FINAL ACCOUNTS WITH SIMPLE ADJUSTMENTS

In practice, however, you are always required to make some adjustments while preparing the final accounts. It is because there may be many expenses and incomes relating to the current year which are still to be brought into the books of account. Then there may be certain items recorded in current year's books which actually relate to the previous year or the next year. Unless such items are duly

Adjusted in the books of account, the final accounts will not reveal the true and fair view of the state of affairs of the business.

Treatment of Adjustments in Final Accounts

There are several items which need adjustment at the time of preparing the final accounts. Some of the important and common adjustments are listed below:

1 Closing Stock
2 Outstanding or Accrued Expenses
3 Prepaid or Unexpired Expenses
4 Outstanding or Accrued Incomes
5 incomes received in Advance (Unearned Income)
6 Depreciation
7 interest on Capital
8 Interest on Drawings
9 Interest on Loan
10 Bad Debts
11 Provision for Bad Debts
12 Provision for Discount on Debtors
13 Provision for Discount on Creditors
14 Manager's Commission
15 Abnormal Loss
16 Drawing of Goods by the Proprietor

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PROVISIONS AND RESERVES

Business firms maintain their accounts as going concerns on the assumption that the business will continue to exist indefinitely, hence, at the end of each accounting year, they must also take into account the future contingencies and the requirements of funds before determining the amount of net profit available for distribution among the owners. Provisions and reserves actually relate to the future needs for which a part of the current earning has to be set aside. In this unit you will learn about the meaning of provision and reserve, the difference between provision and reserve, and also the various types of reserves which are usually created before distribution of profits.

PROVISION

There are certain expenses/losses which are related to the current accounting period but amount of which is not known with certainty because they are not yet incurred. It is necessary to make provision for such items for ascertaining true net profit. For example, a trader who sells on credit basis knows that some of the debtors of the current period would default and would not pay or would pay only partially. It is necessary to take into account such an expected loss while calculating true and fair profit/loss according to the principle of Prudence or Conservatism. Therefore, the trader creates a Provision for Doubtful Debts to take care of expected loss at the time of realisation from debtors. In a similar way, Provision for repairs and renewals may also be created to provide for expected repair and renewal of the fixed assets. Examples of provisions are:

- Provision for depreciation;
- Provision for bad and doubtful debts;
- Provision for taxation; • Provision for discount on debtors; and
- Provision for repairs and renewals.

It must be noted that the amount of provision for expense and loss is a charge against the revenue of the current period. Creation of provision ensures proper matching of revenue and expenses and hence the calculation of true profits. Provisions are created by debiting the profit and loss account. In the balance sheet, the amount of provision may be shown either:

- By way of deduction from the concerned asset on the assets side. For example, provision for doubtful debts is shown as deduction from the amount of sundry debtors and provision for depreciation as a deduction from the concerned fixed assets.

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- On the liabilities side of the balance sheet alongwith current liabilities, for example provision for taxes and provision for repairs and renewals

Accounting Treatment for Provisions

The accounting treatment of all types of provisions is almost similar. Therefore, the accounting treatment is explained here taking up the case of provision for doubtful debts. As already stated that when business transaction takes place on credit basis, debtors account is created and its balance is shown on the asset-side of the balance sheet. These debtors may be of three types:

- Good Debtors are those from where collection of debt is certain.
- Bad Debts are those debtors from where collection of money is not possible and the amount of credit given is a certain loss.
- Doubtful Debts are those debtors who may pay but business firm is not sure about the collection of full amount from them. In fact, as a matter of business experience, some percentage of such debtors are not likely to pay, hence treated as doubtful debts. To consider this possible loss on account of non-payment by some debtors, it is a common practice (and necessary also) to make a suitable provision for doubtful debts at the time of ascertaining true profit or loss. The provision for doubtful debts is usually calculated as a certain percentage of the total amount due from sundry debtors after deducting/writing-off all known bad debts. Provision for doubtful debts is also called 'Provision for bad and doubtful debts'. It is created by debiting the amount of required provision to the profit and loss account and crediting it to provision for doubtful debts account.

- For creating a provision for doubtful debts the following journal entry is recorded:

  Profit and Loss A/c Dr. (with the amount of provision)

  To Provision for doubtful debts A/c

RESERVE

The term reserve refers to the amount set aside out of profits and other surplus which are not designed to meet any liability or diminution in value of assets known to exist at the date of the Balance Sheet. The Indian Companies Act has not given any clear definition of the term 'Reserve'. It states, however, that "the expression 'reserve' shall not include any amount written off or- retained by way of providing for depreciation, renewal or

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diminution in value of an asset, or retained by way of providing for any known liability. In other words, any amount set aside out of profits to meet unexpected future losses and liabilities is called reserve. Not only that if any amount retained by way of providing for any known liability in excess of the amount actually needed for the purpose, shall also be treated as reserve and not a provision.

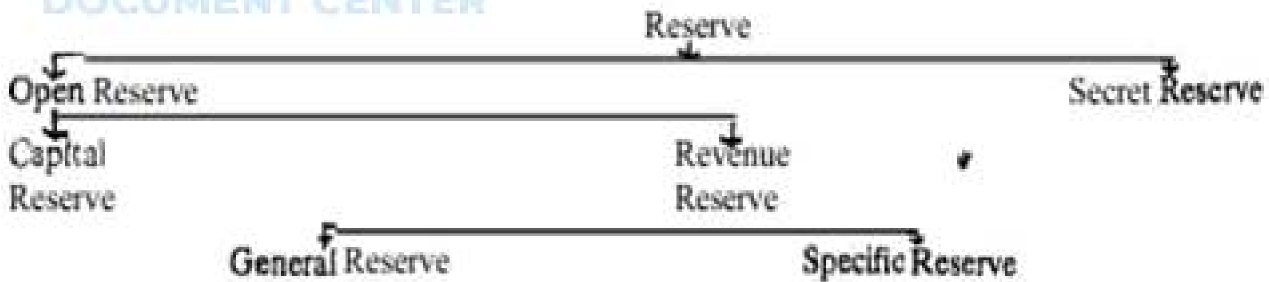
The basic purpose of creating a reserve is to provide for unexpected losses in future and also retain profits within business (not distribute them to the owners or shareholders) to provide funds for expansion of the business. Most well managed companies make it a point not to distribute the whole of their profits to the shareholders. They retain good portion of their profit in the form of general reserve (also called contingency reserve). This also enables them to pay dividend even during the year when the profits are low or there are losses.

