is called Gross Loss.

2.3 Accounting Treatments / Disclosures for Closing Stock

There are two different methods of dealing with Closing Stock, which are explained below –

	Method 1		Method 2	
Description	**Separate Credit in Trading A/c**		**Adjustment against Purchases A/c**	
Time of recording	Closing Stock Value is ascertained **after** preparation of Trial Balance (TB).		Closing Stock Value is ascertained **before** preparation of Trial Balance.	
Treatment in TB	Closing Stock does not **appear** in TB. It is given below the TB as an adjustment.		Closing Stock value **appears** in the TB itself. It is **not** an adjustment below TB.	
Journal Entry	The following Journal Entry is passed **after** preparation of Trial Balance – Closing Stock A/c Dr. To Trading A/c		The following Journal Entry would have been **passed** before preparation of TB – Closing Stock A/c Dr. To Purchases A/c	
Treatment in Trading A/c	Closing Stock is credited to the Trading A/c.		Closing Stock is not credited to Trading A/c, since Purchases A/c is **already adjusted.**	
Treatment in Balance Sheet	Closing Stock is shown on the Assets Side of the Balance Sheet, under "Current Assets".		Closing Stock is shown on the Assets Side of the Balance Sheet, under "Current Assets".	
Display in Trading A/c	To Opening Stock To Purchases To Other Items..... To Gross Profit	By Sales By Closing Stock	To Purchases **(Note 2)** To Other Items..... To Gross Profit	By Sales

Notes:

1. Method 1 (crediting Trading A/c separately) is generally adopted by most entities.
2. Under Method 2, Opening Stock will also be transferred to Purchases Account, by passing the journal entry "Dr. Purchases A/c, and Cr. Opening Stock A/c". Hence, the value of Purchases in such cases will effectively reflect the Cost of Goods Sold during the period.

2.4 Significance of Trading Account

1. The Trading Account shows the surplus of the Sale Value over the Cost of Goods Sold. This is called as the **Gross Profit.** Since the Gross Profit is the basic indicator of business profitability, the preparation of the Trading Account assumes significance.
2. Gross Profit Ratio = Gross Profit ÷ Sales. A fall in the GP Ratio requires investigation and prompt corrective action. Hence, the preparation of Trading Account is useful for analyzing the GP Ratio.

Illustration 1: Preparation of Trading Account

From the following data, prepare Trading Account of Ganesh Co, for the year ended 31st March.

- **Opening Stock = ₹ 28,50,000**
- **Purchases during the year on credit (of which goods worth ₹ 3,20,000 have been returned as defective) = ₹ 83,20,000. However, during the year, Creditors were paid only to the extent of ₹ 73,00,000.**
- **Cash Purchases made during the year (no returns have been made) = ₹ 5,40,000.**
- **Transportation Charges for bringing the goods to the Godown = ₹ 4,20,000.**
- **Wages paid to workers in Godown = ₹ 12,96,000. This includes ₹ 96,000 towards erection of certain equipments. Further, wages payable for March have not been recorded = ₹ 2,40,000.**
- **Sales made during the year (on Cash and Credit) = ₹ 1,31,45,000. From Debtors, ₹ 24,50,000 is not yet collected, and remained as Outstanding as at the end of the year.**
- **Sales Returns out of Credit Sales made was ₹ 8,00,000.**
- **Closing Stock was valued at ₹ 36,00,000, for which no accounting entry has yet been passed in the books.**
- **The above Closing Stock does not include Goods–in–Transit ₹ 5,00,000 for which no accounting entry has yet been passed in the books.**

Solution:

Dr. **Trading Account for the year ended 31st March** **Cr.**

Particulars	₹	Particulars	₹
To Opening Stock (given)	28,50,000	By Sales **(WN 3)** 1,31,45,000	
To Purchases **(WN 1)** 93,60,000		Less: Sales Returns 8,00,000	1,23,45,000
Less: Purchase Returns 3,20,000	90,40,000	By Closing Stock **(WN 4)**	41,00,000
To Transportation Charges (given)	4,20,000		
To Wages **(WN 2)**	14,40,000		
To **Gross Profit** (balancing figure)	**26,95,000**		
Total	**1,64,45,000**	**Total**	**1,64,45,000**

Working Notes:

1. **Purchases:** Both Cash and Credit Purchases are considered in Trading A/c. Amount paid to Creditors is not relevant for Trading A/c. However, Goods–in–Transit should also be included in Purchases amount. Hence, the value of Purchases = Credit Purchases ₹ 83,20,000 + Cash Purchases ₹ 5,40,000 + Goods–in–Transit ₹ 5,00,000 = ₹ **93,60,000**
2. **Wages:** Wages debited to Trading A/c = Wages Paid ₹ 12,96,000 + Wages Payable ₹ 2,40,000 **Less** Wages for erection of equipment to be capitalized ₹ 96,000 = **₹ 14,40,000.**
3. **Sales:** Both Cash and Credit Sales are considered in Trading A/c. Amount actually collected from Debtors (or) amount outstanding at year–end is not relevant for Trading A/c purposes.
4. **Closing Stock:** Value of Closing Stock including Goods–in–Transit = ₹ 36,00,000 + ₹ 5,00,000 = ₹ 41,00,000, to be credited to Trading A/c.