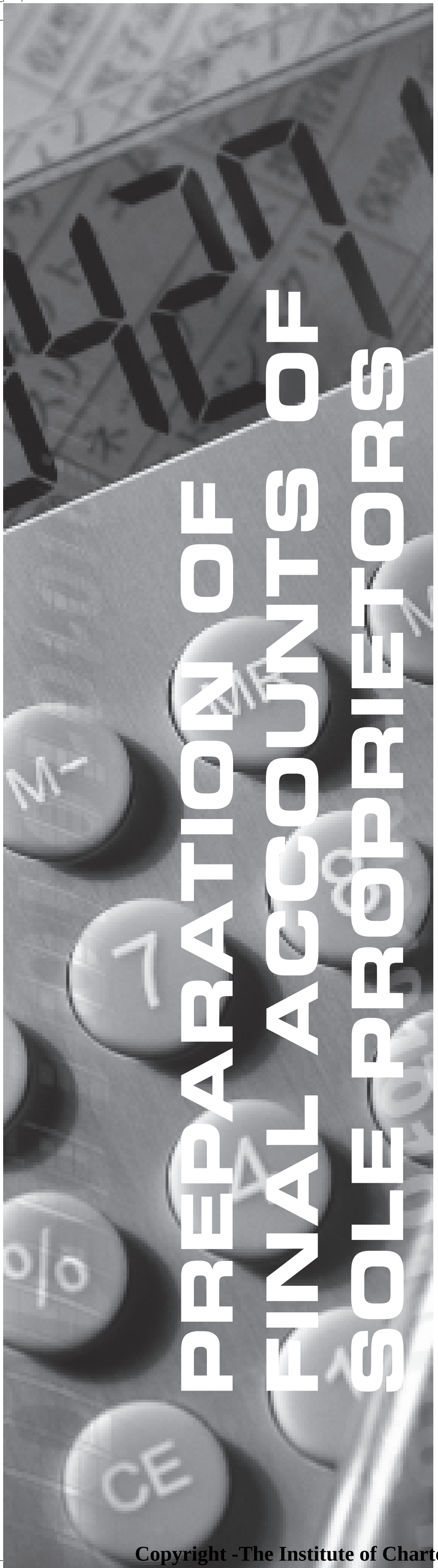


PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORS

CHAPTER - 6

The primary function of accounting is to accumulate accounting data in a manner that the amount of profit made or loss suffered during a period can be determined along with the status of the business in financial terms. Statements prepared for this purpose are called final accounts. Final accounts are also termed as financial statements.

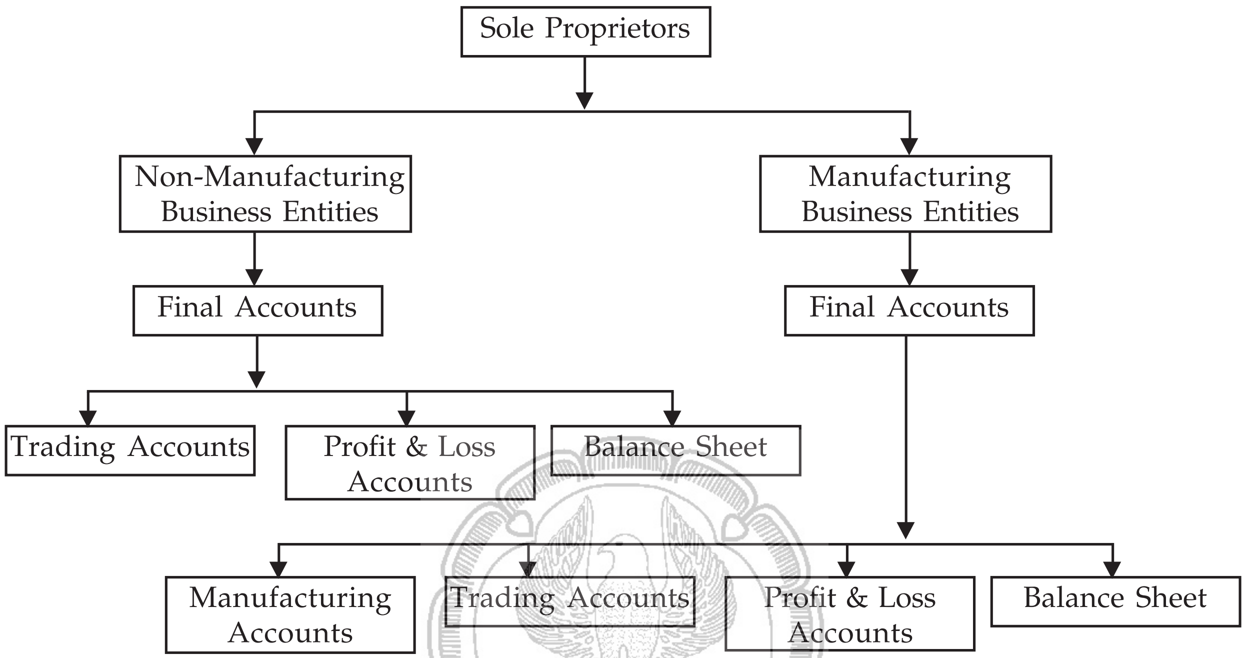
Preparation of final accounts is the last phase of the accounting process. The process of accounting starting from recording of source documents in books of accounts to preparation of trial balance has already been discussed in units 1 to 5 of chapter 2. This chapter deals with preparation of final accounts of sole proprietors headed by one person only. For the purpose of final accounts, the sole proprietors can be classified into non-manufacturing and manufacturing business entities. Final accounts of non-manufacturing entities include Trading account, Profit and Loss Account and Balance Sheet while final accounts of manufacturing entities include Manufacturing account, Trading account, Profit and Loss account and Balance Sheet.

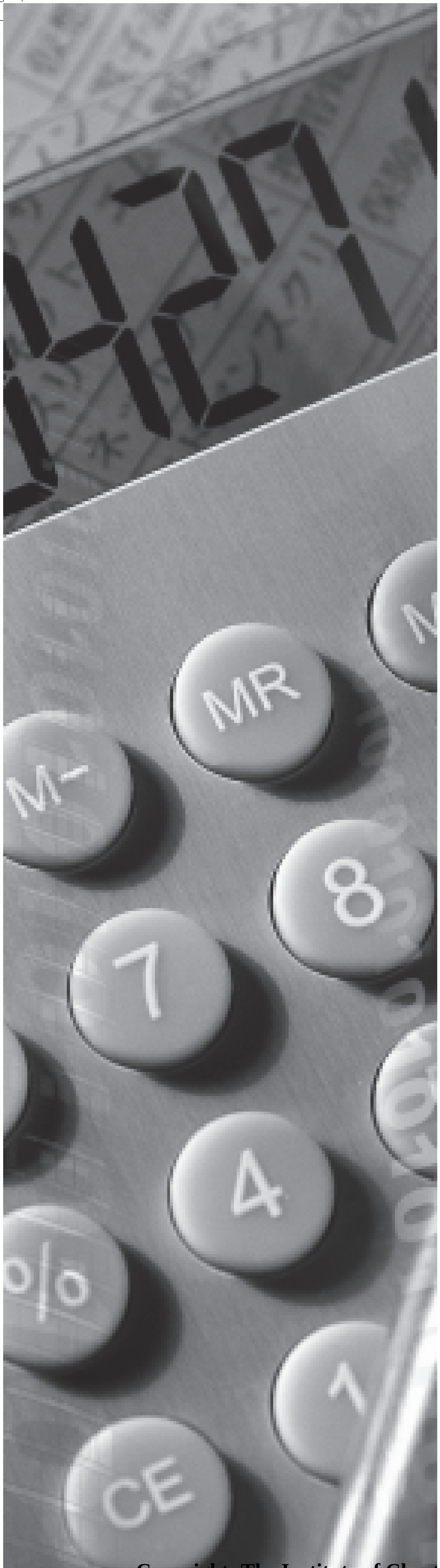
This chapter has been divided into two units :

(i) Final accounts of Non-manufacturing entities and

(ii) Final accounts of Manufacturing entities for the purpose of convenience in understanding of students.

An overview of the final accounts of sole proprietors can be explained with the help of the following chart :





CHAPTER - 6

PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORS

Unit 1

Final Accounts of Non-Manufacturing Entities

Learning Objectives

After studying this unit you will be able to :

- Make out the various accounts, which are the parts of Final Accounts.
- Learn the relationship between Profit and Loss Account and Balance Sheet.
- Understand the Trading Account items. This will help you to learn which of the transactions and events should be shown in the Trading Account.
- Understand the items shown in the Profit and Loss Account. By that you will learn the technique of preparing Profit and Loss Account and deriving the Profit and Loss balance.
- Learn how to adjust outstanding and pre-paid expenses, accrued income and income received in advance.
- Understand the items to be shown in the balance sheet. Also learn the classifications of assets and liabilities and the order by which they are put in the Balance Sheet.

1. INTRODUCTION

Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods at profit without changing the form of the goods. In other words, non-manufacturing entities do not process the goods purchased and sell them in its original form. Meanwhile it indulges in some liabilities, makes some assets and also incurs some expenses like salaries, stationary expenses, advertisement, rent etc to run the business. At the end of the accounting year, the entity must be interested in knowing the results of the business. To ascertain the final outcome of the business i.e., the income and financial position, they prepare financial statements at the end of the year.

Financial Statements are the systematically organized summary of all the ledger account heads presented in such a manner that it gives detailed information about the financial position and the performance of the enterprise. Performance of the enterprise is judged on the basis of the income earned/accrued during the year in the form of profit after the adjustments of expenses related to the enterprise and to the income earned or accrued. In Financial Accounting, profit is measured at two levels :

(a) Gross Profit

(b) Net Profit

The profit of the enterprise is obtained through the preparation of **Income Statement.**

The financial position of the business enterprise is judged by measuring the assets, liabilities and capital of the enterprise and the same is communicated to the users of financial statements. Financial position of the enterprise can be known through the preparation of the **Position Statement.**

From the above explanation, one can conclude that final accounts is the next step after the preparation of trial balance which is mainly divided into following two parts :

A. Income Statement

B. Position Statement

A. Income Statement

The manner in which amount of profit or loss is arrived at is disclosed in the Income Statement, prepared at the close of the year. The Income Statement discloses net profit of the business after adjusting from the income earned during the year, all the expenditures of the business incurred in that year. The various items of income and expenditure, which arouse during the accounting period, are detailed out therein, and grouped under significant heads. The primary objective of the Income Statement is to present the details of various items of income or expenditure which have contributed to the making of the profit or loss.

Income Statement is sub-divided into following two parts for a non-manufacturing concern:

(i) Trading account; and

(ii) Profit and Loss account

Procedure for the preparation of these accounts has been explained separately in this chapter.

B. Position Statement

Position statement mainly comprises of Balance Sheet, which exhibits assets and liabilities of the business as at the close of the period. For proper knowledge of the financial position of the business, sometimes additional statements are also prepared like cash flow statement, statement showing earnings per share, value added statement etc. which is not mandatory for non-corporate entities. These additional statements are prepared for the better understanding of the financial position of the business. You will learn the preparation of these additional statements in Integrated Professional Competence Course and Final.

Here, we will restrict our discussion to Trading account, Profit and Loss account and Balance Sheet only.

2. PREPARATION OF FINAL ACCOUNTS

The principal function of final statements of account (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the profitability and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained. The basic principles in regard to accumulation of accounting period data are:

(i) a distinction should be made between capital and revenue receipts and payments;

(ii) also income and expenses relating to a period of account should be separated from those of another period. What is more important is, different items of income and expenditure should be accumulated under significant heads so as to disclose the sources from which capital has been procured and the nature of liabilities, which are outstanding for payment.

Having regard to these basic principles, the various matters to which attention should be paid for determining the different aspects of transactions, a record of which should be kept, and the different heads of account under which various items of income and expenditure should be accumulated, are stated below:

(a) Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditure should be separated from business income and expenditure.