Reserves are created by debiting their amounts to the Profit and Loss Appropriation Account. But reserve is not a compulsory charge on profits. It is purely voluntary and is regarded as an appropriation of profits. It means that reserve represents an undistributed portion of net profit and not a loss or expense which ought to have been charged before calculating the net profit, as is done in case of the provisions.

Reserve Fund: The term 'reserve fund' is used for the amount of reserve which has been invested in outside securities. The instructions given in the Companies Act for the preparation of Balance Sheet, the word 'fund‘ in relation to any reserve can be used only when such reserve is specifically represented by earmarked investments. Examples of Reserve fund are employees' welfare fund, pension fund, gratuity fund, debenture redemption fund, etc. If, however, the amount of reserve is being utilized by the business itself and not invested in some outside securities, it cannot be called reserve fund.

DIFFERENCE BETWEEN PROVISION AND RESERVE

	Provision		Reserve
1	Provision is made to meet a known liability for depreciation/renewal of assets.	1	Reserve is created to meet unexpected contingencies likely to arise in future.
2	The amount set aside is used only to meet the specific purpose for which provision was made.	2	Amount can be used for any liability or loss.
3	Provision is to be made even if there are no profits.	3	It is created only when there are sufficient profits,
4	It is a charge on profits and must be debited before arriving at the figure of net profit.	4	it is an appropriation of profits and represents undistributed profits.
5	It cannot be used for the payment of dividends.	5	Except in some cases, it can be used for payment of dividends.
6	It cannot be invested outside the business.	6	It can be invested outside the business, when created For a specific purpose.



TYPES OF RESERVES

To have a clear understanding of the nature and purpose of reserves we may classify them into diffrent categories as follows:

pen Reserves:

There are two ways of creating reserves: (1) by debiting the amount to Profit and Loss Account and clear 1 y showing it in the Balance Sheet in one form or the other, and (2) by undervaluation of assets or over providing for losses. The first category of reservescan be easily identified from the financial statements and are termed as open reserves. The second category of reserves cannot be identified by the reader of financial statements. They are known only to the management. Such reserves are called 'secret reserves'

Open reserves are further classified as capital reserves and revenue reserves depending on the nature of profit out of which they are created.

Capital Reserves:
A reserve created out of capital profits is called 'Capital Reserve'. Capital profits may arise on account of revaluation or sale of fixed assets. In case of companies the following items are also regarded as capital profits.
i) Credit balance left in Forfeited Shares Account after the re-issue of such shares,
ii) Premium received on issue of shares on debentures,
iii) Profit realised on the purchase of company's own debentures from the market, and
iv) Profits made prior to incorporation.

It is also to fits cannot normally be used for a distribution of dividends land therefore are transferred to capital reserve. If at all the company, at some stage, wants to utilize capital reserve for the distribution of dividends, it has to satisfy certain specified conditions.

Revenue Reserves:

Any reserve other than capital reserve can be called a revenue reserve. Revenue reserves are usually created out of business profits which are available for distribution of dividends. They are meant for specific purposes or general purposes and are accordingly known as specific reserves or a 'general reserve'. The specific purposes for which they are usually created are dividend equalization (known as dividend equalization reserve), redemption of debenture (known as debenture redemption fund), workmen's compensation (known as worker's compensation

fund); etc. A general reserve, on the other hand, is meant for meeting the unforeseen contingencies and to strengthen the financial position of the business. All these reserves are debited to the Profit and Loss Appropriation Account and shown on the liabilities side under the head _Reserves and Surplus'. As a matter of fact, they reflect the undistributed profits of the business.

Distinction between Capital Reserve and Revenue Reserve:

The capital reserves and revenue reserves differ in many respects. The main points of distinction are as follows:

	Capital Reserve		Revenue Reserve
1	It is created out of capital Profits.	1	It is created out of business profits.
2	It can be used for distribution of dividends only if the company satisfies certain conditions' prescribed by'the Companies Act.	2	It can be used for distribution of dividends without any pre-condition.
3	It is created for meeting capital losses or to be used for purposes specified by Companies Act.	3	It is created for strengthening the financial position, and meeting the unforeseen contingencies or some specific purpose.

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Sinking Fund: A sinking fund is a specific reserve created with the object of providing funds for the redemption of long term liabilities like redeemable debenture. It is created by setting aside a fixed sum out of profits every year for a definite period. Such a sum is invested at a compound interest so that at the end of the period, the annual amounts with accumulated interest will be sufficient to discharge the liability. If, for example, a company has to redeem debentures worth Rs, 1, 00,000 at the end of ten years, it may set aside certain amount of profits every year and invest it in some securities carrying certain rate of interest. The interest earned every year is also re-invested. At the end of ten years, the total amount of investment (including interest) will be equal to the amount needed for redemption i.e., Rs. l, 00,000). The securities are then sold and the amount so realized is used for the redemption of the debenture. The amount of yearly installment can be determined by reference to the sinking fund table. The same is debited to Profit and Loss Appropriation Account and credited to the Debenture Redemption

Fund.

Dividend Equalization Fund: This fund is created by setting aside a portion of distributable profits during prosperous years as a provision for lean period so that company is able to declare usual dividend even if sufficient profits are not there. The amount representing this fund need not be invested in outside securities. Even if there is no specific dividend equalization fund, a company can always use its reserves, if any, for the purpose of equalizing dividends.

