

Preparation of Final Accounts with Adjustments

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5.1 MEANING OF FINAL ACCOUNTS

The term 'Final Accounts' is a broader term. The three following financial statements are prepared for the preparation of final accounts:

- (i) **Trading account:** It shows gross profit/loss of the business.
- (ii) **Profit & loss account:** It shows the net profit/loss of the business.
- (iii) **Balance sheet:** It shows the financial position of the business.

Out of the above three statements, trading, profit & loss accounts are prepared, together, and balance sheet is prepared, independently. Here, it is very necessary to remember that these accounts are not prepared in the ledger rather than on the plain sheets or papers. These papers are filed for future reference.

The method of preparing these accounts is different from other accounts like personal, real, nominal accounts.

5.2 WHY THIS NAME – FINAL ACCOUNTS?

As stated above, the term 'final accounts' refer to trading account, profit & loss account and balance sheet. Balance sheet is a statement but even then it is included in final accounts. Now, here the question arises that why they are named final accounts?

Every businessman is, ultimately, interested to know the final result of the business. These are called final accounts because they are the last accounts, prepared at the end of the year. They serve the ultimate purpose of keeping accounts. Their purpose is to analyze the effect of various incomes and expenses during the year and the resultant profit or loss.

Trading, profit & loss account and balance sheet, all these three together, are called as final accounts. Final result of trading is known through Profit and Loss Account. Financial position is reflected by Balance Sheet. These are, usually, prepared at the close of the year hence known as final accounts.

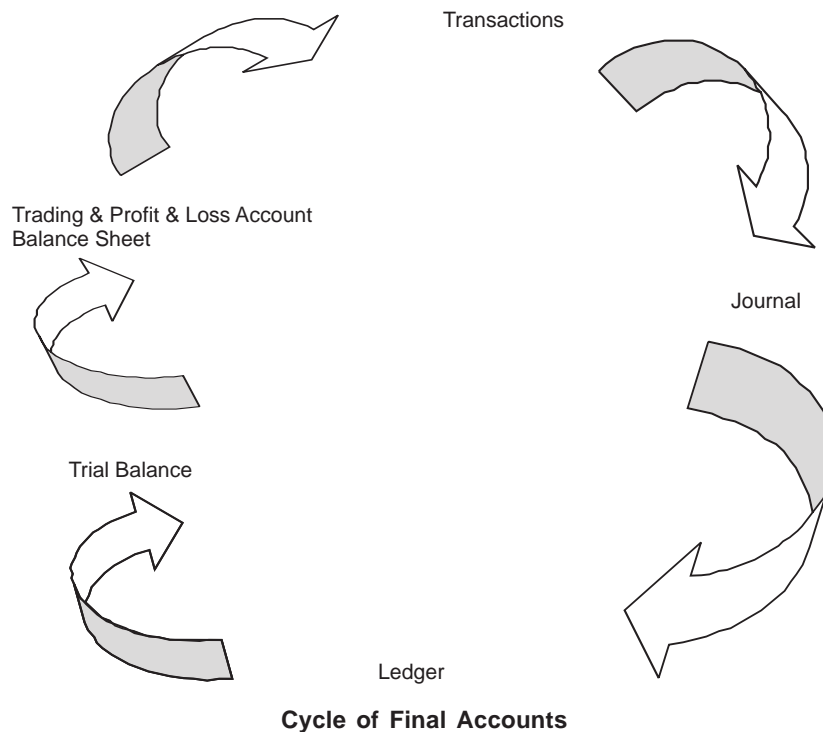
5.3 PREPARATION OF FINAL ACCOUNTS

Final balances of all the accounts in the ledger are transferred to trial balance. From trial balance, expenses and income accounts are transferred to trading account and profit and loss account.

Accounts, with balances, which are to be carried forward to the next year, are shown in the balance sheet. The balance sheet constitutes the final stage of accounting.

Final accounts have to be prepared, every year, in every business. Trading and profit & loss accounts are prepared, after all the accounts have been completely written and trial balance is extracted. Before preparing final accounts, it becomes necessary to examine whether all the expenses and incomes for the year for which accounts are prepared have been duly provided for and included in the accounts. Circumstances and items are common where adjustments, at the end of the accounting period, are to be made. In such items, no cash is involved hence no record has been kept till year-end.

Form of Final Accounts: There is a standard format of final accounts only in the case of a limited company. There is no fixed prescribed format of financial accounts in the case of a proprietary concern and partnership firm.



5.4 MEANING AND NEED OF ADJUSTMENT ENTRIES

Sometimes, it is seen that after preparation of trial balance, but, prior to preparation of final accounts, it may be noticed some business transactions have been, completely or partially, omitted to be recorded or entered wrong. Besides this, there are some incomes or expenses, which are

related to the next year but have been received or paid during the current year. Before preparing trading and profit & loss accounts, adjustment entries are necessary in these accounts.

Transactions omitted relate to the current year must be entered in books. If a transaction entered is not related to the current year, fully or partly, that portion of income or expense must be excluded. This process is made through adjustment entries in the books of accounts. If we ignore to make the necessary adjustments, the trading, profit & loss accounts do not show the true profit or loss and in consequence balance sheet fails to depict true financial position of the business. This situation defeats the very purpose of final accounts. Hence, adjustment entries play an important role in presenting correct picture of accounts.

5.5 ADJUSTMENTS IN FINAL ACCOUNTS

Final Accounts are prepared, normally, for a complete period. It must be kept in mind that expenses and incomes for the relevant accounting period are to be taken, while preparing final accounts. If an expense has been incurred but not paid during the period, a liability for the unpaid amount should be created, before finding out the operating result and financial position of a concern. In order to prepare the final accounts on mercantile system of accounting, all expenses and incomes relating to the period, whether incurred or not, received or not, should be brought into the books. For doing this, a concern is required to pass certain entries at the end of the year to adjust the various items of incomes and expenses. Such entries are called adjusting entries.

Accounting Treatment: Trading and Profit and Loss and Balance sheet, together, are called as final accounts. Item appearing in the trial balance appears only once in final accounts, either on the debit or credit. Any adjustment entry requires two postings, debit and credit for the same amount. Important point is students should do the posting (debit and credit) in the concerned accounts, simultaneously. Care is to be exercised that the amount is the same for the total debit and credit.

The following are the important adjustments, which are, normally made at the end of accounting period.

5.5.1 Closing Stock

Every concern prepares a list of unsold goods at the end of the period and puts value against it. It is to be remembered that stock is valued at cost or market price, whichever is less.

Closing Stock appears below the Trial Balance as an adjustment entry: Normally, closing stock appears as an adjustment entry in the problem and is given at the end of the trial balance. For example, if the value of stock at the end of the period is Rs. 30,000 and is shown below the trial balance, then the following adjusting entry will be passed:

Closing Stock A/c ... Dr	30,000	
To Trading Account		30,000

The two-fold effect of this entry will be:

- (i) Stock will have a debit balance. Being a real account, it will be shown on the assets side of the Balance Sheet.
- (ii) Closing stock will be shown on the credit side of the Trading Account.

Dr.		Trading Account for the year ending...		Cr.	
Particulars	Amt.	Particulars	Amt.		
		By closing stock	30,000		

BALANCE SHEET as on

Liabilities	Amt.	Assets	Amt.
		Closing stock	30,000

Closing Stock appearing in Trial Balance: Sometimes, opening and closing stock are adjusted through purchases. In this case, closing stock (debit balance) appears in the Trial Balance. Closing stock, under this case, will not be shown on the credit side of the Trading Account but will be shown on the assets side of the Balance Sheet only. Remember, any entry appearing in the Trial Balance appears only once either on the debit side or credit side, depending on the nature of the transaction. Closing stock is a real account, hence appears on the assets side of the balance sheet.

5.5.2 Outstanding Expenses

There are certain expenses, which have been incurred but not paid. These expenses are called outstanding expenses. For example, salary to the clerk Rs. 10,000 is due for the month of December. Books are closed at the end of December. In order to bring this transaction into accounts, the following adjustment entry will be passed:

Salary Account .....Dr.	Rs. 10,000	
To Outstanding Salary A/c.		Rs. 10,000

The two fold effect of this entry will be:

- (i) Outstanding salary will be added to salary, if any, on the debit side of Profit & Loss Account.
- (ii) Outstanding Salary Account, being personal and having credit balance, will be shown on the liabilities side of the Balance Sheet.