(b) A distinction should be made between capital and revenue, both receipts and expenditure. Different types of income and expenditure should be classified under separate heads. Assets should be included in the Balance Sheet at a valuation arrived at on the basis at which these are valued in the preceding year. Likewise, a provision for income and expenses which have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.

(c) Every information, considered material for judging the profitability of the business or its financial position, should be disclosed. For example, when the labour charges have increased on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, if some of the items of stock are not readily saleable, these should be valued at their approximate sale price and the basis of valuation and value of such stocks should be shown separately.

(d) Though the record of transactions should be maintained continuously, at the end of each accounting period, the transactions of the closing accounting period should be cut off from those of the succeeding period.

(e) It should be seen that only the effect of transactions, which were concluded before the close of period of account, has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

2.1 INTER-RELATIONSHIP OF THE TWO STATEMENTS

One of the points to be remembered is that of total expenditure incurred. Some appears in the Profit and Loss Account and some in the Balance Sheet. Consider few examples, of the total amount spent on manufacturing goods. That part which is attributable to finished goods in stock is shown in the Balance Sheet as closing stock and the amount debited to the Income Statement is thereby ultimately reduced. When a machine is purchased, that part of it which is attributable to the year considered as depreciation is debited to the Profit and Loss Account and the balance is shown in the Balance Sheet as an asset. Next year again, part of the cost of asset will be debited to the Profit and Loss Account and the remaining cost will be shown as an asset in the Balance Sheet. These illustrations show that the two statements, the Profit and Loss Account and the Balance Sheet, are thoroughly inter-related. The assets shown in the Balance Sheet are mostly only the remainder of the expenditure incurred after a suitable amount has been charged to the Profit and Loss Account or the Trading Account. For preparing the two statements properly, it is of the greatest importance that the amounts to be charged to the Profit and Loss Account should be properly determined as otherwise both statements will show an incorrect position. The principle that governs this is called the Matching Principle.

2.2 MATCHING PRINCIPLE

This principle demands that expenses incurred to earn the revenue should be properly matched. This means the following :

(a) If a certain revenue and income is entered in the Trading / Profit and Loss Account all the expenses relating to it, whether or not payment has been actually made, should be debited to the Trading / Profit and Loss Account. This is why at the end of the year an entry is passed to bring into account the outstanding expenses. That is also the reason why the opening stock of goods is debited to the Trading Account since the relevant sale is credited in the same account.

(b) If some expense has been incurred but against it sale will take place in the next year or income will be received next year, the expense should not be debited to the current year's Profit and Loss Account but should be carried forward as an asset and shown in the Balance Sheet. It will be debited to the Profit and Loss Account only when the relevant income will also be credited. It is because of this principle that :

   (i) at the end of the year inventory of all the stocks in hand is prepared and is valued at cost. The credit to the Trading Account has the effect of reducing the debit in the Trading Account to the extent goods remain unsold or unutilised, these will be sold or used up next year and the cost will therefore, be properly debited to the next year's Trading Account. If the selling or the replacement value is lower than the cost, stock will be valued at the realisable value and not at cost. This has the effect of raising the net debit in the Trading Account higher than the cost of goods sold or utilised in the year, but that is proper. The fall of the selling price below cost means that the loss has occurred in the year and therefore, the debit properly is to current year's Trading and Profit and Loss Account;

   (ii) at the end of the year prepaid expenses are brought into the books by debiting prepaid expenses account and crediting the expenses concerned. The effect of this is also to transfer the debit in respect of prepaid expenses to the year in which the benefit from such expenses will accrue; and

   (iii) at the end of the year, appropriate depreciation of fixed assets is charged to the profit and loss account (and credited to the assets concerned). In this manner, that part of the cost of the assets which has been used up for earning current year's revenue is debited to the Profit and Loss Account.

(c) If an income or revenue is received in the current year but the work against it has to be done and the cost in respect of it has to be incurred next year, the income or the revenue is considered to be of next year. It should be shown in the Balance Sheet on the liabilities side as "income received in advance" and should be credited to the Profit and Loss Account of the next year. Firms, except those, which follow the cash system (and such firms are usually of specialised personal service nature), do not credit to the Profit and Loss Account that income or revenue against which service is to be rendered in future. Newspapers or magazines usually receive subscriptions in advance for a year. The part of subscription that covers copies to be supplied in the next year is treated as income received in advance.

2.3 AN EXCEPTION

There appears to be one exception to the rule that only such costs as have yielded or is expected to yield revenue should only be debited to Profit and Loss Account. For example, if a fire has occurred and has damaged the firm's property the loss must be debited to the Profit and Loss Account to the extent it is not covered by insurance. A loss, resulting from the fall of selling price below the cost or from some debts turning bad, must similarly be debited to the Profit and Loss Account. If this is not done the profit will be over-stated.

3. TRADING ACCOUNT

At the end of the year, as has been seen above, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases. Suppose, in the first year, the net purchases (that is after deducting returns) total Rs. 1,00,000 and that Rs. 15,000 worth of goods (at cost) were not sold at the end of the year. The cost of the goods sold will then be Rs. 85,000. If in the next year purchases are Rs. 1,50,000 and the cost of goods on hand at the end of the year is Rs. 20,000 the cost of goods sold will be Rs. 1,45,000, calculated as follows:

	Rs.
Cost of unsold goods at the beginning of the year	15,000
Purchases during the year	1,50,000
	1,65,000
Less: Cost of unsold goods at the end of the year	20,000
Cost of goods sold	1,45,000

If net sales, i.e., after adjustment for sales returns, total Rs. 2,00,000 the gross profit will be Rs. 55,000, i.e., Rs. 2,00,000 – 1,45,000. This profit is called gross profit since from it expenses have still to be deducted for knowing the net profit.

Gross profit is usually ascertained by preparing a Trading account. For the figures given above, the Trading Account will appear as shown below :

Trading Account for the year ending

Dr.	Rs.		Cr. Rs.
To Opening Stock	15,000	By Sales Account	2,00,000
To Purchase Account	1,50,000	By Closing Stock	20,000
To Gross Profit carried to P & L A/c	55,000		
	2,20,000		2,20,000

The opening stock and purchases are written on the debit side. Sales and the closing stocks are entered on the credit side. If there are any direct expenses then they should also be written on the debit side of the Trading account. If the balance of credit side is more, the difference is written on the debit side as gross profit. This amount will also be carried forward to the Profit and Loss Account on the credit side. In case of gross loss, i.e., when the debit side of the Trading Account exceeds the credit side, the amount will be written on the credit side of the Trading Account and transferred to the debit side of the Profit and Loss Account.

3.1 TRADING ACCOUNT ITEMS

(a) In a trading firm like a wholesaler, the main business consists of buying and selling the same goods. In addition to the amount of the opening stock, the trading account will also be debited with all expenses incurred in bringing the goods to the godown of the firm and in making them ready for sale. For example, freight paid on purchases, cartage, octroi, etc. will all be debited to the Trading Account. The rule is that this account will be debited with all expenses incurred in bringing the goods to their present location and condition.

We shall now consider individual items :

(1) **Opening Stock :** Since this was closing stock of the last year, it must have been entered in the opening stock account, through the opening entry. Therefore, it will be found in the trial balance. This item is usually put as the first item on the debit side of the Trading Account. Of course, in the first year of a business there will be no opening stock.

(2) **Purchases and Purchase Returns :** The purchases account will have debit balance, showing the gross amount of purchases made of the materials. The purchase returns account will have credit balance showing the return of materials to the suppliers. On the debit side of the trading account the net amount is shown as indicated (with assumed figures) :

	Rs.
To Purchases	3,00,000
Less : Purchase Returns	10,000
	2,90,000

It happens sometimes that goods are received but the relevant invoice is not received from the supplier. On the date of the closing of the account, an entry must be passed to debit the purchases account and credit the supplier with the cost of goods. One may also exclude such goods from the closing stock and not pass any entry, but this course is not recommended.

(3) **Carriage or Freight Inwards :** This item should also be debited to the Trading Account, as it is incurred to bring the materials to the firm's godown and make them available for use. However, if any freight or cartage is paid on any asset, like machinery, it should be added to the cost of the asset and not debited to the Trading Account.

(4) **Wages :** Wages paid to workers in the godown/stores, should be debited to the Trading Account. If any amount is outstanding, it must be brought into books so that full

wages for the period concerned are charged to the Trading Account. However, if wages are paid for installation of an asset, it should be added to the cost of the asset.

(5) **Sales and Sales Returns :** The sales account will have a credit balance indicating the total sales made during the year. The sales return account will have a debit balance, showing the total amount of goods returned by customers. The net of the two amounts is entered on the credit side of the Trading Account.

Sometimes, goods which have been sold and for which invoice has been prepared may not have been dispatched. If the sale is complete, that is if the customer is liable to pay the amount, such goods should be kept aside and not included in the closing stock. If however, the sale is not yet complete say, when sent to customers on approval basis, that is when the customer has the right to return the goods within the stipulated period, the cost of the goods should be included in the closing stock and, if any entry was passed to record the "sale", it should be reversed.

(6) **Closing Stock and its valuation :** Usually there is no account to show the value of goods lying in the godown at the end of the year. However, to correctly ascertain the gross profit, the closing stock must be properly taken and valued.

The entry is

Closing Stock Account Dr.
To Trading Account

Alternatively, Closing stock can be adjusted with purchases :

Closing Stock Account Dr.
To Purchases Account

The effect of this entry is to reduce the debit in the Purchases Account. It will then appear in the trial balance. The Closing Stock Account is then not entered in the Trading Account and will be shown only in the Balance sheet.

To ascertain value of the closing stock, it is necessary to make a complete inventory or list of all the items in the godown together with quantities. Of course, damaged or obsolete items are separately listed. To the list of finished goods, one should also add the goods lying with agents sent to them on consignment basis and also the goods sent on approval to customers.

The valuation principle is cost or net realisable value whichever is lower.

Taking stock is quite a lengthy process. Strictly, immediately at the end of the year the taking of stock should be completed. Sometimes, however this is done either a few weeks before or a few weeks after the closing. In such a case the value of the stock thus taken must be adjusted to relate it to the closing date. The adjustment will be necessary because, in the meantime, purchases and sales must have been made. The main point to remember is that in respect of sales their cost has been established. Cost will be sales less gross profit.

(7) **Sales Tax :** Sales Tax is an indirect tax in the sense that it is collected by the seller from the customers and deposited in Government's Account as per requirements of

the Sales Tax Act. Sales tax is generally deducted from gross sales figures and sales tax liability (net of payments) is shown as current liability in the balance sheet.

The Trading Account is very useful; with its help the firm can see the relationship between the costs incurred and the revenues earned and also the level of efficiency with which operations have been conducted. The ratio of gross profit to sales is very significant. It is arrived as

$$\frac{\text{Gross Profit}}{\text{Sale}} \times 100$$

In the illustration given under para 3 of the unit, the rate of gross profit is 27.5%.

3.2 CLOSING ENTRIES IN RESPECT OF TRADING ACCOUNT

The following entries will be required :

(i) **For opening stock :** Debit Trading Account and Credit Stock Account.

(ii) **For purchases returns :** Debit Returns Outward Account and Credit Purchases Account.

For returns inward : Debit Sales Account and Credit Returns Inwards Account. (In the trading account information is usually given both in respect of gross sales; and purchases and the respective returns).

(iii) **For purchases account :** Debit Trading Account and Credit Purchases Account, the amount being the net amount after return.

(iv) **For expenses** to be debited to the Trading Account, for example wages etc; Debit Trading Account and credit the concerned expenses accounts individually.

(v) **For sales :** Debit Sales Account with the net amount after returns, and Credit Trading Account.

The student will see that all the accounts mentioned above will be closed with the exception of the Trading Account.

(vi) **For closing stock :** Debit Stock Account and Credit Trading Account. The Stock Account will be carried forward to the next year.

