

Financial Statements - I

8

Learning Objectives

After studying this chapter, you will be able to :

- *state the nature of the financial statements;*
- *identify the various stakeholders and their information requirements;*
- *distinguish between the capital and revenue expenditure and receipts;*
- *explain the concept of trading and profit and loss account and its preparation;*
- *State the nature of gross profit, net profit and operating profit;*
- *describe the concept of balance sheet and its preparation;*
- *explain grouping and marshalling of assets and liabilities;*
- *prepare profit and loss account and balance sheet of a sole proprietory firm; and*
- *make an opening entry.*

You have learnt that financial accounting is a well-defined sequential activity which begins with Journal (Journalising), Ledger (Posting), and preparation of Trial Balance (Balancing and Summarisation at the first stage). In the present chapter, we will take up the next step, namely, preparation of financial statements, and discuss the types of information requirements of various stakeholders, the distinction between capital and revenue items and its importance and the nature of financial statements and the preparation thereof.

8.1 Stakeholders and their Information Requirements

Recall from chapter I (Financial Accounting Part I) that the objective of business is to communicate the meaningful information to various stakeholders in the business so that they can make informed decisions. A stakeholder is any person associated with the business. The stakes of various stakeholders can be monetary or non-monetary. The stakes can be active or passive; or can be direct or indirect. The owner and persons advancing loan to the business would have monetary stake. The government, consumer or a researcher will have non-monetary stake in the business. The stakeholders are also called users who are normally classified as *internal* and *external* depending upon whether they are inside the business or outside the business. All users have different objectives for joining business and

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consequently different types of information requirements from it. In nutshell, the various users have diverse financial information requirements from the business.

For example we have classified the following into the category of internal and external users specifying their objectives and consequent information requirements.

Name	*Internal/ External users*	*Objective for participating in business*	*Accounting Information requirements*
Current owners	Internal	To make investment in the business and wealth grow.	Likes to know extent of profit in the last accounting period, current position of the assets/liabilities of the business.
Manager and	Internal	For a career. They essentially act as the agent of owners (their employers).	Accounting information in the form of financial statements is like their report card and they are interested in information about both profits financial position.
Government	External	Its role is regulatory and tries to lay down the rules in the best public interest.	Its concerns are that the rights of all stakeholders are protected. Since the government levies taxes on the business, they are interested in information about profitability in particular besides lot of other information.
Prospective owner	External	He is expecting to make investments in the business with a view to make his investment and wealth grow.	He is interested in information about past profits and financial position as indicative of likely future performance.
Bank	External	Bank is interested in safety of the principal as well as the periodic return (interest).	Bank is interested in adequacy of profits only as an assurance of the return of principal and interest back in time. Bank is equally concerned about the form in which the assets are held by the business. When more assets are held in cash or near cash form, the aspect is knnown as liquidity.

Fig. 8.1 : *Analysis of various users of accounting information*

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Box 1

Accounting Process (up to Trial balance) :

1. Identify the transactions, which that are recorded.
2. Record transactions in journal. Only those transactions are recorded which are measured in money terms. The system followed for recording is called double entry system whereby two aspects (debit and credit) of every transaction are recorded. Repeated transactions of same nature are recorded in subsidiary books, also called special journals. Instead of recording all transactions in journal, they are recorded in subsidiary books and the journal proper. For example, the business would record all credit sales in sales book and all credit purchases in purchases book. The other examples of subsidiary books are return inwards book, return outwards book. An other important special book is cash book, in which all cash and bank transactions are recorded. The entries, which are not recorded in any of these books, are recorded in a residual journal called *journal proper*.
3. The entries appearing in the above books are posted in the respective accounts in the ledger.
4. The accounts are balanced and listed in a statement called *trial balance*. If the total amounts of debit and credit balances agree, accounts are taken as free from arithmetical errors.
5. The trial balance forms the basis for making the financial statements, i.e. trading and profit and loss account and balance sheet.

8.2 Distinction between Capital and Revenue

A very important distinction in accounting is between capital and revenue items. The distinction has important implications for making of the trading and profit and loss account and balance sheet. The revenue items form part of the trading and profit and loss account, the capital items help in the preparation of a balance sheet.