Dr.		PROFIT & LOSS Account for the year ending...		Cr.	
Particulars	Amt.	Particulars	Amt.		
To Salary Account	10,000				

BALANCE SHEET as on ...

Liabilities	Amt.	Assets	Amt.
Outstanding Salary	10,000		

5.5.3 Prepaid or Unexpired Expenses

Those expenses which have been paid, in full, but their utility or benefit has not expired during the accounting period are called prepaid or unexpired expenses. In other words, amount has been paid even for the period subsequent to the balance sheet date. For example, annual premium Rs. 12,000 is paid on 1st July, where accounting year closes on 31st December. Rs. 6000 will be insurance paid in advance. To bring this into account, the following adjusting entry will be passed:

Prepaid Insurance Premium Account.....Dr.	Rs. 6,000	
To Insurance Premium		Rs. 6,000

The double effect of this adjusting entry will be:

- (i) Prepaid insurance will be deducted from the insurance premium on the debit side of the Profit & Loss Account.
- (ii) Prepaid insurance, being personal account and having debit balance, will be shown on the assets side of the Balance Sheet.

Dr. PROFIT & LOSS Account for the year ending... Cr.

Particulars	Amt.	Particulars	Amt.
To Insurance Premium	12,000		
Less Prepaid Insurance Premium	<u>6,000</u>		

BALANCE SHEET as on

Liabilities	Amt.	Assets	Amt.
		Prepaid Insurance	6,000

5.5.4 Accrued Income

Income earned but not received during the accounting period is called accrued Income.

Suppose, the interest on investments shown in the trial balance is Rs. 19,500.

The adjustment may run like this. Interest @10% is due on investments of Rs. 10,000 for 6 months, though accrued, has not been yet been received.

This interest Rs. 500 will be accrued income. In order to bring this into account, the following adjusting entry will be passed:

Accrued Interest on Investments AccountDr. Rs. 500

To Interest on Investment Account Rs. 500

The two fold effect of this entry will be:

- (i) Interest on Investment account (accrued interest) will be added to the interest account on the credit side of the profit & loss account.
- (ii) Accrued interest, being personal account and having debit balance, will be shown on the debit side of the Balance Sheet.

Dr. PROFIT & LOSS Account for the year ending... Cr.

Particulars	Amt.	Particulars	Amt.
		By Interest	19,500
		Add Interest accrued	<u>500</u>
			20,000

BALANCE SHEET as on

Liabilities	Amt.	Assets	Amt.
		Accrued Interest on Investments	500

Illustration No. 1

On the 1st January, 2008 Nilesh lent Rs 5,000 @ 6% per annum. Interest is receivable on 31st December each year. The accounts are closed on 30th June each year.

Give journal entries on 30th June, 2008 and 1st July, 2008 and show the ledger, profit & loss account and balance sheet 30th June, 2008.

Solution:

Date	Particulars	L.F.	Dr. Amt.	Cr. Amt.
2008 June 30	Accrued interest a/c Dr. To interest a/c (interest for 6 months accrued but not received)		Rs. 150	Rs. 150
2008 July 1	Interest a/c Dr. To accrued interest a/c (transfer of accrued interest to interest account)		150	150

Ledger

Dr. Interest account Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2008 June 30	To profit & loss a/c	Rs. <u>150</u>	2008 June 30	By accrued interest a/c	Rs. <u>150</u>

Dr.		Accrued Interest account		Cr.	
Date	Particulars	Amount	Date	Particulars	Amount
2008 June 30	To interest a/c	Rs. <u>150</u>	2008 June 30	By balance c/d	Rs. <u>150</u>
2008 July 1	To balanced b/d	150	2008 July 1	By interest a/c	150

Profit & Loss Account for the year ending 30th June, 2008

Particulars	Amount Rs.	Particulars	Amount Rs.
		By interest a/c	150

Balance Sheet as on 30-6-08

Liabilities	Amount Rs.	Assets	Amount Rs.
		Accrued interest	150

5.5.5 Unearned Income or Income Received in Advance

Sometimes, the amount received in respect of an income during the year pertains, partially, to the next year. Suppose a landlord collects rent for one quarter, in advance, and closes his account on 30th June each year. Suppose, a tenant has occupied a house on 1st June and pays Rs. 1,800 as rent for 3 months. The landlord must not treat the whole of the rent received as income for the current year. Two months' rent pertains to the next year and should be credited to the Profit and Loss Account of next year. This will ensure that the income for the current year is not overstated. The required entry is:

Rent Account	....Dr.	Rs. 1,200	
To Rent Received in Advance Account			Rs. 1,200

In the Profit and Loss Account and the Balance Sheet, the item will be shown as indicated below:

Dr.		PROFIT & LOSS Account for the year ending...		Cr.	
Particulars	Amt.	Particulars	Amt.	Particulars	Amt.
		By Rent	1,800		600
		Less: Received in advance	<u>1,200</u>		

BALANCE SHEET as on

Liabilities	Amt.	Assets	Amt.
Rent Received in advance	1,200		

The Rent Received in Advance Account will be transferred to the Rent Account in the next year.

This principle should be applied to all incomes, which pertain wholly, or partially to the next year. Other examples can be the fees received from students, before the summer vacation or subscription received in respect of a magazine. The fees applicable to the period after the close of the accounting year or the subscription for copies, to be supplied after the end of the year, should be credited to unearned income account by debit to the account of the students' fees or the subscription. This will ensure that the income for the current year is not overstated.

5.5.6 Depreciation

The value of fixed assets goes on reducing year by year because of wear, tear and efflux of time. This fall in the value should be treated as a loss or expense, to be considered before profit or loss is ascertained. The value to be shown in the Balance Sheet must also be, suitably, reduced. To continue to show it at the old figure will be overstating the assets. Depreciation is usually computed on the basis of the life of the assets. Suppose, a machine costs Rs. 1,00,000 and has a life of 5 years. Then, each year $1/5^{\text{th}}$ of the cost, i.e., Rs. 20,000 should be treated as an expense; only the remaining amount is to be shown in the balance sheet. The entry is:

Depreciation Account	...Dr. 20,000
To Machinery Account	20,000

Depreciation is debited to the Profit & Loss Account. In the final accounts, the item will figure as shown below:

Dr.	PROFIT & LOSS Account for the year ending ..		Cr.
Particulars	Amt.	Particulars	Amt.
To Depreciation	20,000		

BALANCE SHEET as on

Liabilities	Amt.	Assets	Amt.
		Machinery	1,00,000
		Less: Depreciation	<u>20,000</u>
			80,000

Depreciation appearing in Trial Balance: In this case, depreciation entry has, already, been passed, before preparation of the trial balance. In that case only, the Depreciation Account will figure in the trial balance itself. The concerned asset will appear at its reduced value since the amount of the depreciation would have been credited to it. In such a case, no further adjustment will be necessary; the Depreciation Account will be transferred to the debit of the Profit & Loss Account like other expenses.

Again, it is reminded if any entry appears in the trial balance, only once it appears in the financial statements. Here, it appears in profit & loss account. Only Adjustment involves two entries.

Pro rata depreciation: While computing depreciation, the period for which the asset is used should be kept in mind. Suppose, a machine is purchased on 1st January, 2008 for Rs. 10,000 and another machine is purchased on 30th June, 2008 for Rs. 6,000; the rate of depreciation is 10%. Accounts are closed at the end of the calendar year. The depreciation for 2008 will be Rs. 1,300 as shown below:

	Rs.
On Rs. 10,000 for one year @10%	1,000
On Rs. 6,000 for six months @10%	300
	1,300

Treatment in case of Loose Tools: In some cases like loose tools, depreciation is arrived at by comparing the value on two dates. Suppose loose tools were valued at Rs. 2,300 on 1st January, 2008 and at Rs. 2,100 on 31st December, 2008, the depreciation will be Rs. 200.

5.5.7 Interest on Capital

The proprietor may wish to ascertain his profit, after considering the interest for the amount invested in the firm. Suppose, the capital is Rs. 2,00,000 and the rate of interest is 5%. Then, the interest will be Rs. 10,000. It will be treated like other expenses and debited to the Profit and Loss Account; the amount will also be credited to the Capital Account. The entry is:

Interest on Capital Account	...Dr.	10,000	
To Capital Account			10,000

In the final statements of account, the item will appear as shown below:

Dr.	PROFIT & LOSS Account for the period ending...	Cr.	
Particulars	Amt.	Particulars	Amt.
To Interest on Capital	10,000		

BALANCE SHEET as on...

