Financial Statements, Closing Process & Opening Entries

You have learnt about accounting concepts and principles in previous chapters. You have already learnt about the accounting procedure of Business Organization such as:

- Procedure for day to day cash transactions
- Procedure for purchases
- Procedure for sales
- Procedure for payment of expenses
- Procedure for recording of income
- Procedure for recognition of payable
- Procedure for recognition of receivable
- Procedure for depreciation etc.

In this chapter we will discuss about the last stage of accounting process that is Financial Statements.

Financial Statements are prepared after some adjustment of above business transactions for the fulfillment of the legal requirement of International Accounting Standard (IAS). Students are requested to carefully study the following accounting concepts and principles before preparing the financial statements.

Basic Accounting Concepts

The following are the basic accounting concepts:

i) **Business Entity:** under this concept, it is essential that a business organisation is separate and distinct from its owner or proprietors.

ii) **Unit of Measurement:** in the accounting process, money is used to express facts and all relevant details about the business. Effect of inflation on the value of money is not taken into consideration.

iii) **Going Concern:** In almost all cases the accounting system will treat the values on the assumption that business will continue operating for an indefinite period of time.

iv) **Objective Evidence:** All accounting transactions must be properly supported by objective evidence i.e., purchase invoice, bank statements, and various kinds of vouchers. However in certain cases we may have to depend upon judgement and estimates, for example provision for bad debts, depreciation on fixed assets, etc.

v) **Cost Concept:** Under this concept all assets acquired by the business are to be recorded at cost. The market value at any moment of time is to be ignored.

vi) **Dual Aspect:** This represents the concept of double entry book-keeping. Every transaction entered into by a firm has two aspects, i.e., debit and credit. According to dual aspect concept, at any time, the total assets of a business are equal to its total liabilities.

Assets = Capital + Liabilities

vii) **Accrual principle:** According to this concept, revenues are recognised as they are earned whether money is received or not, and costs are recognised as they are incurred whether money is paid or not.

Accounting Convention

Following are the three accounting conventions generally used to interpret the above mentioned accounting principles:

i) **Conservation (Prudence):** This requires to take into account all possible losses but ignore all possible profits (unrealised profits) which may arise due to business activity in the current year.

ii) **Consistency:** while certain alternatives are equally acceptable, one suitable alternative should be carefully selected and then applied consistently year after year.

iii) **Materiality:** this means that size and extent of any amount will influence its treatment. Financial statement should separately disclose items which are significant enough to affect evaluation or decision. But if the item or event is immaterial, it may not be disclosed.

Financial Statements

Financial Statement means repots on the activities of a business. These reports are the comprehensive way of communicating financial information to the users.

When the trial balance has been prepared, our immediate task is to prepare the financial statements according to the sequence of accounting procedures. Financial statements include the following reports:

1. Income Statement
2. Balance Sheet

1. **Income Statement:** The income statement is a statement in which revenues and expenditures are matched to arrive at a figure of profit or loss. Many business try to distinction between a gross profit earned on trading, and a net profit after other income and expenses.

In the first part of the income statement (the Trading Account) revenue from selling goods is compared with direct costs of acquiring or producing the goods sold to arrive at a gross profit figure.

From gross profit figure, deductions are made in the second half of the income statement (which is called Income & Expenditure Account) in respect of indirect costs and additions for non-trading income. In other words, an income statement is divided into two halves:

i) **Gross Profit** = Sales – Cost of goods Sold
ii) **Net Profit** = Gross Profit – Expenses +Non-Trading Income (income from other sources)

The income statement shows in detail how the profit or loss of a period has arisen.

Format of an INCOME STATEMENT is as under:

XY & Sons
Income Statement
For the year ended June 30, 200C

	Sales			XXX
	Less: Sales returns		XXX	
	Sales discount		+ XXX	(XXX)
	Net Sales			XXX
Less:	**Cost of Goods Sold**			
	Opening Inventory		XXX	
	Add: Purchases	XXX		
	Add: Transportation on purchase	+ XXX		
	Total Purchases	XXX		
	Less: Purchase returns	(XXX)		
	Purchase discount	(XXX)		
	Net purchase		+ XXX	
	Goods available for sale		XXX	
	Less: Closing Inventory		(XXX)	
	Cost of goods sold			(XXX)
	Gross profit			XXX
Less:	**Operating Expenses**			
	Distribution expenses		XXX	
	Selling expenses		XXX	
	Administration expenses		XXX	
	General expenses		XXX	
	Total operating expenses			(XXX)
	Operating Income			XXX
Add:	**Other Incomes**			
	Interest Income/Commission Income			XXX
	Net Income			XXX

2. **Balance Sheet:** A balance sheet is a statement of the liabilities, capital and assets of a business at a given moment in time.