Except entries mentioned in (ii) above, the other entries are usually summarised as follows :

(1)	Trading Account	Dr.
	To Opening Stock Account	
	To Purchases Account	
	To Wages Account	
	To Freight on Purchases Account, etc.	
(2)	Sales Account	Dr.
	Closing Stock Account	Dr.
	To Trading Account	

At this stage Trading Account will reveal the gross profit, if the credit side is more, or gross loss if the credit side is less. The gross profit will be transferred to the Profit and Loss Account by the entry:

Trading Account Dr.

To Profit and Loss Account

The entry for gross loss, if there be any is :

Profit and Loss Account Dr.

To Trading Account

Illustration 1

From the following information, prepare a Trading Account of M/s. ABC Traders for the year ended 31st March, 2009 :

	Rs.
Opening Stock	1,00,000
Purchases	6,72,000
Carriage Inwards	30,000
Wages	50,000
Sales	11,00,000
Returns inward	1,00,000
Returns outward	72,000
Closing stock	2,00,000

Solution

In the books of M/s. ABC Traders

Trading Account for the year ended 31st March, 2009

Dr. Particulars	Rs.	Amount Rs.	Particulars	Rs.	Cr. Amount Rs.
To Opening stock		1,00,000	By Sales	11,00,000	
To Purchases	6,72,000		*Less* : Returns Inward	1,00,000	10,00,000
Less : Returns outward	72,000	6,00,000	By Closing stock		2,00,000
To Carriage Inwards		30,000			
To Wages		50,000			
To Gross profit		4,20,000			
		12,00,000			12,00,000

Illustration 2

From the information given in illustration 1, pass necessary closing entries in the journal proper of M/s. ABC Traders.

Solution

In the Books of M/s. ABC Traders
Journal Proper

Date 2009	Particulars		Dr. Amount Rs.	Cr. Amount Rs.
Mar. 31	Returns outward A/c	Dr.	72,000	
	To Purchases A/c			72,000
	(Being the transfer of returns to purchases account)			
	Sales A/c	Dr.	1,00,000	
	To Returns Inward A/c			1,00,000
	(Being the transfer of returns to sales account)			
	Sales A/c	Dr.	10,00,000	
	To Trading A/c			10,00,000
	(Being the transfer of balance of sales account to trading account)			
	Trading A/c	Dr.	7,80,000	
	To Opening Stock A/c			1,00,000
	To Purchases A/c			6,00,000
	To Wages A/c			50,000
	To Carriage Inwards A/c			30,000
	(Being the transfer of balances of opening stock, purchases and wages accounts)			
	Closing stock A/c	Dr.	2,00,000	
	To Trading A/c			2,00,000
	(Being the incorporation of value of closing stock)			
	Trading A/c	Dr.	4,20,000	
	To Gross Profit			4,20,000
	(Being the amount of gross profit)			
	Gross profit	Dr.	4,20,000	
	To Profit and Loss A/c			4,20,000
	(Being the transfer of gross profit to Profit and Loss Account)			

4. PROFIT AND LOSS ACCOUNT

The Profit and Loss Account starts with gross profit on the credit side. If there is gross loss, it will be written on the debit side. After that all those expenses and losses, which have not been entered in the Trading Account, will be written on the debit side of Profit and Loss Account. Incomes and gains, other than sales, will be written on the credit side.

If we understand word 'expenses' properly, there should be no difficulty in distinguishing between items that will be debited to the Profit and Loss Account and those that will be shown as Assets in the balance sheet. Further, it may be noted that the expenses which are personal in nature will not be charged to Profit and Loss A/c. Only those revenue expenses and losses which are related to the current year, are debited to Profit and Loss Account.

It is desirable, according to modern thinking that the Profit and Loss Account should be prepared in such a manner as will enable the reader to form a correct idea about the profit earned or loss suffered by the firm during the period together with the significant factors. Too many details will prevent a person from knowing properly the factors leading to the profit earned. Therefore, items should be according to the various functions, such as administrations, selling and financing:

(1) Administrative expenses include the following :

(i) Salaries paid to the people working in the general office;

(ii) Rent and rates for the office premises.

(iii) Lighting in the office.

(iv) Printing and stationery.

(v) Postage, telegrams and telephone charges.

(vi) Legal expenses.

(vii) Audit fees, etc.

(2) The selling and distribution expenses will comprise the following :

(i) Salesmen's salaries and commission.

(ii) Commission to agents.

(iii) Advertising.

(iv) Warehousing expenses.

(v) Packing expenses.

(vi) Freight and carriage on sales.

(vii) Export duties.

(viii) Sales tax to the extent it cannot be recovered from the customers.

(ix) Maintenance of vehicles for distribution of goods and their running expenses.

(x) Insurance of finished goods in stock and goods in transit.

(xi) Bad debts.

It will be good idea to either show these expenses in a separate schedule or to indicate the total of these prominently in the Profit and Loss Account. This rule should be followed wherever the number of items is rather large.

Financing expenses normally include interest paid on loan, discount on bills discounted and the discount allowed to customers. It is possible to show only the net amount of interest if it has been both received and paid. It is however; better to show the two figures separately.

On the income side of the Profit and Loss Account, besides the gross profit, there may be interest received, discount received, rent from subletting of premises, miscellaneous incomes such as from sale of junk material etc., It would be desirable to show the totals only under each of the main categories of income. However, interest on fixed deposits, interests or income from investments and other interest should be shown separately. Similarly, items which have to be debited/credited to the proprietor should be segregated from other items. Examples would be interest charged on drawings, interest allowed on capital and charges for services rendered by the firm to the proprietor personally.

We shall now consider a few items individually :

(i) **Drawings :** Drawings are not expenses for the firm and therefore should not be debited to the Profit and Loss Account. If the proprietor has enjoyed some benefit personally, like use of the firm's car, a suitable amount should be treated as drawing and to that extent the charge to the Profit and Loss Account will be reduced, Drawings are debited to the proprietor's capital account.

(ii) **Income Tax :** In case of companies, the income tax payable is treated like other expenses. But in the case of sole proprietorship, income tax is treated as a personal expense. It is debited to the Capital Account and not to the Profit and Loss Account. This is because the amount of the tax will depend on the total income of the partners or proprietor besides the profit of the firm. In case of partnership business, firm's tax liability is to be debited to profit and loss account of the firm but partners' tax liability are not to be borne by the firm. Therefore if the firm pays income tax on behalf of partners, such payment of personal income tax should be treated as drawings.

(iii) **Discount received and allowed :** We have already seen that discount is of two types. Trade discount and Cash discount. Trade discount is allowed when the order for goods is not below a certain figure. It is deducted from the invoice. Only the net amount of invoice is entered in books. There is no further treatment of the trade discount. Cash discount is allowed to a customer if he makes the payment before a certain date. It is allowance made to him for prompt payment. Discount received is really in the nature of interest received and similarly, discount allowed really means interest paid. Discount received is a gain and is credited to the Profit and Loss Account while discount allowed is debited.

There is another term - Rebate. It is the allowance given to a customer when his purchases during a period, say one year, total upto a certain figure. Suppose a firm allows a rebate of 4% to those customers whose purchases during the year are at least Rs. 5,000. One Customer's purchases are Rs. 4,500, he will not get any rebate. Another customer's purchases total Rs. 5,100, he will get a rebate of Rs. 204. The entry for rebate is made only at the end of the year. The Rebate Account is debited and is later written in the profit and Loss Account on the debit side. Various customers who have earned the rebate are credited.

(iv) **Bad Debts:** When a customer does not pay the amount due from him and all hopes of recovering the amount are lost, it is said to be a bad debt. It is a loss to the firm. Therefore, the bad debts account is debited, which is later on written in the Profit and Loss Account on the debit side. Since it is no use showing the amount due still as an asset, the account of the customer concerned is closed by being credited. The entry

Bad Debts Account Dr.

To Debtor's (by name) Account

If later on, the amount is recovered, it should be treated as a gain. It should not be credited to the party paying it. It should be credited to Bad Debts Recovered Account. It will be entered in the Profit and Loss Account on the credit side.

4.1 CLOSING ENTRIES

The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries. We have already seen the entries required for preparing the Trading Account and for transferring the gross profit to the profit and Loss Account. Now to complete the Profit and Loss Account, the under mentioned three entries will be necessary.

(a) For items to be debited to the Profit and Loss Account this account will be debited and the various accounts concerned will be credited. For example,

Profit and Loss Account Dr.

To Salaries Account

To Rent Account

To Interest Account

To Other Expenses Account

(b) Items of income or gain such as interest received or miscellaneous income will be debited and credited to Profit and Loss Account.

Discount Received Account Dr.

Bad debts Recovered Account Dr.

To Profit and Loss Account

(c) At this stage, the Profit and Loss Account will show net profit or net loss. Both have to be transferred to the Capital Account. In case of net profit, i.e., when the credit side is bigger than the debit side, the entry is :

Profit and Loss Account Dr.

To Capital Account

In the case of net loss, the entry will be

Capital Account Dr.

To Profit and Loss Account

Illustration 3

Revenue, Expenses and Gross Profit Balances of M/s ABC Traders for the year ended on 31st March 2006 were as follows:

Gross Profit Rs. 4,20,000, Salaries Rs. 1,10,000, Discount (Cr.), Rs. 18,000, Discount (Dr.) Rs. 19,000, Bad Debts Rs. 17,000, Depreciation Rs. 65,000, Legal Charges Rs. 25,000, Consultancy Fees Rs. 32,000, Audit Fees Rs. 1,000, Electricity Charges Rs. 17,000, Telephone, Postage and Telegrams Rs. 12,000, Stationery Rs. 27,000, Interest paid on Loans Rs. 70,000.

Prepare Profit and Loss Account of M/s ABC Traders for the year ended on 31st March, 2006.

Solution

In the Books of M/s. ABC Traders
Profit and Loss Account
For the year ended 31st March, 2006

Dr.	Particulars	Amount Rs.	Particulars	Cr. Amount Rs.
To	Salaries	1,10,000	By Gross Profit	4,20,000
"	Legal Charges	25,000	By Discount received	18,000
"	Consultancy Fees	32,000		
"	Audit Fees	1,000		
"	Electricity Charges	17,000		
"	Telephone, Postage & Telegrams	12,000		
"	Stationery	27,000		
"	Depreciation	65,000		
"	Discount Allowed	19,000		
"	Bad Debts	17,000		
"	Interest	70,000		
"	Net Profit	43,000		
		4,38,000		4,38,000

Illustration 4

From the information given in illustration 3, show necessary closing entries in the Journal Proper of M/s. ABC Traders.

Solution: **In the Books of M/s. ABC Traders**

Journal Proper

Date 2006	Particulars		Dr. Amount Rs.	Cr. Amount Rs.
March 31	Profit & Loss Account	Dr.	3,95,000	
	To Salaries A/c			1,10,000
	To Legal Charges A/c			25,000
	To Consultancy Fees A/c			32,000
	To Audit Fees A/c			1,000
	To Electricity Charges A/c			17,000
	To Telephone, Postage & Telegrams A/c			12,000
	To Stationery A/c			27,000
	To Depreciation A/c			65,000
	To Discount Allowed A/c			19,000
	To Bad Debts A/c			17,000
	To Interest A/c			70,000
	(Being the transfer of balances of various expenses accounts)			
"	Discount Received A/c	Dr.	18,000	
	To Profit & Loss A/c			18,000
	(Being the transfer of discount received account balance)			
"	Gross Profit A/c	Dr.	4,20,000	
	To Profit & Loss A/c			4,20,000
	(Being the transfer of gross profit from Trading Account)			
"	Profit & Loss A/c	Dr.	43,000	
	To Net Profit A/c			43,000
	(Being the ascertainment of net profit)			
	Net Profit A/c	Dr.	43,000	
	To Capital A/c			43,000
	(Being the transfer of net profit to Capital A/c)			

4.2 ADJUSTMENTS

The fundamental principle of accounting is that the period to which various items of income and expenditure pertain should be co-extensive with the period of account. As such before Final Accounts are drawn up. It must be ensured that the accounts, which require adjustment on this consideration, have been adjusted, both by providing for expense accrued and including income outstanding and excluding expenses the benefit of which extends beyond the year of account as well as the income received in advance. The entries that will have to be passed for adjusting various accounts of income and expenditure are shown below:

(1) Expenses accrued and accruing, e.g., Rent, Interest, Local Taxes, Wages etc.