Liabilities		Amt.	Assets		Amt.
Capital	2,00,000	2,10,000			
Add: Interest on capital	<u>10,000</u>				

5.5.8 Interest on Drawings

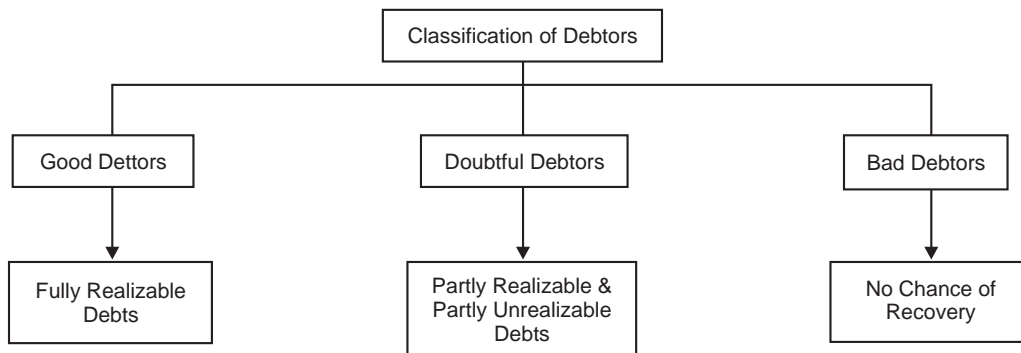
The proprietor may also realize that when he draws money for private use, the firm loses interest as funds for business are reduced. Therefore, the proprietor's capital may be debited with the interest on the money drawn by him. Interest will depend on the amount and the date of

BALANCE SHEET as on...

Liabilities	Amt.	Assets	Amt.
Loan	2,00,000		
Outstanding Interest	2,400		

5.5.10 Classification of Debtors

Once goods are sold on credit, debtors appear in accounts. In place of debtors, bills receivable may also appear. Debtors and bills receivable represent the amounts to be received by the firm for the credit sales made. All debtors and bills receivable may not be realizable. Where recovery is impossible, those amounts are to be written off as bad debts. Against likely bad debts, provision is required to be made. Both bad debts and provision for bad debts reduce the profits of the firm.

**5.5.11 Bad Debts**

Credit sales have become a must these days and bad debts occur, when there are credit sales. Bad Debt is a loss to the business and a gain to the debtor. The following journal entry should, therefore, be passed in the event of a debt becoming bad.

Bad Debts A/c	Dr.
To Debtor's Personal A/c	

Illustration No. 2

Kalyan & Co. has been running its cloth business. At the end of Dec. 2008, the firm's books of accounts show the debtors at Rs. 4,00,000. Out of those debtors, Rs. 20,000 have been recognized as bad debts as those debtors have become insolvent.

Show the position in the financial statements.

PROFIT & LOSS ACCOUNT
for the year ending 31st December, 2008

Particulars	Amount Rs.	Particulars	Amount Rs.
To Bad Debts (as given in the Trial Balance)	5,000		
Add: Additional bad debts	<u>2,500</u>		
	7,500		

BALANCE SHEET
as on 31st December, 2008

Liabilities	Amount Rs.	Assets	Amount Rs.
		Sundry Debtors	50,000
		Less: Bad Debts	<u>2,500</u>
			47,500

Note: Bad debts, appearing in Trial Balance, have already been provided for. Now, the adjustment relates to additional bad debts for the amount appearing in sundry debtors.

5.5.12 Provision for Bad and Doubtful Debts

Prudent accounting principle is to make provision for expected losses and not to take credit for expected profits.

All credit sales would not be realized in the year in which the sales are made. Sales may be made in one year and actual realizations may happen in the succeeding year. A firm, therefore, makes provision at the end of the accounting year, for likely bad debts, which may happen during the course of the next year. The simple reason is all collections do not occur in the same year in which sales are made. Some sales are likely to become bad in the course of the next year. So, the proper course would be to charge such likely bad debts in that accounting year in which sales have been made, since, the profit on such sales has been considered in the year in which the sales have been made.

The following journal entry is passed for creating a provision for bad debts.

Profit & Loss A/c	Dr.
To Provision for Bad and Doubtful Debts	

The provision for bad debts is charged to the Profit & Loss Account and is deducted from debtors in the Balance Sheet.

Calculation of Provision for Bad and Doubtful Debts: Normally, problem states the % of Provision for Bad and Doubtful Debts. On which amount of debtors, this % of Provision for Bad and Doubtful Debts is to be calculated?

- From debtors, first deduct total bad debts from debtors. Bad debts are that amount, appearing in the trial balance and any further provision that may be required in the adjustment for bad debts.
- On the balance amount of debtors only, Provision for Bad and Doubtful Debts is to be calculated. Reason is simple. Once, debt becomes bad, it would be written off. So, bad debts amount is already excluded from debtors. The balance amount of debtors is only good debts, expected to be realized. Even this amount may not be totally recoverable and for this reason only, Provision for Bad and Doubtful Debts would be created.

Provision for Bad and Doubtful Debts is to be calculated on that amount of debtors, after deducting bad debts. Provision for Bad and Doubtful Debts is not to be calculated on the total amount of debtors.

Illustration No. 4

Following are the extracts from the Trial Balance of a firm.

TRIAL BALANCE as on 31st December, 2008

Particulars	Rs.	Rs.
Sundry Debtors	30,000	
Bad Debts	5,000	

Additional Information:

- (i) After preparing the Trial Balance, it is learnt that a debtor, Talwar has become insolvent and therefore, the entire amount of Rs 3,000 due from him was irrecoverable.
- (ii) Create 10% provision for bad and doubtful debts.

You are required to pass necessary adjusting entries and show how the items will appear in the firm's Balance Sheet.

Solution:

ADJUSTING JOURNAL ENTRIES

Date	Particulars	Dr. Amount Rs.	Cr. Amount Rs.
	Bad Debts A/c Dr. To Talwar (Being amount due from Talwar proved to be bad)	3,000	3,000
	Profit & Loss A/c Dr. To Provision for Bad and Doubtful Debts (Being bad debts provision created)	2,700	2,700

PROFIT AND LOSS ACCOUNT
for the year ending 31st December, 2008

Particulars		Amount Rs.	Particulars	Amount Rs.
To Bad Debts (as given in the Trial Balance)	5,000			
Add: Additional bad Debts	<u>3,000</u>	8,000		
Provision for bad and Doubtful debts		2,700		

BALANCE SHEET
as on 31st December, 2008

Liabilities	Amount Rs.	Assets	Amount Rs.
		Sundry Debtors	30,000
		Less: Additional bad debts	<u>3,000</u>
			27,000
		Less: Provision for bad debts	<u>2,700</u>
			24,300

The provision for bad debts created at the end of the accounting year is carried forward to the next year. At the end of the next year, suitable adjusting entry is passed for keeping the provision for doubtful debts at an appropriate amount to be carried forward.

Illustration No. 5

Kishore & co. has been a running garment business. At the end of Dec, 2007, the firm's books of accounts show the debtors at Rs. 3,00,000. Out of those debtors, Rs. 10,00 are not traceable and to be treated as bad debts. By practice, over the years, it has been noticed that the business loses money even on the expected realizations from the good debtors too. The business adopts a consistent policy of making a provision of 5% on the expected good debtors towards bad and doubtful debts.

Show the position in the financial statements.

Solution:

Dr.		PROFIT & LOSS Account for the period ending...		Cr.	
Particulars	Amt.	Particulars	Amt.		
To Bad debts	10,000				
To Provision for Bad and Doubtful debts	14,500				

BALANCE SHEET as on...

Liabilities	Amt.	Assets	Amt.
		Sundry debtors	3,00,000
		Bad debts	<u>10,000</u>
			2,90,000
		Provision for Bad and Doubtful debts	<u>14,500</u>
			2,75,500

Note: Provision for Bad and doubtful debts is to be made on Rs. 2,90,000 but not on Rs. 3,00,000 as Rs. 10,000 has already, been removed as bad debt from sundry debtors. Chance of becoming bad is on the balance amount only i.e. Rs. 2,90,000.