Investment Fluctuation Fund: This is a reserve created to provide for the loss by way of fluctuation in the values of investments made by the company in outside securities. This is generally provided by banks and insurance companies who invest huge funds in government securities.

Workman's Compensation Fund: Under Workmen Compensation Act, the workers are entitled to certain amount of compensation in case of accidents in the factory. When an accident takes place, the amount of compensation involved may be heavy. Hence, in order to avoid such loss being charged to the Profit and Loss Account of the year in which it occurs, the companies set aside a portion of profits every year and create &special fund for this purpose. It is called, 'Workmen's Compensation Fund'. As and when some compensation is paid, the same can be debited to this fund.

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Secret Reserves: The term 'Secret Reserve' is applied to a reserve, the existence of which does not appear on the face of the Balance Sheet. When secret reserves exist, the financial position of the business is better than what may appear on the face of the balance sheet.

The main purpose of creating secret reserve is to reduce the disclosed profit so that during bad period this hidden profit, or a portion of it, may be merged into the earnings and thus help in equalizing the dividends.

Methods of creating Secret Reserves: Secret Reserves may be created in one of the following ways:

i) Writing off excessible depreciation
ii) Undervaluation of closing stock
iii) Charging capital expenditure to Profit and Loss Amount
iv) Making excessive provision for bad and doubtful debts

v) Showing contingent liabilities as actual liabilities

vi) Retaining appreciating assets at cost price

Merits and Demerits:

Creation of secret reserves, within certain limits, is justifiable on the ground of expediency and prudence. Secret Reserves enable the business to meet extra-ordinary losses without the same being disclosed and thus prevent the provisions and Reserves public confidence being shaken. The concealment of huge profits is also essential in order to prevent competition from other firms.

Despite certain merits, the following objections are raised against the practice of creating secret reserves.

i) Secret Reserves prevent the financial statements from showing the true and fair position of the business. The Profit and Loss account charged with fictitious amount in respect of excessive depreciation, doubtful debts, or repairs etc, fails to disclose the true profits. Similarly, when the value of certain asset is understated or some liabilities are overstated, the Balance Sheet cannot be said to represent the true state of affairs of the business. Thus, the financial statements become unreliable.

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ii) The shareholders cannot assess the value of their holding correctly.

iii) Management can conceal its inefficiency by making use of secret reserves.

iv) It permits misuse of secret reserves for personal gain by managers. Sometimes the management, or those close to them, having knowledge of wilful suppression of net profits, may indulge in certain malpractices in the stock markets.

Before the enactment of the Companies Act, 1956, there were no restrictions on the creation of secret reserves. But, at present such reserves cannot be created by a company because the auditor has to certify that the Balance Sheet of the company gives a true and fair view of the state of affairs of the company. In case some secret reserves have been created, the auditor cannot give such a report without disclosing the extent of such reserves.

Manufacturing Accounts

For manufacturing organizations, manufacturing accounts will be needed in addition to a trading and profit and loss accounts. This will be for internal purposes/ use in the company. In place of purchases we will instead have the cost of manufacturing the goods. For a manufacturing business the manufacturing costs are divided into the following types:

i) Direct material costs

Direct material costs are those materials used directly in the manufacture of products i.e. materials that can be identified in the final products. E.g. in the manufacture of tables, direct materials consists of timber, nails, glue etc.

ii) Direct labour costs

These are wages paid to those who are directly involved in the manufacture of a product e.g. in the manufacture of tables; direct labour consists of wage paid to those workers who saw, shape of join the piece of timber into table.

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iii) Direct expenses

These are expenses that must be incurred in the manufacture of a product. That is, they can be directly allocated a particular unit of a product e.g. live charges for a special equipment used in the process of manufacture, royalties.

Note: The sum of all the direct costs is known as prime costs

iv) Indirect manufacturing costs / factory overheads

These are any other expenses (apart from the direct costs) for items being manufactured. E.g. cleaners' wages, factory rents, depreciation of plant and equipment, factory power and lighting

Therefore, prime cost + indirect manufacturing costs = PRODUCTION COSTS

v) Administrative Expenses

These are expenses that are administrative in nature, that is, expenses incurred in the process of panning, controlling and directing the organization. e.g. office rents, office electricity, depreciation of office machinery, secretarial salaries.

vi) Selling and distribution expenses

These are expenses incurred in the process of selling, promoting and distributing the goods manufactured. E.g. advertising expenses, carriage outwards, depreciation of motor van, salesmen salaries etc.

vii) Finance Costs

These are expenses such as bank charges, discount allowed.

Format of the financial statements

Manufacturing account part

This is debited with the production cost of goods completed during the accounting period:
It consists of: Direct materials

- Direct labour
- Direct expenses
- Indirect manufacturing costs.

It also includes adjustments for work in progress (goods that are part- completed at the end of a period).

STEPS

1. Add opening stock of raw materials to purchases and subtract the stock of raw materials. This is to get the cost of materials used during the period.

2. Add in all the direct costs to get the prime costs

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3. Add all the indirect manufacturing costs.

4. Add the opening stock of WIP and subtract the closing stock WIP to get the production cost of all goods completed in the period. This is because WIP cannot be sold and therefore should not be included in the trading account.

5. The manufacturing account when completed shows the total that is available for sale during the period.

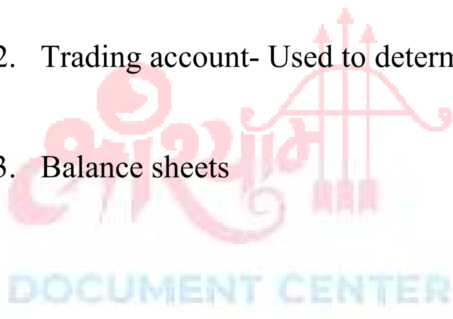
This will be used in trading account in place for purchases.