Appropriate Expense Account Dr.

To Expenses Accrued Account

(2) Income accrued and accruing, e.g., Interest on Government Loans, Discounts on Bill, Professional fees, Rents and Premiums on leases, etc.

Interest/Fees etc. Accruing Account Dr.

To Appropriate Income Account

Notes :

(1) The term "accrued" signifies that an amount has been incurred as expense or earned as income, the due date of payment of which falls in the next trading period. If the due date of payment occurs in the accounting period the term used should be "Outstanding" or "accrued and due".

(2) The expression 'accrued and accruing' signifies items which though not due for payment but pertain to the period of account, a provision for which has been made. Converse is the position so far as items of income are concerned.

(3) Carrying forward income received in advance e.g., Subscription in the case of a club or fees in case of professional person.

Appropriate Income Account Dr.

To Income Received in Advance Account

(4) Carrying forward of payments made in advance e.g., Telephone, Rent, Insurance etc., amounts where of stand debited to an expense account.

Expenses Prepaid Account Dr.

To Appropriate Expenses Account

(5) Adjustment of stock of materials in hand, e.g., Stationery, Advertisement, Material, Manufacturing Stores, etc., the cost whereof already has been debited to expense account.

Stock of Materials Dr.

To Appropriate Expenses Account

Note : Next year in the beginning entries No. (1) to (5) should be reversed.

(6) Provision for Bad and doubtful Debts : When it is feared that some of the amount due from customers will not be collected it is prudent to recognise the expected loss by reducing the current year's profit and placing the amount to the credit of a special account called "Provision for Bad and Doubtful Debts Account". The entry is;

Profit and Loss Account Dr.

To Provision for Bad and doubtful Debts Account

Note : The accounts of the customers concerned are not affected until the amount is actually written off for which the entry is,

Bad Debts Account Dr.

To Customer's A/c

Bad Debts when written off are debited to the provision in this respect where such a provision exists or directly to the Profit and Loss Account the corresponding credit being given (ultimately) to the debtor's account. If, on the other hand, a provision is required to be created, the amount of provision is also debited to the Profit and Loss Account. Where an examination problem requires that certain bad debts should be written off and a provision for doubtful debts made, the amount of bad debts to be written off should be first debited against the existing balance of the provision and the resulting balance in the account afterwards should be raised to the required figure. The method is illustrated below :

Illustration 5

On 1st Jan. 2006 provision for Doubtful Debts existed at Rs. 400. Debtors on 31.12.2006 were Rs. 15,000; bad debts totalled Rs. 1,000. It is required to write off the bad debts and create a provision equal to 5% of the debtors' balances. Show how you would compute the amount debited to the Profit and Loss Account.

Opening Provision (Cr.)	400
Bad Debts written off (Dr.)	1,000
	600
Provision required (Dr.) (5% of Rs. 14,000)	700
Additional amount required for debit to the Profit and Loss Account (Dr.)	1,300

Solution

The account will appear as follows:

Provision for Doubtful Debts Account

2006		Rs.	2006		Rs.
Dec. 31	To Bad Debts Account	1,000	Jan. 1	By Balance b/d	400
	To Balance c/d (required)	700	Dec. 31.	By Profit and Loss A/c	
				(Balancing Figure)	1,300
		1,700			1,700
			2007		
			Jan 1.	By Balance b/d	700

(7) **Provision for Discount :** This provision is created in the same manner, as discussed above but the amount of provision is required to be calculated after deducting the Provision for Bad Debts from the total debtors.

(8) **Provision for Depreciation :** It is made either by debiting Depreciation Account and crediting the asset account concerned and afterwards closing of the Depreciation Account by transfer to the Profit and Loss Account or by directly debiting the profit and loss Account and crediting the asset account and explaining the nature of adjustment by recording a detailed narration in the Journal. More appropriately, the Profit and Loss Account or first the Depreciation Account may be debited and Provision Account credited by the amount of annual depreciation.

(9) **Other Provisions :** Whenever it is expected that a loss, the amount of which is not certain will occur, the proper course is to create a provision for meeting the loss if and when it occurs. This would be the case, for example, if compensation has to be paid for the late delivery of goods. The entry is to debit the Profit and Loss Account and credit an account suitably named.

All accounts showing provisions may appear in the Balance Sheet but it should be noted that:

(i) The provision for Bad and Doubtful Debts and the Provision for Discount on Debtors are deducted from the total book debts; and

(ii) The provision for Depreciation is deducted from the cost of the assets concerned.

(10) Transfers, involving correction of errors, are made by debit or credit to the accounts affected, the corresponding effect being recorded either in a Suspense Account of some other account.

Transfers in respect of special charges to the Profit and Loss Account e.g., partner's salaries, interest, etc., and in respect of appropriation of profits are recorded by debit to the Profit and Loss Account and credit to the parties concerned.

While making adjustments, it is important to remember that every entry has a two-fold aspect, debit and credit. For example, if an adjustment is required to be made on account of prepaid insurance charges, the Insurance Charges Account would be credited, and, to complete the double entry, Prepaid Expenses Account is debited with the same amount. The last mentioned balance would be included on the debit side of the Trial Balance.

Students should, as a matter of course, record on the rough working sheets adjustments in respect of various items stated in a question and then appropriate their effect in the Trial Balance, before proceeding to draw up the Final Accounts.

5. CERTAIN ADJUSTMENTS AND THEIR TREATMENTS

1. **Abnormal loss of stock by accident or fire :** Sometimes loss of goods occurs due to fire, theft, etc. If due to accident or fire, a portion of stock is damaged, the value of loss is first to be ascertained. Thereafter, Abnormal Loss Account is to be debited and Purchase Account is to be credited.

Abnormal Loss Account is to be transferred to Profit & Loss Account. If amount of loss is recoverable from insurance company, then insurance company is to be debited instead of Profit & Loss Account. Till the money not received from the insurance company, Insurance Company's Account will be shown in the Assets side of the Balance Sheet. If any part of the loss is recoverable from the insurance company, then the portion not compensated by the insurance company should be debited to Profit & Loss Account. For example, if goods worth Rs. 6,000 are destroyed by fire and the insurance company admits the claim for Rs. 4,500, the Journal entries will be:-

(i)	Loss by Fire Account	Dr.	6,000	
	To Purchases Account			6,000
(ii)	Insurance Company's A/c (Insurance Claim)	Dr.	4,500	
	Profit & Loss A/c	Dr.	1,500	
	To Loss by Fire A/c			6,000

2. **Goods sent on Approval basis :** Sometimes goods are sold to customers on sale or return basis or on approval basis. It should not be treated as actual sale till the time it is not approved by the customer. When goods were sold we have passed the entry for actual sales. Therefore, at the year end, if the goods are still lying with the customers for approval, following entries are to be passed:

   For example -

   Goods costing Rs.10,000 sent to a customer on sale or return basis for Rs.12,000. The entry for such unapproved sale shall be-

(i)	Sales A/c	Dr.	12,000	
	To Sundry Debtors A/c			12,000
(ii)	Stock with Customers A/c	Dr.	10,000	
	To Trading A/c			10,000

3. **Goods used other than for sale :** Sometimes goods are used for some other purposes, such as distributed as free samples, used in construction of any assets or used by proprietor for personal use. In such cases the amount used for other purposes is subtracted from Purchases A/c and depending upon the specific use done, the suitable account head is debited.

   For example :-

   When goods are given away as donation-

Donation A/c	Dr.	
To Purchases A/c		

   When goods are used by the proprietor for his personal use-

Drawings A/c	Dr.	
To Purchases A/c		

When goods are distributed as free samples :-

Free Samples / Advertisement A/c Dr.

To Purchases A/c

When goods are used in business for construction of Building or the Machinery :-

Building A/c / Plant & Machinery A/c Dr

To Purchases A/c

When goods are used for maintenance of business premises/ Machinery : -

Repair & Maintenance A/c Dr.

To Purchases A/c

4. **Sales Tax :** If Sales Tax is charged from the customers, along with the price of the goods sold, amount of sales tax should be shown separately in the sales day book. Periodically this sales tax is to be deposited with the Sales Tax Department of the Government. The following entries are passed-

(i) At the time of sale-

Cash/Debtors A/c Dr.

To Sales A/c

To Sales Tax Payable A/c

(ii) On payment of sales-

Sales Tax Payable A/c Dr.

To Bank A/c

If any balance remains in the Sales Tax Payable Account, it should be shown in the Balance Sheet as liability.

5. **Commission based on profit :** Sometimes commission is payable to manager based on net profit; in such a case calculation is done as follows:

(i) Commission on net profit before charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100}$$

(ii) Commission on net profit after charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100 + \text{Rate of commission}}$$

Commission is recorded by following journal entry-

Commission A/c Dr.

To Commission Payable A/c

(Being commission payable to Mr ….. @ …..% on net profit after

charging such commission, net profit before charging commission being Rs ……..)

Commission will be debited in the Profit & Loss Account and Commission Payable Account will be shown in the Balance Sheet on liability side.

Illustration 6

The following is the Trial Balance of C. Wanchoo on 31st Dec. 2009.

Trial Balance on 31st December, 2009

	Dr. Rs.	Cr. Rs.
Capital Account		10,000
Stock Account	2,000	
Cash in hand	1,440	
Machinery Account	7,360	
Purchases Account	18,200	
Wages Account	10,000	
Salaries Account	10,000	
Discount Allowed A/c	500	
Discount Received A/c		300
Sundry Office Expenses Account	6,000	
Sales Account		50,000
Sums owing by customer (Sundry Debtors)	8,500	
Sundry Creditors (sums owing to suppliers)		3,700
Total	64,000	64,000
Value of Closing Stock on 31st Dec. 2009 was Rs. 2,700		

Prepare closing entries for the above items.

Solution

Journal

Date 2009	Particulars	L.F.	Dr. Rs.	Cr. Rs.
Dec. 31	Trading Account	Dr.	30,200	
	To Stock Account			2,000
	To Purchase A/c			18,200
	To Wages A/c			10,000
	(Being the accounts in the Trial Balance which have to be transferred to the Trading Account debit side)			
Dec. 31	Sales Account	Dr.	50,000	
	To Trading A/c			50,000
	(Being the amount of Sales transferred to the credit of Trading Account)			
Dec. 31	Stock (Closing) A/c	Dr.	2,700	
	To Trading A/c			2,700
	(Being the value of Stock on hand on 31st Dec. 2009)			
Dec. 31	Trading A/c	Dr.	22,500	
	To Profit and Loss A/c			22,500
	(Being the transfer of gross profit.)			
Dec. 31	Profit and Loss A/c	Dr.	16,500	
	To Discount Allowed Account			500
	To Salaries A/c			10,000
	To Sundry Office Expenses A/c			6,000
	(Being the various expense accounts transferred to the P & L Account)			
Dec. 31	Discount Received A/c	Dr.	300	
	To P & L Account			300
	(Being the credit balance of discount received transferred to Profit and Loss A/c)			
Dec. 31	Profit and Loss A/c	Dr.	6,300	
	To Capital A/c			6,300
	(Being the transfer to Net Profit to the Capital Account)			
			1,28,500	1,28,500

Illustration 7

From the data given in illustration 6, prepare Trading and Profit and Loss Account.