Presentation in Accounts for Bad Debts & Provision for Bad and Doubtful Debts:

Students, in particular non-commerce people, often experience difficulty when both bad debts and provision for bad doubtful debts are to be made, in particular, when the trial balance is already showing the provision for bad and doubtful debts.

Trial balance is showing the provision for bad and doubtful debts. So, this was the balance for bad and doubtful debts at the end of the last year, which has been carried forward.

Follow the simple approach:

- Show bad debts and provision for bad and doubtful debts, separately, in Profit and Loss Account. Do not club them up.

Presentation in Profit & Loss account:

- If the current year's provision for bad and doubtful debts, required to be made, is more than the provision for bad and doubtful debts shown in the trial balance, show the additional provision on the debit side of the profit and loss account as this is an additional expense.
- Is the current year's provision for bad and doubtful debts, required to be maintained at the end of the year, is less than the provision for bad and doubtful debts shown in the trial balance? Show the excess provision (Last year's provision in shown Trial Balance – provision required to be maintained in current year) on the credit side of the profit and loss account. This is an income, as the earlier estimated expense is no longer needed to be continued.

Presentation in Balance Sheet:

- Deduct first provision for bad debts and later provision for bad and doubtful debts, required to be maintained at the end of the year, from the debtors in the balance sheet.

The following problem explains the treatment of higher provision for bad and doubtful debts:

Illustration No. 6

At the end of the year 2008, Radhi & Co. has observed that their the debtors are Rs. 5,00,000. Out of those debtors, Rs. 5,000 are not traceable and to be treated as bad debts. By practice, over the years, it has been noticed that the business loses money on the expected realizations from the good debtors too. The business adopts a consistent policy of making a provision of 5% on the expected good debtors. Provision for bad and doubtful debts stand at Rs. 14,500 at the end of Dec, 2007.

Show the position in the financial statements.

Solution:

Dr.		PROFIT & LOSS Account for the period ending...		Cr.	
Particulars		Amt.	Particulars	Amt.	
To Bad debts		5,000			
To Provision for bad & doubtful debts (required)	24,750	10,250			
Less Existing Provision for bad & doubtful debts	<u>14,500</u>				

BALANCE SHEET as on.....

Liabilities	Amt.	Assets	Amt.
		Sundry debtors	5,00,000
		Bad debts	<u>5,000</u>
			4,95,000
		Provision for bad & doubtful debts	<u>24,750</u>
			<u>4,70,250</u>

The following illustration shows the presentation when provision for bad debts, now, needed is lower than the existing provision in the trial balance:

Illustration No. 7

At the end of the year 2008, Dimpy & Co. has observed that their the debtors are Rs. 2,00,000. Out of those debtors, Rs. 3,000 are to be treated as bad debts. Provision for bad & doubtful debts Rs. 4,000 is needed at the end of Dec, 2008.

Provision for bad & doubtful debts stand at Rs. 10,500 at the end of Dec, 2007.

Show the position in the financial statements.

Solution:

Dr.		PROFIT & LOSS Account for the period ending...		Cr.	
Particulars	Amt.	Particulars	Amt.		
To Bad debts	3,000	By Existing Provision for Bad debt & Doubtful debts	10,500		
		Less Provision required for Bad debt & Doubtful debts	<u>4,000</u>		
				6,500	

Dr.		PROFIT & LOSS Account for the period ending..		Cr.	
Particulars	Amt.	Particulars	Amt.		
To Loss of goods by Fire Account	15,000				

BALANCE SHEET of Sundaram & Co as on...

Liabilities	Amt.	Assets	Amt.
		Oriental Fire Insurance Company (Fire insurance policy amount receivable)	35,000

Note: Out of a loss of Rs. 50,000, Oriental Fire insurance company has admitted the claim for Rs. 35,000. Sundaram & Co. can recover Rs. 35,000 only from the Oriental Fire insurance company. Hence, the net loss due to fire accident Rs. 15,000 has been written off to Profit and Loss Account.

5.5.14 Commission Payable on Net Profits

Sometimes, Company may provide an incentive to the manager in the form of commission on profits to improve profitability of the company. Suppose the profit earned by the firm is Rs. 80,000, without considering the commission; commission is 5%. The commission will be then Rs. 4,000. The profit will be reduced to Rs. 76,000. The entry to be passed will be to debit the Profit and Loss Account and credit the Commission Payable Account. This account will be a liability and shown in the balance sheet.

Sometimes, commission may be on the net profits of the company. If the rate of the commission is 5%, then the profit remaining after the commission should be Rs. 100. In such an event, the profit before the commission should be Rs. 105. In other words, commission is Rs. 5 out of every Rs. 105 profit, before the commission.

The formula to calculate the commission in such a situation is: $5/105 \times \text{Profits before the commission}$.

Illustration No. 9

Kalyan & Co. agrees to pay a commission 5% on net profits to its manager. The profit before commission is Rs. 80,000. The commission has not yet been paid by the company to its manager.

Show the necessary entries in the financial Statements.

Dr.		PROFIT & LOSS Account for the period ending...		Cr.	
Particulars	Amt.	Particulars	Amt.		
To commission to the Manager	3,810				
To Net Profit	76,190				

BALANCE SHEET as on

Liabilities	Amt.	Assets	Amt.
Outstanding commission to the Manager	3,810		

Note: The manager is entitled to a commission of 5% on net profits. So, before deducting commission, profits should be Rs. 105 to enable him to get a commission of Rs. 5. The commission will be Rs. 3,810, i.e., $\text{Rs. } 80,000 \times 5/105$. The profit after the commission is Rs. 76,190 and Rs. 3,810 is 5% of this figure.

If the commission is calculated, directly, on Rs. 80,000, it will be wrong as the remaining profit would be Rs. 76,000 and 5% of Rs. 76,000 is not Rs. 4,000.

5.6 CLOSING ENTRIES

‘Closing Entries’ are essential to ascertain the correct operating results. Accounts relating to expenses and incomes are to be closed to find out the operating profit. So, balances in the expenses and income accounts have to be transferred to Trading and Profit and Loss Accounts. Process of closing expenses and income accounts is done through closing entries.

5.7 MY BALANCE SHEET NOT TALLIED

‘My balance sheet is not tallied, though I have made all the adjustment entries, correctly’ –this is the common statement often heard from the students, coming out of the examination hall.

Follow the following to tips to avoid this situation:

- Entry appearing in Trial balance finds place at one place only, debit or credit.
- Give a special identification (giving reference to the adjustment number in the problem), while reading the trial balance, against the entry, which requires adjustment. You would not forget to do the adjustment as the symbol reminds you to do adjustment! This is ‘Time Management’ too.
- All adjustment entries have to be made at two places for the same amount. Students think that they can make entries at their convenience. This is a wrong approach. Once you debit, make credit for the same amount, simultaneously. Students know the adjustment entry, yet they do not make both the adjustments (changes) at the same time.
- After making the adjustment, before you move to the next entry, check, again, that adjustment has been done at both the places for the same amount.
- Do not forget to check that the debit amount and credit amount are the same.
- Once you follow meticulously, your balance sheet would always tally.

Illustration No. 10

From the following Trial Balance and additional information, you are required to prepare profit and loss account and balance sheet.

TRIAL BALANCE
as on 31st December, 2008

Particulars	Dr. Amount (Rs.)	Cr. Amount (Rs.)
Capital		20,000
Sundry Debtors	5,400	
Drawings	1,800	
Machinery	7,000	
Sundry Creditors		2,800
Wages	10,000	
Purchases	19,000	
Opening Stock	4,000	
Bank Balance	3,000	
Carriage Charges	300	
Salaries	400	
Rent and Taxes	900	
Sales		29,000
	51,800	51,800

Additional Information:

- (i) Closing Stock Rs. 1,200.
- (ii) Outstanding Rent and Taxes Rs. 100.
- (iii) Charge depreciation on machinery at 10%.
- (iv) Wages prepaid Rs. 400.

Solution:

TRADING AND PROFIT & LOSS ACCOUNT
for the year ending 31st December, 2008

Particulars	Amount Rs.	Particulars	Amount Rs.
To Opening Stock	4,000	By Sales	29,000
To Purchases	19,000	By Closing Stock	1,200
To Wages 10,000	9,600	By Gross Loss B/d	2,700
Less Prepaid Wages 400			
To Carriage	300		
	32,900		32,900

To Gross Loss b/d	2,700	By Net Loss transferred to Capital A/c	4,800
To Salaries	400		
To Rent and Taxes	900		
Add outstanding	<u>100</u>		
To Depreciation on Machinery	700		
	<u>4,800</u>		<u>4,800</u>

BALANCE SHEET
As on 31st December, 2008 (Rs.)