Final accounts of a manufacturer

1. Manufacturing accounts – used to determine the cost of production.

2. Trading account- Used to determine the gross profit on trading. 3

3. Balance sheets



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Manufacturing Account of............
for the period ended..........

Dr. **Cr.**

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Work-in-progress at			By Sale of Scrap		...
the beginning		...	By Work-in-progress		...
To Raw Materials Consumed:			at the end		
Opening Stock of					
Raw Materials	...		By Cost of Goods		
Add Purchases of			Produced (transferred		
Raw Materials	...		to Trading Account)		
	...				..
Less Closing Stock					
of Raw Materials	...	...			
To Carriage Inwards					
To Freight, Import					
Duty, Dock Dues, etc.		...			...
To Manufacturing Wages		...			
To Motive Power		...			
To Coal, Gas and Water		...			
To Oil, and Grease		...			
To Factory Lighting					
& Heating		...			
To Factory Insurance		...			
To Repairs to Factory Building		...			
To Repairs to Plant					
and Machinery		...			
To Depreciation on Factory					
Buildings		...			
To Depreciation on					
Plant and Machinery		...			
		...			...

Look at Illustration 1 and study how the cost of goods produced has been arrived at.

Illustration I

The following figures have been extracted from the books of a manufacturing concern. Find out the Cost of Goods Produced during the year ended December 31, 1987.

	Rs.
Stock on January 1, 1987	
Raw Materials	10,000
Work-in-progress	5,000
Stock on December 31, 1987	
Raw Materials	5,000
Work-in-progress	15,000
Purchases of Raw Materials	50,000
Carriage Inwards	5,000
Direct Wages	10,000
Motive Power	5,000
Depreciation on Machinery	5,000

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Solution

		Rs.
Opening Stock of Raw Materials		10,000
Add Purchases of Raw Materials		50,000
Add Carriage Inwards		5,000
		[illegible]
Less Closing Stock of Raw Materials		[illegible]
Cost of Raw Materials Consumed		[illegible]
Add Wages	[illegible]	
Motive Power	[illegible]	
Depreciation on Machinery	[illegible]	[illegible]
Gross Cost of Goods Produced		80,000
Add Opening Work-in-progress		5,000
		85,000
Less Closing Work-in-progress		15,000
Cost of Goods Produced		70,000

Sol

:

Manufacturing Account of........
for the year ending December 31, 1987

Dr. **Cr.**

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Work-in-progress			By Work-in-progress		
at the beginning		5,000	at the end		15,000
To Raw Materials			By Cost of Goods		
Consumed:			Produced		
Opening Stock	10,000		(transferred to		
Add Purchases of			Trading Account)		70,000
Raw Materials	50,000				
	60,000				
Less Closing Stock	5,000				
		55,000			
To Carriage Inwards		5,000			
To Direct Wages		10,000			
To Motive Power		5,000			
To Depreciation on Machinery		5,000			
		85,000			85,000

After studying the form of Manufacturing Account as given above and the Manufacturing Account as prepared above, you will observe the following points:

I. All items of expenses have been shown on the debit side and income from scrap on the credit side.

II. The heading of Manufacturing Account, as in case of Trading Account, indicates the name of the firm and the period of which it is prepared.

III. Opening and closing stocks of rqw materials have been adjusted in the cost of raw materials Consumed on the debit side itself.

IV. Opening stock of work-in-progress has been shown on tht: debit side and closing work-in-progress on the credit side.

V. Expenses on purchases of raw materials have been shown on the debit side separately. They are adjusted in the cost of raw materials consumed.

VI. Cost of production has been shown on the credit side which makes the totals on both sides equal. Thus, cost of production is the excess of the debit side total over the credit side total.

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TRADING ACCOUNT

A **trading account** is an account which contains, "in summarized form, all the transactions, occurring, throughout the trading period, in commodities in which he deals" and which gives the gross trading result. In short, trading account is the account which is prepared to determine the gross profit or the gross loss of a trader.

Items of Trading Account:

The following items usually appear in the debit and credit sides of thetradingaccount.

Debit Side Items:

1. The value of opening stocks of goods (i.e., the stock of goods with which the business was started).
2. Net purchase made during the year (i.e., purchases less returns).
3. Direct expenses, if any.

Credit Side Items:

1. Total sales made during the period less the value of returns, i.e., net sales.
2. The value of closing stock of goods.

The difference between the two sides of the trading account represents either gross profit or gross loss. Thus if the credit side is heavier that would mean that the trader has earned gross profit i.e., the excess of selling price of the goods sold over their purchase price. If the debit side is heavier it would mean that the trader has suffered gross loss i.e., purchase price of goods exceeds the selling price.

The balance of trading account which represents either gross profit or gross loss is transferred to profit and loss account.

Format of Trading Account (T or Account Form):

Trading Account

For the year ending....... 20......

Dr.			Cr.		
To Opening stock		....	By Sales		....
To purchases	....		Less returns	....	....
Less Returns	....	....	By Closing stock		....
To Carriage inwards		....	By Gross loss transferred to profit and loss account		....
To Cartage		....			
To dock charges		....			
To Wages		....			
To Duty		....			
To Freight		....			
To Clearing charges		....			

To Etc. Etc., ...		
To Gross profit (Transferred to profit and loss account)		

Trading Accounts Items:

Now we shall discuss the items of trading account one by one.

1. **Opening Stock:** In case of trading concerns it will consist of only finished goods or goods to be sold without alteration. In manufacturing concerns, the opening stock will consist of three parts:

- Stock of raw material
- Stock of partly completed goods
- Stock of finished goods

In case of new business there will be no opening stock.

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2. **Purchases:** This item includes both cash and credit purchases of goods bought with the object of sales.

3. **Return Outwards or Purchases Returns:** It means the goods returned by a trader to his suppliers from out of his purchases. Return outwards reduce the purchases. It is shown by way of deduction from purchases in the trading account.

4. **Discount on Purchases:** It is also shown by way of deduction from purchases in the trading account.