Solution

C. WANCHOO

Trading Account of the year ended December 31, 2009

	Rs.		Rs.
To Stock A/c	2,000	By Sales A/c	50,000
To Purchases	18,200	By Stock (Closing)	2,700
To Wages	10,000		
To Gross profit trfd. to P & L A/c	22,500		
	52,700		52,700

Profit and Loss Account for the year ended December 31, 2009

	Rs.		Rs.
To Salaries	10,000	By Gross profit trfd. from	
To Discount Allowed	500	the Trading Account	22,500
To Sundry Office Expenses	6,000	By Discount Received	300
To Net Profit transferred to			
Capital A/c	6,300		
	22,800		22,800

6. BALANCE SHEET

The balance sheet may be defined as *"a statement which sets out the assets and liabilities of a firm or an institution as at a certain date."* Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."

In the illustration worked out above it will be seen that the under mentioned accounts have not been closed even after preparation of the Profit and Loss Account and the transfer of the net profit to the capital account.

	Rs.	
Cash in Hand	1,440	Debit balance
Capital Accounts (Rs.10,000+ Rs.6,300)	16,300	Credit balance
Machinery Account	7,360	Debit balance
Sundry Debtors	8,500	Debit balance
Sundry Creditors	3,700	Credit balance
Stock Account	2,700	Debit balance

Looking at these accounts, one would know that various assets : Cash balance in hand, cash at bank, machinery, furniture etc. that the firm possesses and the amounts that are owing as liability to Sundry Creditors and to the proprietor as capital. The capital, of course, will be the difference between the total of assets and of liabilities. The assets, liabilities and capital are usually presented in a statement called the Balance Sheet. This is given below for the accounts mentioned above.

C. WANCHOO

Balance Sheet as at December 31, 2009

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	3,700	Cash in Hand	1,440
Capital	16,300	Sundry Debtors	8,500
		Stock	2,700
		Machinery	7,360
	20,000		20,000

The assets are shown on the right hand side and liabilities and capital on the left hand side.

6.1 CHARACTERISTICS

The balance sheet has certain characteristics, which should be noted. These are the following:

(i) It is prepared at a particular date, rather the close of a day and not for a period. It is true only on that date and not later. Suppose, in the example given above, a part of the goods were sold on 1st January, 2010. This will mean that the value of the stock will be reduced, the cash in hand will increase and the capital account will be reduced.

(ii) The balance sheet is prepared only after the preparation of the Profit and Loss Account. This is the reason why the Profit and Loss Account (including the Trading Account) and the Balance Sheet are together called Final Accounts (Of course, the Balance Sheet is not an account, the two sides are not the debit and the credit sides.) Without being accompanied by the Profit and Loss Account, the Balance Sheet will not be able to throw adequate light on the financial position of the firm. For that purpose an appreciation of the profits of the firm is necessary.

(iii) Since capital always equals the difference between assets and liabilities and since the capital account will independently arrive at this figure, the two sides of the Balance Sheet must have the same totals. If it is not so, there is certainly an error somewhere.

6.2 ARRANGEMENTS OF ASSETS AND LIABILITIES

(1) Assets : Assets may be grouped in one of the following two ways :

(i) *Liquidity :* Under this approach, the asset, which can be converted into cash first, is presented first. Those assets, which are most difficult in this respect, are presented at the bottom.

(ii) Permanence: Assets, which are to be used, for long term in the business and are not meant to be sold are presented first. Assets, which are most liquid, such as cash in hand, are presented at the bottom.

The various assets in two order will be as follows:

In the order of Liquidity	In the order of Permanence
Cash in Hand	Goodwill
Cash at Bank	Patents
Investments	Furniture
Sundry Debtors	Machinery
Stock of Finished Goods	Stock of Partly Finished goods
Stock of Raw Materials	Stock of Raw Materials
Partly Finished goods	Stock of Finished goods
Machinery	Sundry Debtors
Furniture	Investments
Patents	Cash at Bank
Goodwill	Cash in Hand

Some of the assets may be capable of being sold easily like investment in government securities or shares of some companies. They should be treated as liquid or permanent according to the intention of the firm. One should also note that the order in which the assets of a company are to be shown is described by the Companies Act.

(2) Liabilities : Liabilities may also be shown according to the urgency with which payment has to be made. One way is to first show the capital, then long-term liabilities and last of all short term liabilities like amounts due to suppliers of goods or bills payable. The other way is to start with short-term liabilities and then show long term liabilities and last of all capital.

6.3 CLASSIFICATION OF ASSETS AND LIABILITIES

Assets are basically of two types. Those that are meant to be used by the firm over a long period and not sold and those that are meant to be converted into cash as quickly as possible. Examples of the latter are book debts, stocks of finished goods and materials, etc. The later types of assets are called current assets. These include cash also. The former type of assets is called fixed assets. It is desirable that in the balance sheet the two types of assets should be shown separately and prominently. This would give meaningful and logical information.

The liabilities to outsider will be of two types. Those that must be settled within one year and those that will be paid after one year. The former type of liability is called current or short-term liability. The latter type is long term liability. Of course, it will include undistributed profits also.

Sole proprietors generally present Balance Sheet in a horizontal form with "Capital and Liabilities" on the left hand side and 'Assets' on the right-hand side. In the Balance Sheet the various items should be grouped suitably as indicated below:

Balance Sheet as on…………..

Capital and Liabilities	Amount Rs.	Assets	Amount Rs.
Capital A/c:		Tangible Fixed Assets :	
Balance		Land and Building	
Add : Net Profit/Less: Net Loss		Plant and Machinery	
Less : Drawings		Furniture and Fixture	
Long Term Loans :		Vehicles	
Term Loans		Intangibles :	
Other Loans		Goodwill	
Short Term Loans :		Patent Rights	
Cash Credit		Designs and Brand Names	
Overdrafts		Deferred Advertisement	
Other Loans		Investments :	
Current Liabilities :		Long term investments	
Sundry Creditors			
Bills Payable		Current Assets :	
Outstanding Expenses		Stock In Trade	
Advances Taken		Sundry Debtors	
Provision :		Bills Receivable	
Provision for Bad debts		Prepayments	
Provision for Retirement Benefits		Advances	
Provision for Taxation		Bank Balances	
		Cash In Hand	

Of course, there is no hard and fast rule regarding presentation of assets, liabilities and equities in the Balance sheet. However, the model presentation shown above has been designed considering the nature of Balance Sheet elements and categorizing them appropriately.

Proper presentation of Balance Sheet items improves understandability of the information desired to be communicated to the users of account.

Illustration 8

Given below Trial Balance of M/s Dayal Bros. as on 31st March, 2009 :

	Debit Balances Rs.	Credit Balances Rs.
Capital A/c		7,00,000
Land and Building	3,00,000	
14% Term Loan		4,00,000
Loan from M/s. D & Co.		4,60,000
Sundry Debtors	4,20,000	
Cash in hand	20,000	
Stock In Trade	6,00,000	
Furniture	2,00,000	
Sundry Creditors		40,000
Advances to Suppliers	1,00,000	
Net Profit		1,00,000
Drawings	60,000	
	17,00,000	17,00,000

Prepare Balance Sheet as on 31st March, 2009.

Solution

In the Books of M/s Dayal Bros.
Balance Sheet
as on 31st March, 2009

Capital and Liabilities	Rs.	Amount Rs.	Assets	Amount Rs.
Capital: Balances	7,00,000		Land & Building	3,00,000
Add: Net Profit	1,00,000		Furniture	2,00,000
	8,00,000		Stock in Trade	6,00,000
Less: Drawings	60,000	7,40,000	Sundry Debtors	4,20,000
14% Term Loan		4,00,000	Advances to Suppliers	1,00,000
Loan from M/s D & Co.		4,60,000	Cash in Hand	20,000
Sundry Creditors		40,000		
		16,40,000		16,40,000

Illustration 9

The balance sheet of Thapar on 1st January, 2009 was as follows :

Particulars	Rs.	Particulars	Rs.
Sundry Creditors	15,000	Plant & Machinery	30,000
Expenses Payable	1,500	Furniture & Fixture	3,000
Capital	50,000	Stock	13,000
		Sundry Debtors	14,000
		Cash at Bank	6,500
	66,500		66,500

During 2009, his Profit and Loss Account revealed a net profit of Rs. 15,300. This was after allowing for the following :

(a) Interest on capital @ 6% p.a.

(b) Depreciation on Plant and Machinery @ 10% and on Furniture and Fixtures @ 5%.

(c) A provision for Doubtful Debts @ 5% of the debtors as at 31st December, 2009.

But while preparing the Profit and Loss Account he had forgotten to provide for (1) outstanding expenses totaling Rs. 1,800 and (2) prepaid insurance to the extent of Rs. 200.

His current assets and liabilities on 31st December, 2009 were : Stock Rs. 14,500; Debtors, Rs. 20,000; Cash at Bank, Rs. 10,350 and Sundry Creditors Rs. 11,400.

During the year he withdrew Rs. 6,000 for domestic use. Draw up his Balance Sheet at the end of the year.

Solution

Profit and Loss Account (Revised)

Particulars	Rs.	Particulars	Rs.
To Outstanding expenses	1,800	By Balance b/d	15,300
To Net profit	13,700	By Prepaid insurance	200
	15,500		15,500

Balance Sheet of Thapar
as on 31st December, 2005

Liabilities		Rs.	Assets	Rs.	Rs.
Capital	50,000		Cash at Bank		10,350
Add: Net Profit	13,700		Debtors	20,000	
	63,700		*Less:* Provision for		
			doubtful debts	1,000	19,000

Less : Drawings	6,000		Plant and Machinery	30,000	
	57,700		*Less:* Depreciation	3,000	27,000
Add: Interest on capital	3,000	60,700	Furniture & Fixtures	3,000	
Outstanding expenses		1,800	*Less:* Depreciation	150	2,850
Creditors		11,400	Stock		14,500
			Prepaid insurance		200
		73,900			73,900

7. SEQUENCE OF ACCOUNTING PROCEDURE OR THE ACCOUNTING CYCLE

What has been done so far shows that the accounting process in the following order :

(i) recording the transactions in the journal or journalising;

(ii) preparing ledger accounts on the basis of the journal or posting into the ledger;

(iii) taking out the trial balance to check arithmetical accuracy;

(iv) preparing the profit and loss account or the income statement for the period concerned; and

(v) preparing the balance sheet to show the financial position at the end of the period.

8. OPENING ENTRY

We have seen that on commencing a new business one debits the cash account and credits the capital account with the amount introduced. A firm closes the books of account at the end of each year and starts new books in the beginning of each year. The first entry in the journal is to record the closing balances of various assets and liablities at the end of the previous year as the opening balances in the beginning of the new year. The balance sheet prepared at the end of the year records these balances and is the basis for this first entry. It is called the opening entry.

The assets shown in the balance sheet are debited and the liabilities and the capital account credited.

Illustration 10

From the given below balance sheet prepare the relevant opening entry.

BALANCE SHEET
As at 31st December, 2009

Liabilities	Rs.	Assets	Rs.
Mahendra & Sons	5,600	Cash in hand	430
Capital	20,000	Cash at Bank	2,675
		Debtors	7,495
		Closing Stock	9,000
		Machinery and Equipment	6,000
	25,600		25,600

Solution

The Opening Entry :

		Dr. Rs.	Cr. Rs.
Cash A/c	Dr.	430	
Bank A/c	Dr.	2,675	
Sundry Debtors	Dr.	7,495	
Stock A/c	Dr.	9,000	
Machinery and Equipment A/c	Dr.	6,000	
To Mahendra & Sons A/c			5,600
To Capital A/c			20,000
(Being the balances brought forward)		25,600	25,600

8.1 POSTING THE OPENING ENTRY

All the assets show debit balance. Such accounts are opened and the relevant amounts written on the debit side as "To Balance b/d". Following is the cash account arising from the entry given above.

CASH ACCOUNT

Dr.						Cr.
Date	Particulars	Amount Rs.	P.	Date	Particulars	Amount
2010						
Jan. 1	To Balance b/d	430	—			

The accounts of liabilities show credit balances. An account for each liability is opened and the relevant account is written on the credit side as "By Balance b/d". This is shown below by opening the accounts of Mahendra & Sons mentioned in the entry given above.