In other words, a balance sheet is a list of assets, liabilities and capital of a business at some specific point of time. A balance sheet is prepared at the end of the accounting period to which the financial statements relate.

A balance sheet is very similar to the accounting equation. A balance sheet is divided into two halves:

i. Capital and Liabilities in one half called 'Equity' section, and
ii. Assets in the other half

Format of a BALANCE SHEET is as under:

XY & Sons
Balance Sheet
As on June 30, 200C

ASSETS		
Fixed Assets		
Building	XXX	
Less: Allowance for depreciation	(XXX)	XXX
Furniture & Fixtures	XXX	
Less: Allowance for depreciation	(XXX)	XXX
Motors vehicles	XXX	
Less: Allowance for depreciation	(XXX)	XXX
Total Fixed Assets		XXX
Current Assets		
Merchandise inventory	XXX	
Accounts Receivable	XXX	
Income Receivable	XXX	
Prepaid Expenses	XXX	
Bank	XXX	
Cash	XXX	
Total Current Assets		XXX
Total Assets		XXX
EQUITIES		
Capital		
Capital at start (opening balance)	XXX	
Add: Net Profit for the year	XXX	
	XXX	
Less: Drawings	(XXX)	
Capital at end		XXX
Long-Term Liabilities		XXX
Current Liabilities		
Accounts Payable	XXX	
Expenses Payable	XXX	
Tax Payable	XXX	
Bank Overdraft	XXX	
Total Current Liabilities		XXX
Total Capital & Liabilities		XXX

Students also present Balance Sheet in following format:

XY & Sons
Balance Sheet
As on June 30, 200C

ASSETS			EQUITIES		
Fixed Assets			**Capital**		
Building	XXX		Capital at start (opening balance)	XXX	
Less: Allowance for depreciation	(XXX)	XXX	Add: Net Profit for the year	XXX	
Furniture & Fixtures	XXX			XXX	
Less: Allowance for depreciation	(XXX)	XXX	Less: Drawings	(XXX)	
			Capital at end		XXX
Motors vehicles	XXX				
Less: Allowance for depreciation	(XXX)	XXX	**Long-Term Liabilities**		XXX
Total Fixed Assets		XXX			
Current Assets			**Current Liabilities**		
Merchandise inventory	XXX		Accounts Payable	XXX	
Accounts Receivable	XXX		Expenses Payable	XXX	
Income Receivable	XXX		Tax Payable	XXX	
Prepaid Expenses	XXX		Bank Overdraft	XXX	
Bank	XXX		Total Current Liabilities		XXX
Cash	XXX				
Total Current Assets		XXX			
Total Assets		**XXX**	**Total Equities**		**XXX**

The order of items in the Balance Sheet

A balance sheet lists assets, liabilities and capital in a particular order. This order is not compulsory, however, you should try to get into the habit of using the conventional order of items yourself.

The format most commonly used in the report form balance sheet (or vertical balance sheet format), which lists:

(a) Net assets above and capital below; or

(b) Fixed assets and net current assets above, with capital and long-term liabilities below; or

(c) Assets above and liabilities (including capital) below; or

(d) Capital and liabilities above, with assets below.

Note: there is no hard and fast rule about the order of items in a report form (or vertical) balance sheet.

Order of Items with in Categories

Students should note the following points:

(i) Fixed assets are listed in a descending order of 'length of useful life'. Building has a longer life than furniture & fixtures, which in turn perhaps have a longer life than motor vehicles. This is why the fixed assets are listed in the order shown above.

(ii) Current assets are listed in descending order of the length of time it might be before the assets will be converted into cash. Broadly speaking, inventory will convert into accounts receivable, and accounts receivable will convert into cash, and so inventory, accounts receivable and cash will be listed in that order. Prepayments, because they are similar to accounts receivable, should be listed after account receivable and before cash.