Liabilities		Amount	Assets		Amount
Outstanding Rent & Taxes		100	Cash at Bank		3,000
Creditors		2,800	Debtors		5,400
Capital	20,000		Closing Stock		1,200
Less: Net Loss	<u>4,800</u>		Prepaid Wages		400
	15,200		Machinery	7,000	6,300
Less: Drawings	<u>1,800</u>	13,400	Less Depreciation	<u>700</u>	
		<u>16,300</u>			<u>16,300</u>

Note: Carriage is treated as carriage inwards, hence shown in trading account.

Illustration No. 11

From the following balances of Shyam & Co., prepare trading and Profit & Loss Account for the year ended 31st Dec., 2008 and balance sheet on that date:

Debit Balances:

	Rs.		Rs.
Drawings	1,700	Rent	450
Plant & Machinery	12,000	Misc. Expenses	150
Horses & carts	2,600	Bad Debts	500
Debtors	3,600	Carriage inwards	160
Purchases	2,000	Credit Balances	
Wages	800	Creditors	2,000
Cash at Bank	2,600	Sales	4,200
Salaries	800	Interest	1,350
Repairs	190	Commission	1,600
Opening stock	1,600	Capital	20,000

Adjustments:

- (1) Closing stock Rs. 1,600
- (2) Depreciate plant & machinery 10%, horses & carts 15%.
- (3) Allowed interest on capital at 5%p.a.
- (4) Rs. 150 is due for wages.
- (5) Paid rent Rs. 150 in advance
- (6) Accrued interest Rs. 150.
- (7) Commission received in advance Rs. 200
- (8) Interest on drawings Rs. 100
- (9) Further bad debts Rs. 200

Solution:

TRADING and PROFIT & LOSS A/c SHYAM & Co.
For the year ended 31st December, 2008

Rs.

To opening stock	1,600	By sales	4,200
To purchases	2,000	By closing stock	1,600
To wages	800		
Outstanding wages	<u>150</u>		
To carriage inwardards	160		
To gross profit c/d	1,090		
	<u>5,800</u>		<u>5,800</u>
To salaries	800	By gross profit b/d	1,090
To repairs	190	By interest	1,350
To rent	450	Add: accrued	
To less paid in advance	<u>150</u>	Interest	<u>150</u>
	300		1,500
To Misc. expenses	150	By commission	1,600
To bad debts	500	Less received in	
Add : further		Advance	<u>200</u>
Bad debts	<u>200</u>		1,400
To interest on capital	1,000	By interests on drawings	100
To depreciation on plant	1,200	Net loss transferred to capital a/c	640
& machinery	1,590		
Houses & carts	<u>390</u>		
	<u>4,730</u>		<u>4,730</u>

BALANCE SHEET of Shyam & Co. as on 31st Dec., 2008

Liabilities		Amount	Assets		Amount
Creditors		2,000	Cash at bank		2,600
Outstanding wages		150	Stock		1,600
			Prepaid rent		150
Commission received in advance		200	Accrued interest		150
Capital	20,000		Debtors	3,600	
Add interest on			Less bad debts	<u>200</u>	3,400
Capital	<u>1,000</u>				
	21,000		Machinery	12,000	
			Less depreciation	<u>1,200</u>	10,800
Less			Houses & carts	2,600	2,210
Drawings	1,700		Less depreciation	<u>390</u>	
Interest on drawings	100				
net loss	<u>640</u>	18,560			
	<u>2,440</u>				
		<u>20,910</u>			<u>20,910</u>

Illustration No. 12

The Trial Balance of Srinivas stores appeared on 31st March 2008 as below.

Prepare Trading and Profit & Loss Accounts & Balance Sheet as on 31st March 2008.

Debit Balance:

Stock 1 st April, 2007	57,500	Interest on	1,500
Purchases	1,60,000	Mortgage	
Productive Wages	65,000	Cash in hand	250
Carriage	2,750	Cash at Bank	27,250
Discount	1,300	Building	40,000
Traveling Expenses	5,000	Machinery	15,000
Salaries	20,000	Horses & Carts	5,000
Insurance	1,500	Sundry Debtors	32,500
Commission	3,250	Credit Balance	
Rent & Rates	5,000	Sales	3,00,000
Stable Expenses	1,950	Interest on	30,500
Repairs	1,050	Mortgage	
Sundry Expenses	550	Capital	1,06,550
Sales Return	11,700	Sundry Creditors	21,000

Adjustments:

On 31st March, 2008, the Stock was valued at Rs. 60,750.

- (i) Rent & taxes Rs. 300 were paid in Advance.
- (ii) Depreciation is to be written off at 2.5% on Building, 5% on Machinery & 7.5% on Horse & Carts.

Provision is to be made for doubtful debts at 5% on debtors.

Solution:

Dr. Trading A/c and Profit/Loss A/c for the year ended 31st March 2008 Cr.

Particulars	Amounts	Particulars	Amounts
To opening stock	57,500	By Sales	3,00,000
To Purchases	1,60,000	Less: Sales Returns	11,700
To Productive Wages	65,000		2,88,300
To Carriage	2,750	By Closing Stock	60,750
To Gross Profit c/d (Transfer to Profit and Loss A/c)	63,800		
	<u>3,49,050</u>		<u>3,49,050</u>
To Traveling expenses	5,000	By Gross Profit b/d	63,800
To Salaries	20,000	By Interest on Mortgage	30,500
To Insurance	1,500		
To Commission	3,250		
To Rent & Rates	5,000		
() Advance	300		
To stable expenses	1,950		
To Repairs	1,050		
To Sundry expenses	550		
To Interest on Mortgage	1,500		
To Discount	1,300		
To Depreciation on			
Building	1,000		
Machinery	750		
Horses & Carts	375		
To Provision for Bad Debts	1,625		
To Net Profit (Transfer to Balance Sheet)	49,750		
	<u>94,300</u>		<u>94,300</u>

Balance Sheet as on 31st March 2008

Liabilities		Amount	Assets		Amount
Capital	1,06,550	1,56,300	Cash in Hand		250
(+) Net Profit	<u>49,750</u>		Cash at Bank		27,250
Sundry creditors			21,000	Building	40,000
			() Depreciation	<u>1,000</u>	39,000
			Machinery	15,000	
			() Depreciation	<u>750</u>	14,250
			Horses & carts	5,000	
			() Depreciation	<u>375</u>	4,625
			Sundry Debtors	32,500	
			() Provision for Bad Debts	<u>1,625</u>	30,875
			Closing Stock		60,750
			Advance Rent & Rates		300
		<u>1,77,300</u>			<u>1,77,300</u>

IMPORTANT TIP

Before solving the problem, students are advised to check the total of the trial balance and find out whether debits are equal to credits. Many a time, due to printing mistake or the problem is made deliberately so, there may be a difference in the trial balance. The difference may be shown in the Profit and Loss Account, with a note about the disagreement in trial balance.

This procedure would save precious time during the examination.

Illustration No. 13

Prepare Trading and Profit & Loss A/c for the year ended 31st March, 2007 and Balance Sheet of M/s. Varshney & Company as on that date from the following Trial Balance:

	Dr. (Rs.)	Cr. (Rs.)
Purchase	70,000	
Goods Returned		5,000
Carriage Inwards	1,500	
Salaries and Wages	14,000	
Rent, Rates and Taxes	2,800	
Insurance	500	
Discount	800	
Bank	13,700	
Plant and Machinery	12,000	

Investments	8,000	
Furniture and Fittings	5,000	
Bills Receivable	45,500	
Cash in hand	1,000	
Sundry Expenses	500	
Opening Stock	31,500	
Sales		1,10,000
Bills Payable		15,800
Capital Account		76,000
(Rs.)	2,06,800	2,06,800

Adjustments:

Provide outstanding salary Rs. 2,500/-

Make a provision for bad debts in bills receivable by Rs. 1,500/-

Closing stock Rs. 65,000/-

Stocks lost by fire were Rs. 7,000/-. However, insurance company settled the claim for Rs. 5,000/ and is still receivable.

Manager is entitled to commission @10% on net profits.