MAHENDRA & SONS

Dr.							Cr.
Date	Particulars	Amount Rs.	P.	Date	Particulars	Amount Rs.	P.
				2010			
				Jan. 1	By Balance b/d	5,600	–

By posting the opening entry completely all the accounts of assets and liabilities in the beginning are opened. We illustrate below a complete cycle of journalising, posting and trial balance.

Students should work through the following illustration given by way of practice on the method of making adjustments in some of the accounts contained in a Trial Balance and afterwards preparing the final Account.

Illustration 11

Shri Mittal gives you the following Trial Balance and some other information :

Trial Balances as on 31st March, 2009

	Dr. Rs.	Cr. Rs.
Capital		8,70,000
Purchases and Sales	6,05,000	12,10,000
Opening Stock	72,000	
Debtors and Creditors	90,000	1,70,000
14% Bank Loan		2,00,000
Overdrafts		1,12,000
Salaries	2,70,000	
Advertisements	1,10,000	
Other expenses	60,000	
Returns	40,000	30,000
Furniture	4,50,000	
Building	8,90,000	
Cash in Hand	5,000	
	25,92,000	25,92,000

Closing stock on 31st March, 2009 was valued at Rs. 1,00,000.

Prepare his final accounts.

Solution

In the books of Shri Mittal
Trading Account
for the year ended 31st March, 2009

Dr.	Particulars		Amount Rs.		Particulars		Cr. Amount Rs.
To	Opening Stock		72,000	By	Sales	12,10,000	
To	Purchases	6,05,000			*Less:* Returns	40,000	11,70,000
	Less: Returns	30,000	5,75,000	By	Closing stock		1,00,000
To	Gross Profit		6,23,000				
			12,70,000				12,70,000

Profit and Loss Account
For the year ended 31st March, 2009

Dr. Particulars	Amount Rs.	Particulars	Cr. Amount Rs.
To Salaries	2,70,000	By Gross profit	6,23,000
To Advertisement	1,10,000		
To Other expenses	60,000		
To Net profit	1,83,000		
	6,23,000		6,23,000

Balance Sheet as on 31st March, 2009

Liabilities	Rs.	Amount Rs.	Assets	Amount Rs.
Capital	8,70,000		Building	8,90,000
Add: Net profit	1,83,000	10,53,000	Furniture	4,50,000
14% Bank Loan		2,00,000	Debtors	90,000
Creditors		1,70,000	Closing stock	1,00,000
Overdrafts		1,12,000	Cash in hand	5,000
		15,35,000		15,35,000

Illustration 12

Mr. Mohan gives you the following trial balance and some other information:

Trial Balance as on 31st March, 2009

	Dr. Rs.	Cr. Rs.
Capital		6,50,000
Sales		9,70,000
Purchases	4,30,000	
Opening Stock	1,10,000	
Freights Inward	40,000	
Salaries	2,10,000	
Other Administration Expenses	1,50,000	
Furniture	3,50,000	
Debtors and Creditors	2,10,000	1,90,000
Returns	20,000	12,000
Discounts	19,000	9,000

Bad Debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and Cash at Bank	1,87,000	
	18,31,000	18,31,000

Other Information :

(i) Closing stock was Rs. 1,80,000;

(ii) Depreciate Furniture @ 10% p.a.

You are required to prepare Trading and Profit and Loss Account for the year ended on 31.3.2009 and Balance Sheet of Mr. Mohan as on that date.

Solution

In the books of Mr. Mohan
Trading Account
for the year ended 31st March, 2009

Dr. Particulars		Amount Rs.	Particulars		Cr. Amount Rs.
To Opening stock		1,10,000	By Sales	9,70,000	
To Purchases	4,30,000		*Less:* Returns	20,000	9,50,000
Less: Returns	12,000	4,18,000	By Closing stock		1,80,000
To Freight Inwards		40,000			
To Net profit		5,62,000			
		11,30,000			11,30,000

Profit and Loss Account
for the year ended 31st March, 2009

Dr. Particulars	Amount Rs.	Particulars	Cr. Amount Rs.
To Depreciation	35,000	By Gross profit	5,62,000
To Salaries	2,10,000	By Discount received	9,000
To Administration expenses	1,50,000		
To Discount allowed	19,000		
To Bad debts	5,000		
To Net profit	1,52,000		
	5,71,000		5,71,000

Balance Sheet
as on 31st March, 2009

Liabilities		Amount Rs.	Assets		Amount Rs.
Capital	6,50,000		Furniture	3,50,000	
Add: Net profit	1,52,000	8,02,000	*Less:* Depreciation	35,000	3,15,000
Creditors		1,90,000	Closing stock		1,80,000
			Debtors		2,10,000
			Investment in Govt securities		1,00,000
			Cash in Hand and Cash at Bank		1,87,000
		9,92,000			9,92,000

Illustration 13

From the following Trial Balance prepare a Trading and Profit and Loss Account for the year ending 31st December, 2009 and a Balance Sheet as on that date:

	Rs.		Rs.
Debit Balance :			
Sundry Debtors	3,500	Salaries	2,200
Stock 1st January, 2009	5,000	Purchases	12,500
Cash in Hand	5,600	Plant and Machinery	15,700
Wages	3,000	*Credit Balance:*	
Bad Debts	500	Capital	25,000
Furniture and Fixtures	1,500	Sundry Creditors	9,000
Depreciation	1,500	Sales	17,000

On 31st December, 2009 the stock was valued at Rs. 10,000.

Solution

Trading and Profit and Loss Account for the year ending 31st Dec., 2009

	Rs.		Rs.
To Opening Stock	5,000	By Sales	17,000
To Purchases	12,500	By Closing Stock	10,000
To Wages	3,000		
To Gross Profit c/d	6,500		
	27,000		27,000
To Bad Debts	500	By Gross Profit b/d	6,500
To Depreciation	1,500		
To Salaries	2,200		
To Net Profit trfd. to Capital A/c	2,300		
	6,500		6,500

Balance Sheet as at 31st Dec., 2009

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Current Liabilities:			*Current Assets :*		
Sundry Creditors		9,000	Cash in Hand	5,600	
Capital:			Sundry Debtors	3,500	
Previous Balance	25,000		Closing Stock	10,000	19,100
Add : Net Profit	2,300	27,300	*Fixed Assets :*		
			Furniture & Fixtures	1,500	
			Plant & Machinery	15,700	17,200
		36,300			36,300

Illustration 14

Sengupta & Co. employs a team of eight workers who were paid Rs. 3,000 per month each in the year ending 31st December, 2008. At the start of 2009, the company raised salaries by 10% to Rs. 3,300 per month each.

On July 1, 2009 the company hired two trainees at salary of Rs. 2,100 per month each. The work force are paid salary on the first working day of every month, one month in arrears, so that the employees receive their salary for January on the first working day of February etc.

Calculate:

(i) Amount of salaries which would be charged to the profit and loss for the year ended 31st December, 2009.

(ii) Amount actually paid as salaries during 2009.

(iii) Outstanding Salaries as on 31st December, 2009.

Solution

		Rs.
(i)	Salaries to be charged to profit and loss account for the year ended 31st December, 2009:	
	Salaries of 8 employees for full year @ Rs. 3,300 per month each	3,16,800
	Salaries of 2 trainees for 6 months @ Rs. 2,100 p.m.	25,200
		3,42,000
(ii)	Salaries actually paid in 2009	
	December, 2008 salaries paid in January, 2009 (8 x 3,000)	24,000
	Salaries of 8 employees for January to November, 2009 paid in February-December, 2009 @ Rs. 3,300 for 11 months	2,90,400
	Salaries of 2 trainees for July to November paid in August-December @ Rs. 2,100 for 5 months	21,000
		3,35,400

(iii) Outstanding salaries as at 31st December, 2009

8 employees @ Rs. 3,300 each for 1 month	26,400
2 trainees @ Rs. 2,100 each for 2 months	4,200
	30,600

Illustration 15

Mr. James submits you the following information for the year ended 31.3.2006:

	Rs.
Stock as on 1.4.2008	1,50,500
Purchases	4,37,000
Manufacturing expenses	85,000
Expenses on sale	33,000
Expenses on administration	18,000
Financial charges	6,000
Sales	6,25,000
Gross profit is 20% of sales.	
Compute the net profit of Mr. James for the year ended 31.3.2009.	

Solution

Statement showing Computation of Net Profit of Mr. James for the year ended 31.3.2009

	Rs.	Rs.
Gross profit on sales (Rs.6,25,000x 20/100)		1,25,000
Less: Overhead expenses:		
Administration expenses	18,000	
Selling expenses	33,000	
Financial charges	6,000	57,000
Net profit		68,000

Alternatively, trading and profit and loss account for the year ended 31st March, 2009 can be prepared to compute the amount of net profit.

Trading and Profit & Loss Account of Mr. James for the year ended 31st March, 2009

	Rs.		Rs.
To Opening stock	1,50,500	By Sales	6,25,000
To Purchases	4,37,000	By Closing stock	1,72,500
To Manufacturing expenses	85,000	(balancing figure)	
To Gross profit c/d	1,25,000		
	7,97,500		7,97,500

To Administration expenses	18,000	By Gross profit b/d	1,25,000
To Selling expenses	33,000		
To Financial charges	6,000		
To Net profit	68,000		
	1,25,000		1,25,000

Illustration 16

The Balance Sheet of Mr. Popatlal, a merchant on 31st December, 2009 stood as below:

Liabilities	Amount Rs.	Assets		Amount Rs.
Capital	24,000	Fixed Assets		12,560
Creditors	16,400	Stock		20,640
Bank Overdraft	14,600	Debtors	18,800	
		Less: Provision	620	18,180
		Cash		3,620
	55,000			55,000

Show opening journal entry on 1st January, 2010 in the books of Mr. Popatlal.

Solution

Opening entry

			(Dr.) Rs.	(Cr.) Rs.
1.1.2010	Fixed Assets A/c	Dr.	12,560	
	Stock A/c	Dr.	20,640	
	Debtors A/c	Dr.	18,800	
	Cash A/c	Dr.	3,620	
	To Creditors A/c			16,400
	To Bank Overdraft A/c			14,600
	To Provision for Doubtful Debts A/c			620
	To Capital A/c			24,000

9. PROVISIONS AND RESERVES

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

Thus, a provision may be either in respect of loss in the value of an asset provided or written off on the basis of an estimate or the one in respect of a liability for expenses incurred in respect of a claim which is disputed i.e. when it is a contingent liability. On the occurrence of a diminution in asset values due to some of them having become irrecoverable or stock items are lost as a result of some natural calamity, amounts contributed or transferred from profit to make good the diminution also are described as provision.

The following are instances of amount retained in the business out of earning for different purposes that are described as provisions.

(1) Amount provided for meeting claims which are admissible in principle but the amount whereof has not been ascertained.

(2) An appropriation made for payment of taxes still to be assessed.

(3) Amount set aside for writing off bad debts or payment of discounts.

The term 'reserve' is not defined in Part III of Schedule VI except negatively in the sense that profit retained in the business not having any of the attribute of a 'provision' is to be treated as a reserve. Also provisions in excess of the amount considered necessary for the purposes these were originally made, are to be considered as reserves. It is thus evident that provisions are a charge against profits, while reserve is an appropriation of profits. Also provisions that ultimately prove to be in excess of amounts required or have been made too liberally are reserves. Such a distinction is essential for disclosing truly in the Balance Sheet the amount by which the equity of shareholders has increased with the accumulation of undistributed profits.

Reserve Fund : It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.

Illustration 17

Crimpson Ltd.'s profit and loss account for the year ended 31st December, 2009 includes the following information:

		Rs.
(i)	Depreciation	57,500
(ii)	Bad debts written off	21,000
(iii)	Increase in provision for doubtful debts	18,000
(iv)	Proposed dividend	15,000
(v)	Retained profit for the year	20,000
(vi)	Liability for tax	4,000

State which one of the items (i) to (vi) above are – (a) transfer to provisions; (b) transfer to reserves; and (c) neither related to provisions nor reserves.