5. **Sales:** This item includes total of both cash and credit sales of goods in which businessman deals in. It is credited to trading account.

6. **Returns Inwards or Sales Returns:** It means goods returned to a trader by his customers from out of goods sold to them. It is shown by way of deduction from sales on the credit side, of the trading account.

7. **Discount on Sales:** This account has always a debit balance and is shown by deduction from sales in the trading account.

8. **Direct Expenses:** Direct expenses are those expenses which are incurred to convert raw-materials into finished goods or which may be regarded as a part of the cost of purchasing the goods. e.g., wages paid by a manufacturer to construct furniture out of raw wood, the expenses incurred to bring goods from the place of purchase to the business place of the trader etc. All the direct expenses are charged to the trading account. The items usually included in the direct expenses are:

a) **Wages:** This item usually signifies some hourly, daily or piecework remuneration paid to laborers. It is direct expenditure and should be charged to trading account.

b) **Manufacturing or Productive Wages:** This item usually signifies the wages of factory workmen actually engaged in making or producing something. It is a direct charge on the cost of manufacturer. It is debited to manufacturing account or trading account.

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c) **Carriage Inward:** Carriage means conveyance charges of goods by land. Carriage inward are the conveyance expenses incurred to bring the goods purchased in the godown or shop. It is debited to trading account. In examination questions when the item only "carriage" is given and is not expressly stated to be inward or outward, it should be assumed to be inward and debited to trading account. The reason is that carriage on goods is usually paid by the purchaser.

d) **Cartage:** The cartage charges on goods purchased are direct expenses and should be debited to trading account.

e) **Freight:** Freight is the charge made for conveyance of goods by sea. Freight on goods purchased is charged to trading account.

f) **Customs Duty, Octroi Duty etc:** When goods are purchased from a foreign country import duty will be payable. When goods are received from another city, the municipal corporation may charge octroi duty. All duties on goods purchased should be debited

to trading account.

g) **Excise Duty:** It is a tax levied by the government. If the duty is levied on production it will be treated as manufacturing expenses and debited to trading account.

h) **Stores Consumed:** This item stores denote lubricating oil, tallow, grease, cotton and jute waste, etc., required for running the machinery of manufacturing concern. The amount of stores consumed is a direct expense and should be charged to trading account.

i) **Motive Power:** This item includes, coke, gas, water or electric energy consumed in propelling the machinery. It is debited to manufacturing account in the absence of a manufacturing account, it is debited to trading account.

j) **Royalty:** Royalty is an amount paid to a person for exploiting rights possessed by him it is usually paid to patentee, author, or landlord for the right to use his patent, copyright or land. If they are productive expenses, they are debited to manufacturing account; but in the absence of a manufacturing account, they are debited to trading account.

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k) **Manufacturing Expense:** All other expenses such as factory rent, factory insurance, factory repair etc., are direct expenses and should be charged to trading account.

Closing Stock and its Valuation:

Closing stock represents the value of goods lying unsold in the hands of a trader at the end of a trading period. The value of closing stock is ascertained by means of compilation of list of materials, stores and goods actually in possession at the close of the trading period. This work is known as taking the inventory. The inventory or lists of physical stock are then faired and valued. The total of the lists will be closing stock. The closing stock is
valued at cost or market price whichever is lower. As this item materially affects the gross profit (or gross loss), it is essential that all possible care should be taken to calculate the closing stock at a proper value.

The value of closing stock is taken into consideration only at the time of preparing the trading

account and not before. The trial balance is prepared before the preparation of the trading account. Hence the closing stock does not appear in a trial balance. It is brought into account by means of a journal entry debiting stock account and crediting the trading account.

Closing Entries for Trading Account:

Closing entries are those which are passed at the end of each financial period for the purpose of transferring the various revenues items to the trading and profit and loss account and thus the nominal accounts are closed. I preparing a trading account, the opening stock, purchases, sales, returns both inwards and outwards, direct expenses and closing stock are transferred to it by means of journal entries as follows:

1. Trading Account
   To Purchases Account
   To Returns Inwards Account
   To Direct Expenses Account (wages, carriage etc.) (Being the transfer of the latter accounts to the former.)

---

2. Sales Account
   Return
   s
   Out
   war
   d
   Acc
   ount
   To
   Tra
   ding
   Acc
   ount
   (Sales etc., transferred to trading account)

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3. Closing Stock Account

   To Trading Account

   (Being to record closing stock)

Advantages of Trading Account:

The advantages of the trading account are as follows:

1. A trader can find out the gross profit and thereby can ascertain the percentage of profit he has earned on the cost of goods sold. This percentage of gross profit may serve as his ready guide for the adjustment of future sale price.

2. A trading account help a trader to compare his stock at open with that at the close. He can further find out whether the purchases he has made during the period of account have been judicious.

3. Once can compare the figure of sales with similar figure of the previous year and can find out whether business is improving or declining.

4. If the gross profit disclosed by the trading account is less than expected, an enquiry can be made into the cause responsible for the decline. And if the gross profit is more than was expected, steps can be taken to maintain it.

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Illustration 2

Prepare a trading account of M/s Prime Products from the following particulars pertaining to the year 2013-14.

	Rs.
Opening stock	50,000
Purchases	1,10,000
Return inwards	5,000
Sales	3,00,000
Return outwards	7,000
Factory rent	30,000
Wages	40,000

Solution

Books of Prime Products
Trading Account
for the year ended March 31, 2014

Dr. **Cr.**

Expenses/Losses		*Amount Rs.*	*Revenues/Gains*		*Amount Rs.*
Opening stock		50,000	Sales	3,00,000	
Purchases	1,10,000		*Less* : Return inwards	(5,000)	2,95,000
Less : Return outwards	(7,000)	1,03,000			
Factory rent		30,000			
Wages		40,000			
Gross profit		72,000			
		2,95,000			2,95,000

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PROFIT AND LOSS ACCOUNT

Profit and loss account is the account whereby a trader determines the net result of his business transactions. It is the account which reveals the net profit (or net loss) of the trader.