Solution:

TRADING and PROFIT & LOSS ACCOUNT of M/S. Varshney & Company.
for the year ending 31st March, 2007

Particulars		Amount	Particulars	Amount
To Opening Stock		31,500	By Sales	1,10,000
To Purchases	70,000		By Closing Stock	65,000
Less : Goods Returned	<u>5,000</u>	65,000	By Loss of Goods by Fire	7,000
To Carriage Inwards		1,500		
To Gross Profit c/d		84,000		
		<u>1,82,000</u>		<u>1,82,000</u>
To Salaries and Wages	14,000		By Gross Profit b/d	84,000
Add : Outstanding Wages	<u>2,500</u>	16,500		
To Rent, Rates and Taxes		2,800		
To Insurance		500		
To Discount		800		
To Sundry Expenses		500		

To Bad Debt in respect of Bills Receivable		1,500		
To Loss by Fire**		2,000		
To Commission to Manager*		5,400		
To Net Profit transferred to Capital A/c		54,000		
		<u>84,000</u>		<u>84,000</u>

**BALANCE SHEET of M/s. Varshney & Company
as on 31st March, 2007**

Liabilities		Amount	Assets		Amount
Bills Payable		15,800	Cash in hand		1,000
Capital	76,000		Bank		13,700
<i>Add : Net Profit</i>	<u>54,000</u>	1,30,000	Investments		8,000
Outstanding Salaries		2,500	Bills Receivable	45,500	
Outstanding Commission to Manager		5,400	<i>Less : Bad Debt</i>	<u>1,500</u>	44,000
			Closing Stock		65,000
			Plant and Machinery		12,000
			Furniture & Fittings		5,000
			Insurance Claim		5,000
		<u>1,53,700</u>			<u>1,53,700</u>

* Formula for calculating the commission is $\frac{10}{110} \times 59,400$.

** Out of goods lost by fire Rs. 7,000, claim admitted by insurance company is Rs. 5,000 hence loss by fire Rs. 2,000 is written off.

Illustration No. 14

From the following Trial Balance of M/s Sameer & Co., Bhopal, prepare a Trading and Profit & Loss Account for the year ending 31st March, 2007 and also a Balance Sheet as on the date:

	Dr. (Rs.)	Cr. (Rs.)
Capital Account		45,000
Drawings	3,250	
Land and Building	12,750	
Plant and Machinery	7,250	
Furniture and Fixtures	750	
Carriage	2,125	
Wages	10,750	
Salaries	2,350	
Bad Debts Reserve (1.4.2006)		1,250
Sales		47,500
Return Inwards	900	
Bank Charges	750	
Taxes	425	
Discount		60
Purchases	20,000	
Bills Receivable	750	
Debtors	18,900	
Creditors		6,125
Opening Stock	12,500	
Cash in hand	7,000	
Bank loan		515
	Rs. 1,00,450	1,00,450

Adjustments:

- (1) Closing Stock (31.3.2007) Rs. 3,625.
- (2) Provide 10% depreciation per annum on all types of fixed assets.
- (3) Allow interest on capital @ 5% per annum. No interest is to be charged on drawings.
- (4) Increase Bad Debt Reserve to Rs. 1,750.
- (5) Make a provision for Commission to General Manager on Gross Profit @ 2%.

Solution:

TRADING and PROFIT & LOSS ACCOUNT of M/s. Sameer & Co.
for the year ending 31st March, 2007

Particulars		Amount (Rs.)	Particulars		Amount (Rs.)
To Opening Stock		12,500	By Sales	47,500	
To Purchases		20,000	Less : Return Inwards	<u>900</u>	46,600
To Wages		10,750	By Closing Stock		3,625
To Carriage*		2,125			
To Gross Profit c/d		4,850			
	Rs.	<u>50,225</u>		Rs.	<u>50,225</u>
To Salaries		2,350	By Gross Profit b/d		4,850
To Bank Charges		750	By Discount		60
To Taxes		425	By Net Loss Transferred to Capital A/c		3,537
To Interest on Capital		2,250			
To Depreciation - Building	1,275	2,075			
- Plant and Machinery	725				
- Furniture	<u>75</u>				
To Bad Debts Reserve New	1,750				
Less : Old Reserve	<u>1,250</u>	500			
To Commission to General Manager (2% on Rs. 4,850)		97			
		<u>8,447</u>			<u>8,447</u>

BALANCE SHEET of M/s. Sameer & Co.
As on 31st March, 2007

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Sundry Creditors		6,125	Cash in hand		7,000
Bank Loan		515	Bills Receivable		750

Capital	45,000	40,463	Debtors	18,900	17,150
<i>Less : Net Loss</i>	<u>3,537</u>		<i>Less : Bad Debts</i>	<u>1,750</u>	
	41,463		Reserve		3,625
<i>Less : Drawings</i>	<u>3,250</u>		Closing Stock		
	38,213		Land and Building	12,750	11,475
<i>Add : Interest on Capital</i>	<u>2,250</u>		<i>Less :</i>	<u>1,275</u>	
			Depreciation		
Outstanding Commission to General Manager		97	Plant and Machinery	7,250	6,525
			<i>Less :</i>	<u>725</u>	
			Depreciation		
			Furniture	750	675
			<i>Less :</i>	<u>75</u>	
			Depreciation		
		<u>47,200</u>			<u>47,200</u>

Note:

- * Carriage is treated as carriage inwards, hence shown in trading accounts. If treated as carriage outwards, it has to appear in profit and loss account.

Illustration No. 15

The following is the Trial Balance of Theer and Tarkh & Co. on 31st December, 2008.

	Dr. Rs.	Cr. Rs.
Cash in Hand	540	
Cash at Bank	2,630	
Purchases Account	40,675	
Sales Account		98,780
Returns Inward Account	680	
Returns Outward Account		500
Wages Account	10,480	
Fuel & Power Account	4,730	
Carriage on Sales Account	3,200	
Carriage on Purchases Account	2,040	
Stock Account (1 st January 2008)	5,760	
Buildings Account	30,000	
Freehold Land Account	10,000	
Machinery Account	20,000	
Patents Account	7,500	

Salaries Account	15,000	
General Expenses Account	3,000	
Insurance Account	600	
Drawings Account	5,245	
Capital Account		71,000
Sundry Debtors Account	14,500	
Sundry Creditors Account		6,300
TOTAL	1,76,580	1,76,580

Taking into account the following adjustments, make the necessary Journal entries, including closing entries and prepare Trading and Profit and Loss Account and the Balance Sheet as on 31st December, 2008:

- Stock on hand on 31st December, 2008 is Rs. 6,800.
- Machinery is to be depreciated at the rate of 10% and Patents at the rate of 20%.
- Salaries for the month of December, 2008 amounting to Rs. 1,500 were unpaid.
- Insurance includes a premium of Rs. 170 per annum on a policy expiring on 30th June, 2009.
- Wages include a sum of Rs. 2,000 spent on the erection of a cycle shed for employees and customers.
- A provision for Bad and Doubtful Debts is to be created to the extent of 5 per cent on Sundry Debtors.

Solution:

JOURNAL

Adjustment Entries:

Date		Particulars	L.F.	Dr.	Cr.
				Amount	Amount
				Rs.	Rs.
Dec.	31	Stock Account Dr.		6,800	
2008		To Trading Account			6,800
		(Being the value of the closing stock.)			
„	„	Depreciation Account Dr.		3,500	
		To Machinery Account			2,000
		To Patents Account			1,500
		(Being the amount written off as depreciation on machinery (10% on Rs.20,000) and on patents (20% on Rs. 7,500)			

”	”	Salaries Account Dr. To Outstanding Salaries A/c (Being the amount still due on account of salaries.)	1,500	1,500
”	”	Insurance Prepaid Account Dr. To Insurance Account (Being half the premium on a policy which will expire on 30 th June, 2009, i.e., 6 months after the closing date)	85	85
”	”	Building Account Dr. To Wages Account (Being the wages spent on erection of a cycle shed transferred to Buildings Account)	2,000	2,000
”	”	Profit and Loss Account Dr. To Provision for Bad & Doubtful Debts Account (Being the Provision required to be maintained in respect of anticipated bad & doubtful debts)	725	725
”	”	Closing Entries: Trading Account Dr. To Stock Account To Purchases Account To Wages Account..... To Fuel & Power Account To Carriage on Purchases A/c To Returns Inward Account [Being the various accounts transferred to the Trading Account]	62,365	5,760 40,675 8,480 4,730 2,040 680
”	”	Sales Account Dr. Returns Outward Account Dr. To Trading Account ---- (Being the accounts transferred to the Trading Account.)	98,780 500	99,280
”	”	Trading Account Dr. To Profit & Loss Account (Being the transfer of gross profit.)	43,715	43,715
”	”	Profit & Loss Account Dr. To Carriage on Sales Account To Salaries Account To General Expenses Account To Insurance Account To Depreciation Account (Being the various expenses transferred to the debit of the Profit and Loss Account.)	26,715	3,200 16,500 3,000 515 3,500

”	”	Profit & Loss Account	..... Dr.	16,275	
		To Capital Account	....		16,275
(Being transfer of net profit.)					
”	”	Capital Account	..... Dr.	5,245	
		To Drawings Account	....		5,245
(Being transfer of drawings to the Capital Account.)					