Solution

(a) Transfer to provisions - (i), (iii) (vi)

(b) Transfer to reserves - (v)

(c) Neither related to provisions nor reserves - (ii), (iv).

10. LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements suffer from a number of limitations. These must, therefore be studied with care, in order that correct inferences may be drawn. The limitations are less serious if the objective is only to appraise the performance of a single company over a period of years. Where, however, a comparison of the working of different companies for the same period is to be made. It can be misleading unless the companies concerned have followed the same system and basis of accounting. On the account, a comparison of the profitability of different industries on the basis of financial statements, should be undertaken only if it is not practicable to make such a comparison on any other basis.

The principal limitations affecting financial statements are the following:

(a) ***Historical Cost :*** Accounting records and, on that account, the financial statements are prepared only on the basis of the money value prevailing at the time the transaction were entered into. Thus, the effect of subsequent changes in the value of money is not taken into account. At times this has the effect of making the statements of account quite misleading. Take the obvious example of a house built in 1945, say at the cost of Rs. 15,000, in 2009 the benefit receivable from its occupation will be as much as that of a house created in 2009, say at a cost of Rs. 14,50,000. If the house were included in the financial statements at its original cost, as normally it would not convey a true picture except to a knowledgeable person.

The limitations can be serious in the case of other fixed assets that have been working over a long period over which prices have changed radically. It is, however, not easy to get over this difficulty, since revaluation of fixed assets, apart from being costly is not practicable when the value of money is continuously falling. On this account, historical cost continues to be the accepted basis for the preparation of financial statements. Though it may not be possible to do much to remove the limitation mentioned above, one must always remember to read the balance sheet and the profit and loss account in the light of what they cannot reveal as well as what they do.

(b) ***Intangible strengths and weaknesses :*** A company may have a number of strengths and weaknesses which cannot be shown in the balance sheet e.g., the loyalty and calibre of its staff. These must be kept in mind while judging the financial position of the company.

(c) ***Perpetual continuity and periodical account :*** Financial statements ordinarily are drawn up at the end of each year but the accounting record is maintained on the assumption that the business undertaking shall continue to exist forever. In consequence, much of the expenditure other than revenue expenditure has to be distributed arbitrarily over a number of years during which benefit of the expenditure is expected to arise. As a result, financial statements of account are not absolutely correct.

The management of a business entity is left with discretion as regard valuation and treatment of a number of assets, some of which are mentioned below:

(i) Goodwill and other intangible assets;

(ii) Wasting assets like mines, quarries etc.;

(iii) Deferred revenue expenditure; and

(iv) Fictitious assets like Preliminary Expenses, Discount on Debentures, etc.

As a result, if one company follows one method as regards valuation of one or more of these assets and the second follows another, the financial results shown by the two companies are not comparable.

(d) ***Different accounting policies :*** It is permissible for a company within certain limits to adopt different policies for the preparation of accounts, valuation of various assets and distribution of expenditure over different periods of account. For example, a company may decide to provide annually for payment of pensions and gratuities to staff and thus build up a 'fund' out of which payments will be made ultimately whereas another company may deal with these only when actual payments are made. Similarly, a company may decide whether or not to include intangible assets amongst its assets or manner in which the amounts thereof should be written off.

Whatever basis of accounting is decided upon the same must be followed consistently, from year to year. Whenever it is departed from, the effect of it would be the effect of obscuring the profit of the year in which the change in the basis of accounting is made.

(e) ***Management policies :*** There is general impression that each undertaking endeavours to earn as much profit as it can. This is not wholly correct. The management often attempts not to allow its profit to rise above a level that it consider appropriate, in the circumstances it is functioning, due to a variety of reasons. This may be:

(i) Disinclination to undertake new risks and responsibilities on account of high rates of taxation;

(ii) Fear of the odium of profiteering a bad reputation that prices charged by the concern for its goods are not reasonable :

(iii) Fear that larger profits may give rise to demand for higher wages which may throw the costs and prices relationship out of gear or impression may gain ground that there has been an increased workload on the workers which may lead to discontentment amongst them :

(iv) Fear that the concern may be considered to have developed monopolistic tendencies;

(v) Consideration to maintain efficiency; and

(vi) Unwillingness to expand, unduly on account of uncertainty of the future.

To conclude, on these considerations. Financial statements need to be studied with great care. The information disclosed by them has to be judged in the light of the economic change, such as inflationary condition over the short period, as well as, over the long period (like one witnessed in India after 1971) and the nature of management and its basic motives. Despite the limitations, the financial statements, verified by independent auditors, often are the only tangible evidence available as regards the profitability and the financial position of the company. Their importance, therefore, cannot be under-estimated. If properly analysed, they are capable of yielding a flood of information.

CHAPTER - 6

PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORS

Unit 2

Final Accounts of Manufacturing Entities

Learning Objectives :

After studying this unit you will be able to :

- Understand the purpose of preparing Manufacturing Account.
- Learn the items to be included in the Manufacturing Account.

1. INTRODUCTION

The manufacturing entities generally prepare a separate Manufacturing Account as a part of Final accounts in addition to Trading Account, Profit and Loss Account and Balance Sheet. The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities. Manufacturing costs of finished goods are then transferred from the Manufacturing Account to Trading Account.

2. PURPOSE

A manufacturing account serves the following functions:

(1) It shows the total cost of manufacturing the finished products and sets out in detail, with appropriate classifications, the constituent elements of such cost. It is, therefore, debited with the cost of materials, manufacturing wages and expenses incurred directly or indirectly on manufacture.

(2) It provides details of factory cost and facilitates reconciliation of financial books with cost records and also serves as a basis of comparison of manufacturing operations from year to year.

(3) The Manufacturing Account may also be used for various other purposes. For example, if the output is carried to the Trading Account at market prices, it discloses the profit or loss on manufacture. Similarly, it may also be used to fix the amount of production of profit sharing bonus when such schemes are in force.

3. MANUFACTURING COSTS

Manufacturing costs are classified into :

Raw Material Consumed	....
Direct Manufacturing Wages	....
Direct Manufacturing Expenses	....
Prime Cost	....
Indirect Manufacturing expenses or Manufacturing Overhead	....
Total Manufacturing Cost	______

Raw Material consumed is arrived at after adjustment of opening and closing stock of raw materials:

Raw Material Consumed	= Opening Stock of Raw Materials
	+ Purchases
	- Closing Stock of Raw Materials

If there remain unfinished goods at the beginning and at the end of the accounting period, cost of such unfinished goods (also termed as Work-In-Process) is shown in the Manufacturing Account – opening stock of Work-in-Process is posted to the debit of the Manufacturing Account and closing stock of Work-in-Process is posted to the credit of the Manufacturing Account.

3.1 DIRECT MANUFACTURING EXPENSES

Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.

Examples of direct manufacturing expenses are (i) Royalties for using license or technology if based on units produced, (ii) Hire charge of the plant and machinery used on hire, if based on units produced, etc.

When royalty or hire charges are based on units produced, these expenses directly vary with production.

Illustration 1

10,000 units were produced in a factory. Per unit material cost was Rs. 10 and per unit labour cost was Rs. 5. That apart it was agreed to pay royalty @Rs. 3 per unit to the Japanese collaborator who supplied technology.

Solution

In this case Prime Cost comprises of –

Raw Material consumed	(10,000 × Rs. 10)	Rs. 1,00,000
Direct Wages	(10,000 × Rs. 5)	Rs. 50,000
Direct Expenses	(10,000 × Rs. 3)	Rs. 30,000
		Rs. 1,80,000

3.2 INDIRECT MANUFACTURING EXPENSES

These are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages and indirect expenses. Indirect material means materials which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc. Indirect wages are those which cannot be directly linked to the units produced, for example, wages for maintenance works, holding pay, etc. Indirect expenses are those which cannot be directly linked to the units produced, for example, training expenses, depreciation of plant and machinery, depreciation of factory shed, insurance premium for plant and machinery, factory shed, etc.

Accordingly, indirect manufacturing expenses comprise indirect material, indirect wages and indirect expenses of the manufacturing division.

3.3 BY-PRODUCTS

In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale. For example, the production of hydrogenated vegetable oil is accompanied by the production of oxygen gas and the production of steel yields scrap. The subsidiary product is termed as a by-product because its production is not consciously undertaken but results out of the production of the main product. It is usually very difficult to ascertain the cost of the product. Moreover, its value usually forms a very small percentage of the main product.

By-product is a secondary product. This is produced from the same raw materials, which are used for producing the main product and without incurring any additional expenses from the same production process in which the main product is produced. Some examples of by-product are given below:

(i) Molasses is the by-product in sugar manufacturing;

(ii) Butter milk is the by-product of a dairy which produces butter and cheese, etc.

By-products generally have insignificant value as compared to the value of main product. They are generally valued at net realisable value, if their costs cannot be separately identified. It is often treated, as "Miscellaneous income" but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.

4. DESIGN OF A MANUFACTURING ACCOUNT

There is no standardized design for the presentation of a Manufacturing Account. Given below is a format covering various elements:

Manufacturing Account

Dr.	Particulars	Units	Amount Rs.		Particulars	Units	Cr. Amount Rs.
To	Raw Material Consumed:			By	By-products at net realisable value		
	Opening Stock	… .		"	Closing Work-in-Process		
	Add: Purchases	…..		"	Trading A/c - Cost of production		
	Less: Closing Stock	…..	……				
"	Direct Wages		……				
"	Direct expenses:		……				
	Prime cost		……				
To	Factory overheads:						
	Royalty	…..					
	Hire charges	…..					
"	Indirect expenses:	…..					
	Repairs & Maintenance	…..					
	Depreciation	…..	…….				
	Factory cost		…….				
To	Opening Work-in-process		…….				

Tutorial Note : Frequently, problems are set, in which all the ledger balances are not given. Instead, details are given regarding the number of items in stocks, quantity manufactured etc. the figures for stocks, sales etc., would therefore have to be worked out independently from the data given.

The following general rules may be observed.

(a) The Manufacturing Account should have columns showing the quantities and values. Frequently, all the quantities are not given and the quantities applicable to one or more of the items would have to be worked out. For example, if the question does not state the total number of items sold, the quantity can be worked out by adding opening stock and units manufactured and deducting closing stock. It is, therefore, useful to have quantity columns in the account so that it can be seen that both sides balance.

(b) The Manufacturing Account will show the quantity of raw materials in stock at the beginning and at the end of the year and the purchases during the year. As regards finished goods, it will only show the quantity manufactured and, as regards work-in-progress, the opening and closing amounts.

(c) The Trading Account will show the quantities of finished goods manufactured and sold and the opening and closing stocks. It will not show the quantity of raw materials or work-in-progress.

(d) For determining the value of closing stock, in the absence of specific instruction to the contrary, it must be assumed that sales have been on "first in-first out" basis, that is, the closing stock consists as far as possible of goods produced during the year, the opening stock being sold out.

It may be mentioned here that nowadays no manufacturing business entity prepares manufacturing account as part of its final set of accounts. Even the items of manufacturing account are shown either in trading account (in case of non-corporate entities) or in profit and loss account (in case of corporate entities).

The procedure of preparation of Trading Account, Profit and Loss Account and Balance Sheet have already been explained in Unit 1 of this chapter. Students should refer the earlier unit for attempting the problems based on the preparation of complete set of final accounts of a sole proprietor.

Illustration 2

Mr. Vimal runs a factory which produces toilet soaps. Following details were available in respect of his manufacturing activities for the year ended on 31.3.2009:

Opening Work-in-Process (10,000 units)	16,000
Closing Work-in-Process (12,000 units)	20,000
Opening Stock of Raw Materials	1,70,000
Closing Stock of Raw Materials	1,90,000
Purchases	8,20,000

Hire charges of machine @ Re. 0.60 per unit manufactured Hire charges of factory	 2,20,000
Direct wages-Contracted @ Re. 0.80 per unit manufactured and @ Re. 0.40 per unit of Closing W.I.P.	
Repairs and Maintenance	1,80,000
Units produced – 5,00,000 units	

You are required to prepare a Manufacturing Account of Mr. Vimal for the year ended 31.3.2009.