Distinction between Income Statement and Balance Sheet

	Income Statement	Balance Sheet
1.	It is prepared for an accounting period	It is normally prepared for the last day of accounting period
2.	It records only incomes and expenses	It records only assets, liabilities and capital
3.	It shows how the profits are earned or losses are incurred	It shows the financial position of the business
4.	The accounts that are transferred to the Income statement are closed	The accounts that are transferred to the balance sheet are not closed
5.	The balance (net profit or loss) of this statement is transferred to the capital account in the balance sheet	The balances of this statement become the opening balances of the next period

OPENING ENTRIES:

When the assets and liabilities are transferred from the previous year to the current year the same is to be passed through journal entries called **"Opening Entries"**. It is to be noticed in this respect that all assets will be debited and all liabilities will be credited and the difference between the assets and liabilities will represent capital at the beginning of the year.

Example: Show the opening entries from the following particulars:

	Rs.
Cash at bank	10,000
Cash in hand	5,000
Plant & Machinery	6,000
Merchandise inventory	7,000
Accounts receivable	10,000
Allowance for bad debts	1,000
Accounts payable	5,000
Bills receivable	3,000
Bills payable	1,000
Loan payable	1,000
General reserve (Cr.)	1,000

Solution:

General Journal Entries

Date	Particulars	P/R	Debit	Credit
	Cash at bank		10,000	
	Cash in hand		5,000	
	Plant & Machinery		6,000	
	Merchandise inventory		7,000	
	Accounts Receivable		10,000	
	Bills receivable		3,000	
	Allowance for bad debts			1,000
	Accounts payable			5,000
	Bills payable			1,000
	Loan			1,000
	General Reserve			1,000
	Capital (balancing figure)			32,000
	(To record the opening assets and liabilities)			

Note:

- Opening entries are passed only for assets, liabilities and capital on the first day of the current year.
- Closing balances of assets, liabilities and capital of the current year will become opening balances of the next year.

CLOSING ENTRIES:

In order to ascertain the profit or loss for the year all the revenue accounts relating to income or expenditure are transferred to profit and loss A/c from which the gross profit and the net profit are arrived at. The same is done by the help of journal entries called 'Closing Entries'. For this purpose, usually the following entries are made:

General Journal Entries

Date	Particulars	Debit	Credit
	Expense and revenue summary	XXX	
	Purchases		XXX
	Opening Inventory		XXX
	Salaries and Wages		XXX
	Sales return & allowance		XXX
	All other expenses		XXX
	(To close various expense accounts)		
	Sales	XXX	
	Closing inventory	XXX	
	Purchase return & allowance	XXX	
	All other income	XXX	
	Expense and revenue summary		XXX
	(To close various revenue accounts)		
	Expense and revenue summary	XXX	
	Capital A/c		XXX
	(To transfer of net profit to capital A/c)		

Example:

Give closing entries of the following balances as on December 31, 2004:

Opening inventory	20,000	Rent expense	7,000
Purchases	70,000	Insurance expense	1,000
Purchase return	5,000	Sales discount	3,000
Wages & salaries	31,000	Purchase discount	2,000
Carriage in	3,000	Commission income	5,000
Freight & duty	5,000	Repair & maintenance	1,000
Sales	150,000	Depreciation	4,000
Carriage out	3,000	Interest expense	3,000
Sales return	2,000	Closing inventory	60,000

Solution:

General Journal Entries

Date	Particulars	P.R.	Debit	Credit
2004 Dec.31	Expense and revenue summary		153,000	
	Opening inventory			20,000
	Purchases			70,000
	Wages & salaries			31,000
	Carriage in			3,000
	Freight & duty			5,000
	Carriage out			3,000
	Sales return			2,000
	Rent expense			7,000
	Insurance expense			1,000
	Sales discount			3,000
	Repair & maintenance			1,000
	Depreciation			4,000
	Interest expense			3,000
	(To close various expense accounts)			
Dec.31	Sales		150,000	
	Purchase return		5,000	
	Purchase discount		2,000	
	Commission income		5,000	
	Closing inventory		60,000	
	Expense and revenue summary			222,000
	(To close various revenue accounts)			
Dec.31	Expense and revenue summary(222,000 – 153,000)		69,000	
	Capital A/c			69,000
	(To transfer of net profit to capital A/c)			