LEDGER

Dr.				PURCHASES ACCOUNT				Cr.	
Date		Particulars	Folio	Amount	Date		Particulars	Folio	Amount
2008 Jan. to Dec.	31	To Sundries		Rs. <u>40,675</u>	2008 Dec.	31	By Trading A/c		Rs. <u>40,675</u>

Dr.				SALES ACCOUNT				Cr.	
2008 Dec.	31	To Trading A/c		<u>98,780</u>	2008 Jan. to Dec.	31	By Sundries		<u>98,780</u>

Dr.				RETURNS INWARD ACCOUNT				Cr.	
2008 Jan. to Dec.	31	To Sundries		<u>680</u>	2008 Dec.	31	By Trading A/c		<u>680</u>

Dr.				RETURNS OUTWARD ACCOUNT				Cr.	
2008 Dec.	31	To Trading A/c		<u>500</u>	2008 Jan. to Dec.	31	By Sundries		<u>500</u>

Dr.				WAGES ACCOUNT				Cr.	
2008 Jan. to Dec.	31	To Sundries		10,480 <u>10,480</u>	2008 Dec.	31	By Buildings A/c		2,000
					”	”	By Trading A/c		8,480
									<u>10,480</u>

Dr.				FUEL & POWER ACCOUNT				Cr.	
2008 Jan. to Dec.	31	To Sundries		<u>4,730</u>	2008 Dec.	31	By Trading A/c		<u>4,730</u>

Dr.		CARRIAGE ON SALES ACCOUNT						Cr.	
2008 Jan. to Dec.	31	To Sundries		<u>3,200</u>	2008 Dec.	31	By Profit A/c Loss A/c		<u>3,200</u>

Dr.		CARRIAGE ON PURCHASES ACCOUNT						Cr.	
2008 Jan. to Dec.	31	To Sundries		<u>2,040</u>	2008 Dec.	31	By Trading A/c		<u>2,040</u>

Dr.		OPENING STOCK ACCOUNT						Cr.	
2008 Jan.	1	To Balance b/d		<u>5,760</u>	2008 Dec.	31	By Trading A/c		<u>5,760</u>

Dr.		BUILDINGS ACCOUNT						Cr.	
2008 Jan.	1	To Balance b/d		30,000	2008 Dec.	31	By Balance c/d		32,000
2008 Dec.	31	To Wages A/c		<u>2,000</u>					
				<u>32,000</u>					<u>32,000</u>
2009 Jan.	1	To Balance b/d		32,000					

Dr.		FREEHOLD LAND ACCOUNT						Cr.	
2008 Jan.	1	To Balance b/d		<u>10,000</u>	2008 Dec.	31	By Balance c/d		<u>10,000</u>
2009 Jan.	1	To Balance b/d		10,000					

Dr.		MACHINERY ACCOUNT						Cr.	
2008 Jan.	1	To Balance b/d		20,000	2008 Dec.	31	By Dep By Balance c/d		2,000 18,000
2009 Jan.	1	To Bal b/d		<u>20,000</u>		"			<u>20,000</u>
				18,000					

Dr.		PATENTS ACCOUNT						Cr.		
2008 Jan.	1	To Balance b/d		7,500		2008 Dec. "	31	By Dep		1,500
								By Balance c/d		6000
				<u>7,500</u>						<u>7,500</u>
2009 Jan.	1	To Balance b/d		6,000						

Dr.		SALARIES ACCOUNT						Cr.		
2008 Jan. to Dec.	31	To Sundries To Outstanding Salaries A/c		15,000		2008 Dec.	31	By Profit & Loss		16,500
				1,500						
				<u>16,500</u>						<u>16,500</u>

Dr.		GENERAL EXPENSES ACCOUNT						Cr.		
2008 Jan. to Dec.	31	To Sundries		<u>3,000</u>		2008 Dec.	31	By Profit & Loss A/c		<u>3,000</u>

Dr.		INSURANCE ACCOUNT						Cr.		
2008 Jan. to Dec.	31	To Sundries		600		2008 Dec. "	31 "	By Insurance Prepaid		85
				<u>600</u>				By Profit & Loss A/c		<u>515</u>
										<u>600</u>

Dr.		DRAWINGS ACCOUNT						Cr.		
2008 Jan. to Dec.	31	To Sundries		<u>5,245</u>		2008 Dec.	31	By capital account - Transfer		<u>5,245</u>

Dr.		CAPITAL ACCOUNT						Cr.	
2008 Dec.	31	To Drawings A/c		5,245	2008 Jan.	1	By Balance b/d		71,000
	31	To Balance c/d		82,030	2008 Dec.	31	By Profit & Loss A/c		16,275
				<u>87,275</u>					<u>87,275</u>
					2009 Jan.	1	By Balance b/d		82,030

Dr.		SUNDRY DEBTORS						Cr.	
2008 Dec.	31	To Balance b/d		<u>14,500</u>	2008 Dec.	31	By Balance c/d		<u>14,500</u>
2009 Jan.	1	To Balance b/d		14,500					

Dr.		SUNDRY CREDITORS						Cr.	
2008 Dec.	31	To Balance c/d		<u>6,300</u>	2008 Dec.	31	By Balance b/d		<u>6,300</u>
					2009 Jan.	1	By Balance b/d		6,300

Dr.		DEPRECIATION ACCOUNT						Cr.	
2008 Dec.	31	To Machinery A/c		2,000	2008 Dec.	31	By Profit & Loss A/c		3,500
		To Patents A/c		1,500					
				<u>3,500</u>					<u>3,500</u>

Dr.		OUTSTANDING SALARIES ACCOUNT						Cr.	
2008 Dec.	31	To Balance c/d		1,500	2008 Dec.	31	By Salaries A/c		1,500
					2009 July.	1	By Balance b/d		1,500

Dr.		INSURANCE PREPAID ACCOUNT						Cr.	
2008 Dec.	31	To Insurance A/c		<u>85</u>	2008 Dec.	31	By Balance c/d		<u>85</u>
2009 Jan.	1	To Balance b/d		85					

Dr.		PROVISION FOR BAD & DOUBTFUL DEBTS ACCOUNT						Cr.	
2008 Dec.	31	To Balance c/d		<u>725</u>	2008 Dec.	31	By Profit & Loss A/c		<u>725</u>
					2009 Jan.	1	By Balance b/d		725

Dr.		CLOSING STOCK ACCOUNT						Cr.	
2008 Dec.	31	To Trading A/c		<u>6,800</u>	2008 Dec.	31	By Balance c/d		<u>6,800</u>
2009 Jan.	1	To Balance b/d		6,800					

Dr.		CASH BOOK						Cr.			
Date		Particulars	L.F.	Cash Rs.	Bank Rs.	Date		Particulars	L.F.	Cash Rs.	Bank Rs.
2008 Dec.	31	To Balance b/d		<u>540</u>	<u>2,630</u>	2008 Dec.	31	By Balance c/d		<u>540</u>	<u>2,630</u>
2009 Jan.	1	To Balance b/d		540	2,630						

TRADING & PROFIT & LOSS ACCOUNT
for the year ended 31st Dec, 2008

		Rs.			Rs.
To Opening Stock Account		5,760	By Sales A/c	98,780	
To Purchases A/c	40,675		Less Returns Inwards	<u>680</u>	98,100
Less Returns Outward	<u>500</u>	40,175	By Closing Stock A/c		6,800
To Wages A/c		8,480			
To Fuel & Power A/c		4,730			
To Carriage on		<u>2,040</u>			