Solution

In the Books of Mr. Vimal
Manufacturing Account for the Year ended 30.6.2009

Dr.	Particulars		Units	Amount Rs.		Particulars	Units	Cr. Amount Rs.
To	Opening Work-in-Process		10,000	16,000	By	Closing Work-in-Process	12,000	20,000
To	Raw Materials Consumed:				"	Trading A/c – transfer of manufacturing cost @ Rs. 4.00 per unit	5,00,000	19,00,800
	Opening Stock	1,70,000						
	Add: Purchases	8,20,000						
		9,90,000						
	Less: Closing Stock	1,90,000		8,00,000				
To	Direct Wages – W.N.(1)			4,04,800				
To	Direct expenses: Hire charges on Machinery – W.N. (3)			3,00,000				
To	Indirect expenses: Hire charges of Factory Shed			2,20,000				
	Repairs & Maintenance			1,80,000				
				19,20,800				19,20,800

Working Notes :

(1)	Direct Wages – 5,00,000 units @ Rs. 0.80 =	Rs. 4,00,000
	12,000 units @ Rs. 0.40 =	Rs. 4,800
		Rs. 4,04,800
(3)	Hire charges on Machinery – 5,00,000 units @ Re. 0.60 =	Rs. 3,00,000

Illustration 3

Mr. Pankaj runs a factory which produces motor spares of export quality. The following details were obtained about his manufacturing expenses for the year ended on 31.3.2009.

			Rs.
W.I.P.	- Opening		3,90,000
	- Closing		5,07,000
Raw Materials	- Purchases		12,10,000
	- Opening		3,02,000
	- Closing		3,10,000
	- Returned		18,000
	- Indirect material		16,000
Wages	- direct		2,10,000
	- indirect		48,000
Direct expenses		- Royalty on production	1,30,000
		- Repairs and maintenance	2,30,000
		- Depreciation on factory shed	40,000
		- Depreciation on plant & machinery	60,000
By-product at selling price			20,000

You are required to prepare Manufacturing Account of Mr. Pankaj for the year ended on 31.3.2009.

Solution

In the Books of Mr. Pankaj
Manufacturing Account
for the year ended on 31.3.2009

Dr. Particulars		Rs.	Amount Rs.		Particulars	Cr. Amount Rs.
To	Opening W.I.P.		3,90,000	By	Closing W-I-P	5,07,000
To	Raw Material Consumed:			By	By - products	20,000
	Opening Stock	3,02,000		By	Trading A/c-	17,81,000
	Purchases	12,10,000			Cost of finished goods transferred	
		15,12,000				
	Less: Return	18,000				
		14,94,000				
	Less: Closing Stock	3,10,000	11,84,000			
To	Direct Wages		2,10,000			
To	Direct expenses:					
	Royalty		1,30,000			
To	Manufacturing Overhead:					
	Indirect Material	16,000				
	Indirect Wages	48,000				
	Repairs & Maintenance	2,30,000				
	Depreciation on Factory Shed	40,000				
	Depreciation on Plant & Machinery	60,000	3,94,000			
			23,08,000			23,08,000

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

1. The balance of the petty cash is

   (a) an expense (b) an income (c) an asset (d) a liability

2. Fixed assets are

   (a) kept in the business for use over a long time for earning income

   (b) meant for resale

   (c) meant for conversion into cash as quickly as possible

   (d) All of the above

3. Goodwill is

   (a) a current asset (b) an intangible fixed asset

   (c) a tangible fixed asset (d) an investment.

4. Stock is

   (a) included in the category of fixed assets

   (b) an investment.

   (c) a part of current assets

   (d) an intangible fixed asset.

5. The manufacturing account is prepared:

   (a) to ascertain the profit or loss on the goods produced

   (b) to ascertain the cost of the manufactured goods

   (c) to show the sale proceeds from the goods produced during the year

   (d) both (b) and (c).

6. A new firm commenced business on 1st January, 2009 and purchased goods costing Rs. 90,000 during the year. A sum of Rs. 6,000 was spent on freight inwards. At the end of the year the cost of goods still unsold was Rs. 12,000. Sales during the year Rs. 1,20,000. What is the gross profit earned by the firm?

   (a) Rs. 36,000 (b) Rs. 30,000 (c) Rs. 42,000 (d) Rs. 38,000

7. From the following figures ascertain the gross profit:

	Rs.
Opening stock (1.1.2009)	25,000
Goods purchased during 2009	1,30,000
Freight and packing on above	5,000
Closing Stock (31.12.2009)	15,000
Sales	1,90,000
Selling expenses on sales	9,000

(a) Rs.36,000 (b) Rs. 45,000 (c) Rs. 50,000 (d) Rs.59,000

8. A prepayment of insurance premium will appear in the Balance Sheet and in the Insurance Account respectively as:

(a) a liability and a debit balance. (b) an asset and a debit balance.

(c) an asset and a credit balance. (d) None of the above

9. Under-statement of closing work in progress in the period will

(a) Understate cost of goods manufactured in that period.

(b) Overstate current assets.

(c) Overstate gross profit from sales in that period.

(d) Understate net income in that period.

10. If sales revenues are Rs. 4,00,000; cost of goods sold is Rs. 3,10,000 and operating expenses are Rs.60,000, the gross profit is

(a) Rs. 30,000. (b) Rs. 90,000. (c) Rs. 3,40,000. (d) Rs. 60,000

11. Sales is equal to

(a) Cost of goods sold – Gross profit. (b) Cost of goods sold + Gross profit.

(c) Gross profit – Cost of goods sold. (d) Cost of goods sold + Net profit.

12. A Company wishes to earn a 20% profit margin on selling price. Which of the following is the profit mark up on cost, which will achieve the required profit margin?

(a) 33% (b) 25% (c) 20% (d) None of the above

13. If sales is Rs. 2,000 and the rate of gross profit on cost of goods sold is 25%, then the cost of goods sold will be

(a) Rs. 2,000. (b) Rs. 1,500. (c) Rs. 1,600. (d) None of the above.

14. Sales for the year ended 31st March, 2009 amounted to Rs. 10,00,000. Sales included goods sold to Mr. A for Rs. 50,000 at a profit of 20% on cost. Such goods are still lying in the godown at the buyer's risk. Therefore, such goods should be treated as part of

(a) Sales. (b) Closing stock. (c) Goods in transit. (d) Sales return.

15. The capital of a sole trader would change as a result of:
    (a) a creditor being paid his account by cheque.
    (b) raw materials being purchased on credit.
    (c) fixed assets being purchased on credit.
    (d) wages being paid in cash.
16. Rent paid on 1st October, 2008 for the year to 30 September, 2009 was Rs. 1,200 and rent paid on 1st October, 2009 for the year to 30 September, 2010 was Rs. 1,600. Rent payable, as shown in the profit and loss account for the year ended 31 December 2009, would be:
    (a) Rs. 1,200. (b) Rs. 1,600. (c) Rs. 1,300. (d) Rs. 1,500.
17. A decrease in the provision for doubtful debts would result in:
    (a) an increase in liabilities. (b) a decrease in working capital.
    (c) a decrease in net profit. (d) an increase in net profit.

From the given information, choose the most appropriate answer for Questions 18, 19 & 20:

Sales Rs.	*Opening Stock Rs.*	*Purchases Rs.*	*Closing Stock Rs.*	*Cost of goods sold Rs.*	*Gross Profit Rs.*	*Selling Expenses Rs.*	*Net Profit Rs.*
15,000	6,000	10,000	?	9,000	?	4,000	?

18. The value of closing stock is
    (a) Rs. 9,000 (b) Rs.4,000 (c) Rs.8,000 (d) Rs. 7,000
19. Gross profit will be
    (a) Rs. 6,000 (b) Rs. 5,000 (c) Rs.8,000 (d) Rs. 7,000
20. Net profit will be
    (a) Rs. 6,000 (b) Rs. 5,000 (c) Rs. 2,000 (d) Rs. 7,000

From the given information, choose the most appropriate answer for Questions 21 and 22:

Opening Capital Rs.	*Investment By Proprietor Rs.*	*Drawings Rs.*	*Capital at the end of the year Rs.*	*Net Profit (Loss) Rs.*
16,000	Nil	3,000	13,500	?

21. The net profit will be
    (a) Rs. 600 (b) Rs. 500 (c) Rs. 550 (d) Rs. 700
22. If in the given information, Net Loss is Rs. 1,000, then the investment made by the proprietor during the year will be
    (a) Rs.1,500 (b) Rs. 2,000 (c) Rs. 1,200 (d) Rs. 1,700

From the given information, choose the most appropriate answer for Questions 23 and 24:

	Rs.		Rs.
Opening Stock	20,000	Carriage on sales	3,000
Closing Stock	18,000	Rent of Office	5,000
Purchases	85,800	Sales	1,40,700
Carriage on purchases	2,300		

23. Gross profit will be

    (a) Rs. 50,000 (b) Rs. 47,600 (c) Rs. 42,600 (d) Rs. 50,600

24. Net profit will be

    (a) Rs. 42,600 (b) Rs. 50,600 (c) Rs. 45,600 (d) Rs. 47,600

From the given information, choose the most appropriate answer for Questions 25 and 26:

The Zed Company, a whole seller estimates the following sales for the indicated months:

	June 2009 Rs.	July 2009 Rs.	August 2009 Rs.
Opening stock	4,08,000	4,34,400	4,60,800
Credit Sales	15,00,000	16,00,000	17,00,000
Cash Sales	2,00,000	2,10,000	2,20,000
Total Sales	17,00,000	18,10,000	19,20,000

Selling price is 125% of the purchase price.

25. The cost of goods sold for the month of June, 2009 is:

    (a) Rs. 15,20,000 (b) Rs. 14,02,500 (c) Rs. 12,75,000 (d) Rs. 13,60,000

26. Stock purchased in July, 2006 is :

    (a) Rs. 16,05,000 (b) Rs. 14,74,400 (c) Rs. 14,40,000 (d) Rs. 13,82,500

Considering the following information answer the Questions 27, 28 and 29 given below:

	1st January *Rs.*	*31st December* *Rs.*
Stock of raw materials	17,400	18,100
Work-in-progress	11,200	11,400
Stock of finished goods	41,500	40,700

During the year manufacturing overhead expenses amounted Rs. 61,100, manufacturing wages Rs. 40,400 and purchase of raw materials Rs. 91,900. There were no other direct expenses.

27. The cost of raw materials consumed, issued and used were:
    (a) Rs. 1,09,300 (b) Rs. 91,200 (c) Rs. 91,900 (d) Rs. 92,600.
28. The manufacturing cost of finished goods produced were:
    (a) Rs. 1,31,600 (b) Rs. 1,93,300 (c) Rs. 1,91,900 (d) Rs. 1,92,500.
29. The manufacturing cost of finished goods sold was:
    (a) Rs. 1,91,700 (b) Rs. 1,92,500 (c) Rs. 1,94,000 (d) Rs. 1,93,300.
30. Capital is the difference between
    (a) Income and expenses
    (b) Sales and Cost of goods sold
    (c) Assets and liabilities
    (d) None of the above

ANSWERS

1.	(c)	2.	(a)	3.	(b)	4.	(c)	5.	(b)	6.	(a)	7.	(b)
8.	(c)	9.	(d)	10.	(b)	11.	(b)	12.	(b)	13.	(c)	14.	(a)
15.	(d)	16.	(c)	17.	(d)	18.	(d)	19.	(a)	20.	(c)	21.	(b)
22.	(a)	23.	(d)	24.	(a)	25.	(d)	26.	(b)	27.	(b)	28.	(d)
29.	(d)	30.	(c)										