Study Block -1: Concept Development

Question - 1 *Income Statement and Classified Balance Sheet*

The trial balance of the Khalid Traders for the year ended December 31,2004 is as under:

	Debit	Credit
Cash	10,000	
Accounts receivable	24,000	
Merchandise inventory (1-1-2004)	20,000	
Pre-paid insurance	3,000	
Office equipment	100,000	
Allowance for depreciation (office equipment)		24,000
Accounts payable		16,000
Capital (1-1-2004)		104,600
Drawing	12,000	
Sales		160,000
Sales discount	8,000	
Purchases	80,000	
Purchases return & allowance		10,000
Transportation in	11,600	
Advertising expense	14,600	
Salaries expense	24,000	
Insurance expense	5,000	
Depreciation expense (office equipment)	4,000	
Salaries payable		4,000
Pre-paid advertising	2,400	
Bad debts expense	2,400	
Allowance for Bad debts		2,400
	321,000	321,000

Merchandise inventory on December 31, 2004 was Rs.30,000

Required:
(a) Prepare Income Statement for the year ended December 31, 2004
(b) Prepare classified balance Sheet as on December 31, 2004.

Solution:

Khalid Traders
Income Statement
For the year ended December 31, 2004

	Sales		160,000	
	Less: Sales discount		(8,000)	
	Net Sales			152,000
Less:	**Cost of Goods Sold**			
	Opening Inventory		20,000	
	Add: Purchases	80,000		
	Add: Transportation on purchase	11,600		
	Total Purchases	91,600		
	Less: Purchase returns	(10,000)		
	Net purchase		81,600	
	Goods available for sale		101,600	
	Less: Closing Inventory		(30,000)	
	Cost of goods sold			(71,600)
	Gross profit			80,400
Less:	**Operating Expenses**			
	Advertising expense		14,600	
	Salaries expense		24,000	
	Insurance expense		5,000	
	Depreciation expense		4,000	
	Bad debts expense		2,400	
	Total operating expenses			(50,000)
	Net Income			**30,400**

Khalid Traders
Balance Sheet
As on December 31, 2004

ASSETS

Fixed Assets			
Office equipment		100,000	
Less: Allowance for depreciation		(24,000)	76,000
Current Assets			
Merchandise inventory		30,000	
Accounts Receivable	24,000		
Less: Allowance for bad debts	(2,400)	21,600	
Income Receivable		3,000	
Prepaid Expenses		2,400	
Cash		10,000	
Total Current Assets			67,000
Total Assets			143,000

EQUITIES

Capital		
Capital as on 1-1-2004	104,600	
Add: Net Profit for the year	30,400	
	135,000	
Less: Drawings	(12,000)	
Capital as on 31-12-2004		123,000
Current Liabilities		
Accounts Payable	16,000	
Expenses Payable	4,000	
Total Current Liabilities		20,000
Total Capital & Liabilities		143,000

Note:
- **Net income** determined in the income statement is transferred to the capital account in the balance sheet.
- Closing balance of merchandise inventory is deducted from the goods available for sale in the income statement, and is shown as current asserts in the balance sheet.

Question - 2 ***Income Statement and Classified Balance Sheet***

The trial balance of the Raheel Traders for the year ended December 31,2005 is as under:

	Debit	Credit
Cash	18,000	
Accounts receivable	43,200	
Merchandise inventory (1-1-200C)	36,000	
Pre-paid insurance	5,400	
Office equipment	180,000	
Allowance for depreciation (office equipment)		43,200
Accounts payable		28,800
Capital (1-1-200C)		188,280
Drawing	21,600	
Sales		288,000
Sales discount	14,400	
Purchases	144,000	
Purchases return & allowance		18,000
Transportation in	20,880	
Advertising expense	26,280	
Salaries expense	43,200	
Insurance expense	9,000	
Depreciation expense (office equipment)	7,200	
Salaries payable		7,200
Pre-paid advertising	4,320	
Bad debts expense	4,320	
Allowance for Bad debts		4,320
	577,800	577,800

Merchandise inventory on December 31, 2004 was Rs.54,000

Required:
(a) Prepare Income Statement for the year ended December 31, 200C
(b) Prepare classified balance Sheet as on December 31, 200C.