To Gross Profit transferred to Profit & Loss A/c		43,715		
				1,04,900
To Salaries A/c	15000		By Gross Profit transferred from Trading A/c	43,715
<i>Add outstanding salary</i>	<u>1,500</u>	16,500		
To Carriage on Sales A/c		3,200		
To General Expenses A/c		3,000		
To Insurance A/c	600			
<i>Less Prepaid</i>	<u>85</u>	515		
To Provision for Bad & Doubtful Debts A/c		725		
To Depreciation A/c				
Machinery	2,000			
Patents	<u>1,500</u>	3,500		
To Net Profit transferred to Capital A/c		16,275		
		<u>43,715</u>		<u>43,715</u>

BALANCE SHEET OF Theer and Tarkh & Co. as on 31st Dec, 2008

Liabilities		Rs.	Assets		Rs.
Capital			Current Assets :		
Balance in the beginning	71,000		Cash in Hand		540
<i>Add Profit during the year</i>	<u>16,275</u>		Cash at Bank		2,630
	87,275		Sundry Debtors	14,500	
<i>Less Drawings</i>	<u>5,245</u>	82,030	Less Provision for Bad & Doubtful Debts	<u>725</u>	13,775
			Insurance Prepaid		85
			Closing Stock		6,800
			Fixed Assets :		
			Freehold Land		10,000

Liabilities :			Building	30,000	
Sundry Creditors		6,300	Cycle shed	2,000	32,000
Outstanding Salaries		1,500	Machinery	20,000	
			Less Depreciation	<u>2,000</u>	18,000
			Patents	7,500	
			Less Depreciation	<u>1,500</u>	
					<u>6,000</u>
	Total	<u>89,830</u>		Total	<u>89,830</u>

Check Your Understanding

State whether the following statements are True or False

1. Revenue is not increased by taking loans although assets are increased.
2. A transaction, which increases the capital, is called 'Income'.
3. Capital is assets minus liabilities.
4. Profits or losses have no effect on the closing balance in capital.
5. The value of human resources is shown as an asset in the balance sheet.

Answers

1. True 2. False 3. True 4. False 5. False

Pick up the most appropriate

1. In case of a limited company, the term financial statements includes:
 - (a) P and L A/c and Balance Sheet
 - (b) Balance Sheet
 - (c) P and L A/c, P and L Appropriation A/c and Balance Sheet.
2. Rent is shown at Rs. 30,000 in Profit and Loss Account. Balance sheet shows an outstanding rent of Rs. 5,000. What was the cash outgo for the firm under the head 'Rent'?
 - (a) 35,000
 - (b) 30,000
 - (c) 25,000
 - (d) nil
3. Cash received towards income from investment is Rs. 60,000. Assets side of the balance sheet shows Rs. 10,000 as accrued income from investments. So, Profit and Loss Account should show on the credit side
 - (a) 70,000
 - (b) 60,000
 - (c) 50,000
 - (d) nil
4. Advertisement expenses are shown Rs. 90,000 in Profit and Loss Account. Actual cash payment for advertisement is Rs. 1,00,000. What amount balance sheet should show under the head prepaid advertisement expenses?
 - (a) 1,10,000
 - (b) 10,000
 - (c) 80,000
 - (d) nil

Answers

1. (c) 2. (c) 3. (a) 4. (b)

Interview Questions

Q.1. What are 'Final Accounts'? Why they are so called?

Ans. Trading and Profit and Loss Account and Balance Sheet, all together, are called as 'Final Accounts'.

These are called as final accounts because they are the last accounts prepared at the end of the year. The final accounts convey the final position of the firm, in terms of final profit and final financial position of the organization.

Q.2. What is the purpose of Trading, Profit and Loss Account and Balance Sheet?

Ans. Every businessman is interested to know the operating results and ascertain the financial position of the firm he runs for monitoring, from time to time. Trading Account shows the gross profit, while Profit and Loss Account shows the net profit. Final results of business, profit or loss, are known through Profit and Loss Account.

Balance sheet exhibits the final financial position of the organization.

Q.3. What is the meaning of 'Marshalling of Assets and Liabilities'?

Ans. 'Marshalling of Assets and Liabilities' means arranging the assets and liabilities of the firm in a specific sequence.

Assets may be recorded on the basis of liquidity, speed of conversion of assets into cash. Liquid assets first and non-liquid assets, later, are shown on the assets side of the balance sheet. In a similar manner, capital is recorded first and other liabilities later. There is no standard format of the balance sheet for a proprietary concern and partnership firm, unlike a limited company.

Q.4. What is the need of 'Adjustment Entries'?

Ans. 'Adjustment Entries' are required to be made, before preparing the financial statements such as Trading, Profit and Loss Account and Balance Sheet. Financial statements are made on the basis of trial balance. However, certain accounting adjustments do not find a place in the trial balance. All expenses and incomes related to the year are to be fully accounted for, before drawing the financial statements. There may be certain outstanding expenses, payments made in advance, accrued income but not accounted for and income received in advance etc. All these adjustments are to be made in the financial statements. Then only, profit and loss account shows the factual operating results and balance sheet shows the financial position in a proper way.

Q.5. Why 'Closing Entries' are required to be made?

Ans. 'Closing Entries' are essential to ascertain the correct operating results. Accounts relating to expenses and incomes are to be closed to find out the operating profit. So, balances in the expenses and income accounts have to be transferred to Trading and Profit and Loss

Accounts. Process of transferring expenses and income accounts to Trading and Profit and Loss Accounts is done through closing entries.

Q.6. What is the need of 'Opening Entries'?

Ans. Assets, liabilities, capital appearing in the previous year's balance sheet are to be brought into the ledger of the current year. Balances of these accounts are brought forward into the ledger for continuation in the current year. The process of bringing them into the current year's ledger is done through 'Opening Entries'.

Q.7. What is the difference between outstanding expenses and prepaid expenses?

Ans. Outstanding expenses are the expenses, which have been incurred, but not paid. Prepaid expenses are the amounts paid for which benefit has not been received during the year in which the payment has been made.

Q.8. What is depreciation? What adjustment entry is made for it?

Ans. Depreciation is a reduction in the value of the asset for use, wear and tear etc. Depreciation account is debited and the concerned asset account is credited with the amount of depreciation.

Q.9. What is the need for providing depreciation, when there is no cash outgo?

Ans. Depreciation is an expense as asset has been used in conducting the business. Adjustment for depreciation is to be made before drawing the financial statements to show proper operating results and financial position.

Q.10. A businessman's daughter comes to father's garments shop and takes the clothes of her choice for her personal use.

Why this transaction is to be accounted for when the business belongs to the proprietor? In what manner, the transaction is to be recorded? What impact it would have on the financial statements, if the transaction is not recorded?

Ans. This transaction — consumption of garments by the owner's daughter — is to be accounted for even when the business belongs to the proprietor. Reason is issue of ownership of business and calculating correct operating results are two different matters. For the proprietor too, it is necessary to know the correct operating results and financial position. Business may be in loss and if the proprietor does not know in time, remedial steps cannot be taken by him, in time.

The transaction is to be recorded as personal drawings of the proprietor. If not so recorded, profit would be understated and capital would be overstated.

Q.11. What is a contingent liability?

Ans. Contingent liability is a liability that may occur depending on the happening of a future event. Contingent liability is a liability that may occur or may not occur. There is no certainty of its happening.

Occurrence of the liability is uncertain as it depends on the happening of an external event, in future, on which the company has no control.

Q.12. On which side of the balance sheet does contingent liability appear? Explain with an example?

Ans. Contingent liability does not appear on any side of the balance sheet. Contingent liability is not shown in the main body of the balance sheet. Contingent liability is always shown in 'Notes to Accounts', beneath the balance sheet.

Example for contingent liability is 'liability for bills discounted, not matured'. As the bill is already discounted, say with a bank, bill amount does not appear on the assets side in the balance sheet. Due date has not yet arrived, so the position of liability is not known. Liability may occur only if the drawee (person who has accepted the bill and liable to make payment on the due date) fails to make the payment to the bank on the due date, which is subsequent to the balance sheet date.

Q.13. 'Balance Sheet is a 'Snap Shot'. Why it is so called?

Ans. When you are photographed, your photo shows the dress you wear for the photo. It does not show the dress that has been changed, ten minutes back. In a similar manner, balance sheet shows the financial position in respect of assets and liabilities on a particular date. Balance sheet does not show the changes that have occurred, earlier.