The profit and loss account is opened with gross profit transferred from the trading account (or with gross loss which will be debited to profit and loss account). After this all expenses and losses (which have not been dealt in the trading account) are transferred to the debit side of the profit and loss account. If there are any incomes or gains, these will be credited to the profit and loss account. The excess of the gain over the losses is called the net profit and that of the loss over the gain is called the net loss. The account is closed by transferring the net profit or loss to capital account of the trader.

Format of the Profit and Loss Account:

Profit and Loss Account

For the year ended.............

To Gross Loss	xxxx	By Gross Profit	xxxx
To Salaries	xxxx	By Interest Received	xxxx
To Rent	xxxx	By Discount Received	xxxx
To Rent and Rates	xxxx	By Commission Received	xxxx
To Discount Allowed	xxxx	By Other Receipts	xxxx
To Commission Allowed	xxxx	By Etc., Etc.	xxxx
To Insurance	xxxx		
To Bank Charges	xxxx	By Net Loss (transferred to capital	
			xxxx
To Legal Charges	xxxx	account of the trader)	
To Repairs	Xxxx		
To Advertising	Xxxx		
To Trade Expenses	ex.		
To Office Expenses	xxxx		
To Bad Debts	xxxx		
To Traveling Expenses	xxxx		
To Etc., Etc.	xxxx		
To Net Profit (transferred to capital			

account of the trader)	xxxx		

Closing Entries for Profit and Loss Account:

The following usual entries are passed at the end of each trading period.

1. **Transferring all expenses or losses:**

   Profit and loss account

   To each of the various expenses or losses

(This entry will close the expenses accounts)

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2. **Transferring all items of gains etc:**

   Various nominal accounts

   (representing ains) To

   Profit and loss account

   (This entry will close all the remaining nominal accounts)

3. **Transferring net gain to capital account:**

   Prof
   i
   t
   a
   n
   d
   l

oss account To Capital account

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(This entry closes the P & L account)

4. **Transferring net loss to capital account:**

Capital account

To Profit and loss account

(This entry closes the P & L account)

CLOSING STOCK

You know that all goods purchased or produced during the year are not completely sold-out by the end of the year. Some goods always remain unsold as at the end of the which are called 'Closing Stock'. The Closing Stock does not usually appear in the Trial Balance. It is mostly given in the form of additional information. Since Gross Profit or loss cannot be worked out without accounting for the closing stock it is brought into books by means of the following adjustment entry.

Closing Stock A/c Dr.
To Trading A/c

The closing stock is treated in the final accounts as follows:

i. On the credit side of Trading Account: shown as a separate item, and
ii. On the assets side of the Balance Sheet: shown as a separate item under Current Assets.

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OUTSTANDING EXPENSES

Outstanding expenses are those expenses which have been incurred during the current accounting year but have not been paid till the end of the year. They are also called 'expenses accrued'. The common examples of such expenses are the salaries, wages and rent for the last month of the accounting year paid in the first month of the next year. Since they remained unpaid as at the end of accounting year, no entry might have been passed in the books of account. So, they must be taken into account while preparing the Trading and Profit and Loss Account otherwise it will not reveal the correct amount of profit or loss. The following adjustment entry is passed in respect of outstanding expenses.

Concerned Expense A/c Dr.
To Outstanding Expenses A/c

The outstanding expenses will be treated in final accounts as follows:

I. Added to the concerned expenses in the Trading and Profit and Loss Account, and

II. Shown on the liabilities side of the Balance Sheet as a separate item under Current Liabilities.

PREPAID EXPENSES

Sometimes, the benefit of some expenses will be available not only in the current accounting year but also during the next year. That portion of expense the benefit of which is yet to be received is called 'prepaid expense'. It is also called 'unexpired expense'. Examples of such expenses are unexpired insurance, interest paid in advance, etc. In such situations it is necessary to find out the unexpired portion and adjust it in the concerned expense. The following adjustment entry is passed in respect of the prepaid expenses:

Prepaid Expenses A/c Dr.
To Concerned Expense Alc

The Prepaid expenses will be treated in financial accounts as follows:

i. Subtracted from the concerned expense in the Trading and Profit and Loss Account, and

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ii. Shown on the assets side of the Balance Sheet as a separate item under Current Assets.

ACCRUED INCOME

Accrued Incomes are those incomes which have been earned during the current accounting year but have not been received till the end **of** the year. They are also called 'outstanding incomes' or 'incomes earned but not yet received'. Examples of such incomes are commission receivable, income on investments due but not yet received, etc. The following adjustment entry is passed in respect of accrued income.

Accrued Income A/c Dr.
To Concerned Income A/c

The Accrued income is treated in final accounts as follows:

I. Added to the concerned income in the Profit and Loss Account, and

II. Shown on the asset side of the Balance Sheet as a separate item under Current Assets.

INTEREST ON DRAWINGS

In case interest is allowed to the proprietor on his capital, it is a usual practice to also charge interest on his drawings. Interest on drawings will be a gain for the business and the following adjustments entry is passed to bring it into the books of account.

Capital A/c or Drawings A/c Dr.

To Interest on Drawings A/c

Interest on Drawings is treated in final accounts as follows:

I. On the credit side of Profit and Loss Account: shown as a separate item, and

II. Deducted from Capital on the liabilities side of Balance Sheet.

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Illustration 6

From the following balances obtained from the few accounts of Mr. H. Balaram. Prepare the Trading and Profit and Loss Account.