Solution: Try yourself as same as Q – 1 above

Question - 3 ***Income Statement and Classified Balance Sheet***

The following is the Trial Balance of Mr. Yassen as on June 30, 2005:

	Debit		Credit
Cash	70,000	All. for depreciation on furniture	21,000
Notes receivable	60,000	Note payable	140,000
Accounts receivable	110,000	Capital (July 1,2004)	270,000
Merc. inventory (July 1, 2004)	120,000	Sales	1,020,000
Supplies	21,000	Interest income	2,200
Furniture	80,000	Accounts payable	116,000
Drawing	20,000	Wages payable	6,600
Purchases	850,000	Unearned interest income	1,500
Wages expenses	161,600		
Rent expenses	50,000		
Interest expense	4,000		
Supplies expense	10,000		
Depreciation expense	5,000		
Prepaid wages	15,000		
Interest income receivable	700		
	1,577,300		1,577,300

Merchandise inventory on June 30,2005 was Rs.85,000

Required:
(a) Prepare Income Statement for the year ended June 30, 2005
(b) Prepare classified balance Sheet as on June 30, 2005.

Solution:

Mr. Yaseen
Income Statement
For the year ended June 30, 2005

	Sales		1,020,000
Less:	<u>**Cost of Goods Sold**</u>		
	Opening Inventory	120,000	
	Add: Purchase	850,000	
	Goods available for sale	970,000	
	Less: Closing Inventory	(85,000)	
	Cost of goods sold		(885,000)
	Gross profit		135,000
Less:	<u>**Operating Expenses**</u>		
	Wages expenses	161,600	
	Rent expenses	50,000	
	Interest expense	4,000	
	Supplies expense	10,000	
	Depreciation expense	5,000	
	Total operating expenses		(230,600)
	Operating Loss		(95,600)
Add:	<u>**Other Incomes**</u>		
	Interest income		2,200
	Net Loss		**(93,400)**

Mr. Yaseen
Balance Sheet
As on June 30, 2005

ASSETS			EQUITIES		
Fixed Assets			**Capital**		
Furniture	80,000		Capital as on 1-7-2004	270,000	
Less: Allowance for dep.	(21,000)	59,000	**Less:** Net Loss for the year	(93,400)	
				176,600	
Current Assets			**Less:** Drawings	(20,000)	
Merchandise inventory	85,000		Capital as on 30-6-2005		156,600
Supplies	21,000				
Notes receivable	60,000		**Current Liabilities**		
Accounts receivable	110,000		Note payable	140,000	
Interest income receivable	700		Accounts payable	116,000	
Prepaid wages	15,000		Wages payable	6,600	
Cash	70,000		Unearned interest income	1,500	
Total Current Assets		361,700	Total Current Liabilities		264,100
Total Assets		**420,700**	**Total Capital & Liabilities**		**420,700**

Note:
- **Net loss** determined in the income statement is transferred to the capital account in the balance sheet.
- **Closing balance of merchandise inventory is deducted from the goods available for sale in the income statement, and is shown as current asserts in the balance sheet.**

Question - 4 ***Income Statement and Classified Balance Sheet***

The following is the Trial Balance of Mr. Ameen as on June 30, 2001:

	Debit	Credit
Cash	126,000	
Notes receivable	108,000	
Accounts receivable	198,000	
Merchandise inventory (July 1, 200A)	216,000	
Supplies	37,800	
Furniture	144,000	
Allowance for depreciation on furniture		37,800
Note payable		252,000
Capital (July 1, 200A)		486,000
Drawing	36,000	
Sales		1,836,000
Purchases	1,530,000	
Wages expenses	290,880	
Rent expenses	90,000	
Interest income		3,960
Accounts payable		208,800
Interest expense	7,200	
Supplies expense	18,000	
Depreciation expense	9,000	
Wages payable		11,880
Prepaid wages	27,000	
Interest income receivable	1,260	
Unearned interest income		2,700
	2,839,140	**2,839,140**

Merchandise inventory on June 30,200B was Rs.153,000

Required:

a) Prepare Income Statement for the year ended June 30, 200B
b) Prepare classified balance Sheet as on June 30, 200B.

Solution: Try yourself as same as Q – 3 above.