	Rs.		Rs.
Stock on Apr. 01, 2013	8,000	Bad debts	1,200
Purchases for the year	22,000	Rent	1,200
Sales for the year	42,000	Discount allowed	600
Purchase expenses	2,500	Commission paid	1,100
Salaries and wages	3,500	Sales expenses	600
Advertisement	1,000	Repairs	600

Closing stock on March 31, 2014 is Rs. 4,500

Books of H. Balaram
Trading Account
for the year ended March 31, 2014

Dr. **Cr.**

Expenses/Losses	*Amount* Rs.	*Revenues/Gains*	*Amount* Rs.
Opening stock	8,000	Sales	42,000
Purchases	22,000	Closing stock	4,500
Purchase expenses	2,500		
Gross profit c/d	14,000		
	46,500		46,500
Salaries and Wages	3,500	Gross profit b/d	14,000
Rent	1,200		
Advertisement	1,000		
Commission	1,100		
Discount allowed	600		
Bad debts	1,200		
Sales expenses	600		
Repairs	600		
Net profit (transferred to capital account)	4,200		
	14,000		14,000

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Preparing Balance Sheet

All the account of assets, liabilities and capital are shown in the balance sheet. Accounts of capital and liabilities are shown on the left hand side, known as Liabilities. Assets and other debit balances are shown on the right hand side, known as Assets. There is no prescribed form of Balance sheet, for a proprietary and partnership firms. (However, Schedule VI Part I of the Companies Act 1956 prescribes the format and the order in which the assets and liabilities of a company should be shown). The horizontal format in which the balance sheet is prepared is shown in the figure 9.7.

Balance Sheet of ....as at March 31, 2014

Liabilities		*Amount Rs.*	*Assets*	*Amount Rs.*
Capital	.....		Furniture	.....
Add Profit	.....	.....	Cash	.....
Long-term loan		.....	Bank	.....
Short-term loan			Goodwill	.....
Sundry creditors		.....	Sundry debtors	.....
Bills payable			Land and Buildings	
Bank overdraft			Closing stock	
		xxxx		xxxx

Illustration 8

From the following balances prepare a trading and profit and loss account and balance sheet for the year ended March 31, 2014

Account Title	*Amount Rs.*	*Account Title*	*Amount Rs.*
Carriage on goods purchased	8,000	Cash in hand	2,500
		Bank overdraft	30,000
Carriage on goods sold	3,500	Motor car	60,000
Manufacturing expenses	42,000	Drawings	8,000
Advertisement	7,000	Audit fees	2,700
Excise duty	6,000	Plant	1,53,900
Factory lighting	4,400	Repairs to plant	2,200
Debtors	80,000	Stock at the end	76,000
Creditors	61,000	Purchases *less* return	1,60,000
Dock and Clearing charges	5,200	Commission on purchases	2,000
Postage and Telegram	800	Incidental trade expenses	3,200
Fire Insurance Premium	3,600	Investment	30,000
Patents	12,000	Interest on investment	4,500
Income tax	24,000	Capital	1,00,000
Office expenses	7,200	Sales *less* return	5,20,000
		Salest tax paid	12,000
		Discount allowed	2,700
		Discount on purchases	3,400

Trading and Profit and Loss Account
for the year ended March 31, 2014

Dr. Cr.

Expenses/Losses	*Amount* Rs.	*Revenues/Gains*	*Amount* Rs.
Purchases *less* return	1,60,000	Sales *less* return	5,20,000
Commission on purchases	2,000		
Carriageon goodspurchasesd	8,000		
Manufacturing expenses	42,000		
Factory lighting	4,400		
Dock and Clearing charges	5,200		
Gross profit c/d	2,98,400		
	5,20,000		5,20,000
Carriage on sales	3,500	Gross profit b/d	2,98,400
Advertisement	7,000	Interest on investment	4,500
Excise duty	6,000	Discount on purchases	3,400
Postage and telegram	800		
Fire Insurance premium	3,600		
Office expenses	7,200		
Audit fees	2,700		
Repairs to plant	2,200		
Incidental trading expenses	3,200		
Sales tax paid	12,000		
Discount allowed	2,700		
Net profit (transferred to capital account)	2,55,400		
	3,06,300		3,06,300

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Balance Sheet as at March 31, 2014

Liabilities		*Amount* Rs.	*Assets*	*Amount* Rs.
Bank overdraft		30,000	Cash in hand	2,500
Creditors		61,000	Debtors	80,000
Capital	1,00,000		Closing stock	76,000
Add Net profit	2,55,400		Investment	30,000
	3,55,400		Motor car	60,000
Less Drawings	(8,000)		Plant	1,53,900
	3,47400		Patents	12,000
Less Income tax	(24,000)	3,23,400		
		4,14,400		4,14,400

DEPRICIATION

When the benefit of expenditure is available beyond the accounting year (for one or more years) such expenditure is treated as capital expenditure and it often results in acquisition of an asset. Since many accounting years are likely to receive benefits on account of the use-of such an asset, the cost of investment must necessarily be allocated over the period of its useful life and charged to the Profit and Loss Account. Allocation of the appropriate amount to each period is called depreciation which represents the expired portion of the cost of an asset.

Pickles defined depreciation as "the permanent and continuous diminution in the quality, quantity or value of an asset."

According to IGMA (Institute of Cost and Management Accounts, London) terminology, "Depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time.‖

Thus, depreciation refers to that part of the cost of fixed asset which has expired on account of its usage and or the passage of time. It is thus the 'lost usefulness', 'expired utility', or 'reduction in the intrinsic value' of a fixed asset. Depreciation is charged on almost all fixed assets, possible exceptions being land, antiques, etc. Usually the value of land and antiques appreciates over a period of time, because they do not have finite economic life as in the case of machinery or furniture.

CAUSES OF DEPRICIATION

The causes of depreciation can be stated as follows:

1. Wear and tear: Wearing out of the asset on account of its constant use is called wear and tear. This causes a definite reduction in the value of the asset and is regarded as the main source of depreciation.

2. Lapse of Time: Normally, the passage of time also causes some reduction in the value of fixed assets because as they become old their value stands reduced. That is why the depreciation is usually charged on time basis. In case of certain assets like least patents, etc., the value decreases with passage of time as they generally have a fixed number of years of legal life. For example, a building is taken on lease for a period of 10 years

costing Rs. 1, 00,000. The yearly depreciation of lease will amount to Rs. 10,000 (1/10 of Rs. 1, 00,000) and charged as such to the Profit and Loss Account every year.

3. Obsolescence: 'The acquisition of an improved model may render the existing machine obsolete. As the new machine performs the same operation more quickly and/or more economically existing machine is said to have become out of date or obsolete. This causes a drastic reduction in the value of existing machinery and the amount of depreciation is bound to be heavy.

4. Depletion: Some assets arc of a wasting character. For example mines, quarries, oil wells etc. Due to continuous extraction of materials the natural resources get depleted. Depreciation, in case of such assets is often computed on the basis of actual depletion. For example, a coal mine has the coal deposits of 200 million tons. In the first year we extract 10 m tons of coal. The depreciation in the first five years shall amount to 10/200 of the cost of mine.

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METHODS FOR PROVIDING DEPRICIATION

I. **Fixed Instalment Method:** This method is also called 'equal instalment method' or 'straight line method'. Under this method, a fixed and equal amount is charged as depreciation every year during the life time of an asset. When this amount of depreciation is presented on a graph paper it would show a straight line parallel to the X-axis, and hence the alternative name 'straight line method'. This method writes off a fixed percentage of the original cost of the asset every year so that the asset is reduced to zero or its salvage value at the end of its working life. The annual amount of depreciation to be charged under this method can be calculated with the help of the following formula :

$$\text{Annual Depreciation} = \frac{\text{Original Cost} - \text{Scrap Value}}{\text{Life of the Asset in number of years}}$$

$$\text{or } D = \frac{C - S}{N}$$

II. **Diminishing Balance Method:** Under this method, though the rate of depreciation is fixed, it is calculated on the written down value of the asset. Consequently the amount of depreciation to be charged goes on reducing from year to year. For example, a machine was purchased on January 1, 1986 for Rs. 10,000. It is to be depreciated at 15% per annum under the diminishing balance-method. In this case, the depreciation for 1986 would be Rs. 1,500 (15% of 8500), for 1987 it would be Rs. 1,275 (15% of 8,500), and for1988 it would work out as Rs. 1,084 (15% of 7,225). Thus you will notice that the annual depreciation goes on reducing. Hence, it is also known as 'reducing instalment method'. This method is considered better than the fixed instalment method because with reducing instalrnents of depreciation the combined effect of repairs and depreciation will be more or less uniform throughout the life of the asset.

Need for Depreciation

The need for providing depreciation in accounting records arises from conceptual, legal, and practical business consideration. These considerations provide depreciation a particular significance as a business expense.

Matching of Costs and Revenue

The rationale of the acquisition of fixed assets in business operations is that these are used in the earning of revenue. Every asset is bound to undergo some wear and tear, and hence lose value, once it is put to use in business. Therefore, depreciation is as much the cost as any other expense incurred in the normal course of business like salary, carriage, postage and stationary, etc. It is a charge against the revenue of the corresponding period and must be deducted before arriving at net profit according to ‘Generally Accepted

Consideration of Tax

Depreciation is a deductible cost for tax purposes. However, tax rules for the calculation of depreciation amount need not necessarily be similar to current business practices,

True and Fair Financial Position

If depreciation on assets is not provided for, then the assets will be over valued and the balance sheet will not depict the correct financial position of the business. Also, this is not permitted either by established accounting practices or by specific provisions of law.

Compliance with Law

Apart from tax regulations, there are certain specific legislations that indirectly compel some

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business organizations like corporate enterprises to provide depreciation on fixed assets.

Illustration 1

M/s Singhania and Bros. purchased a plant for Rs. 5,00,000 on April, 01 2014, and spent Rs. 50,000 for its installation. The salvage value of the plant after its useful life of 10 years is estimated to be Rs. 10,000. Record journal entries for the year 2014-15 and draw up Plant Account and Depreciation Account for first three years given that the depreciation is charged using straight line method if :

(i) The books of account close on March 31 every year; and

(ii) The firm charges depreciation to the asset account.

Books of Singhania and Bros.

Journal

Date	*Particulars*	*L.F.*	*Debit Amount Rs.*	*Credit Amount Rs.*
2014 Apr. 01	Plant A/c Dr. To Bank A/c (Purchased plant for Rs. 5,00,000)		5,00,000	5,00,000
Apr. 01	Plant A/c Dr. To Bank A/c (Expenses incurred on installation)		50,000	50,000
2015 Mar. 31	Depreciation A/c Dr. To Plant A/c (Depreciation charged on asset)		54,000	54,000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Depreciation debited to profit and loss account)		54,000	54,000

Plant Account

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2014 Apr. 01	Bank		5,00,000	2015 Mar. 31	Depreciation		54,000
	Bank (Installation expenses)		50,000		Balance c/d		4,96,000
			5,50,000				5,50,000
2015 Apr. 01	Balance b/d		4,96,000	2016 Mar. 31	Depreciation		54,000
					Balance c/d		4,42,000
			4,96,000				4,96,000
2016 Apr. 01	Balance b/d		4,42,000	2017 Mar. 31	Depreciation		54,000
					Balance c/d		3,88,000
			4,42,000				4,42,000
2017 Apr. 01	Balance b/d		3,88,000				

Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amounts Rs.
2015 Mar. 31	Plant		54,000	2015 Mar. 31	Profit and Loss		54,000
2016 Mar. 31	Plant		54,000	2016 Mar. 31	Profit and Loss		54,000
2017 Mar. 31	Plant		54,000	2017 Mar. 31	Profit & Loss		54,000

Workings Notes

(1) Calculation of original cost

	(Rs.)
Purchase cost	5,00,000
Add: Installation cost	50,000
Original cost	5,50,000
Salvage value	10,000
Useful life	10 years

(2) Depreciation amount = $\frac{\text{Rs. } 5,50,000 - \text{Rs. } 10,000}{10}$ = Rs. 54,000 p.a.