8.2.1 Expenditure

Whenever payment and/or incurrence of an outlay are made for a purpose other than the settlement of an existing liability, it is called expenditure. The expenditures are incurred with a viewpoint they would give benefits to the business. The benefit of an expenditure may extend up to one accounting year or more than one year. If the benefit of expenditure extends up to one accounting period, it is termed as *revenue expenditure*. Normally, they are incurred for the day-to-day conduct of the business. An example can be payment of salaries, rent, etc. The salaries paid in the current period will not benefit the business in the next accounting period, as the workers have put in their efforts in the current accounting period. They will have to be paid the salaries in the next accounting period as well if they are made to work. If the benefit of expenditure extends more than one accounting period, it is termed

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as *capital expenditure*. An example can be payment to acquire furniture for use in the business. Furniture acquired in the current accounting period will give benefits for many accounting periods to come. The usual examples of capital expenditure can be payment to acquire fixed assets and/or to make additions/ extensions in the fixed assets.

Following points of distinction between capital expenditure and revenue expenditure are worth noting :

(a) Capital expenditure increases earning capacity of business whereas revenue expenditure is incurred to maintain the earning capacity.
(b) Capital expenditure is incurred to acquire fixed assets for operation of business whereas revenue expenditure is incurred on day-to-day conduct of business.
(c) Revenue expenditure is generally recurring expenditure and capital expenditure is non-recurring by nature.
(d) Capital expenditure benefits more than one accounting year whereas revenue expenditure normally benefits one accounting year.
(e) Capital expenditure (subject to depreciation) is recorded in balance sheet whereas revenue expenditure (subject to adjustment for outstanding and prepaid amount) is transferred to trading and profit and loss account.

Sometimes, it becomes difficult to classify the expenditure into revenue or capital category. In normal usage, the advertising expenditure is termed as revenue expenditure. The heavy expenditure incurred on advertising is likely to benefit the business firm for more than one accounting period. Such revenue expenditures, which are likely to give benefit for more than one accounting period, are termed as *deferred revenue expenditure*.

It must be understood that expenditure is a wider term and includes expenses. Expenditure is any outlay made/incurred by the business firm. The part of the expenditure, which is perceived to have been used or consumed in the current year, is termed as expense of the current year.

Revenue expenditure is treated as an expense for the current year and is shown in trading and profit and loss account. For example, salary paid by the business firm is treated as an expense of the current year. Capital expenditures are charged to income statement and are spread over to more than one accounting period. Hence, furniture of ₹ 50,000 if expected to be used for 5 years will be treated as expense @ ₹ 10,000 per year. The name given for the expense is depreciation. The treatment of deferred revenue expenditure is same as of capital expenditure. They are also written-off over their expected period of benefit.

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8.2.2 Receipts

The similar treatment is given to the receipts of the business. If the receipts imply an obligation to return the money, these are capital receipts. The example can be an additional capital brought in by the owner or a loan taken from the bank. Both receipts are leading to obligations, the first to the owner (called equity) and the other to the outsiders (called liabilities). Another example on a capital receipt can be the sale of a fixed asset like old machinery or furniture. However, if a receipt does not incur an obligation to return the money or is not in the form of a sale of fixed asset, it is termed as revenue receipt. The examples of revenue receipts sales made by the firm and interest on investment received by the firm.

8.2.3 Importance of Distinction between Capital and Revenue

As stated earlier, the distinction between capital and revenue items has important implications for the preparation of trading and profit and loss account and the balance sheet as all items of revenue value are to the shown in the trading and profit and loss account and the items of capital nature in the balance sheet. If any item is wrongly classified, i.e. if any item of revenue nature is treated as capital item or vice-versa, the ascertainment of profit or loss will be incorrect. For example, the revenues earned during an accounting period are ₹ 10,00,000 and the expenses shown are ₹ 8,00,000, the profit shall work out as ₹ 2,00,000. On scrutiny of the details, you find that a revenue item of ₹ 20,000 (an expenditure on repairs of machinery) has been treated as capital expenditure (added to the cost of machinery and debited to machinery account, not to repairs account), and hence, does not form part of the expenses for the period. It means the actual expenses for the period are ₹ 8,20,000 and not ₹ 8,00,000. So, the correct profit is ₹ 1,80,000, not ₹ 2,00,000. In other words, the profit has been over stated. Similarly, if any capital expenditure is wrongly shown as revenue expenditure (for example, purchase of furniture shown as purchases), it will result in under statement of profits, and also an under statement of assets. Thus, the financial statements will not reflect the true and fair view of the affairs of the business. Hence, it is necessary to identify the correct nature of each item and treat it accordingly in the book of accounts. It is also important from taxation point of view because capital profits are taxed differently from revenue profits.

8.3 Financial Statements

It has been emphasised that various users have diverse informational requirements. Instead of generating particular information useful for specific users, the business prepares a set of financial statements, which in general satisfies the informational needs of the users.

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The basic objectives of preparing financial statements are :

(a) To present a true and fair view of the financial performance of the business;

(b) To present a true and fair view of the financial position of the business; and

For this purpose, the firm usually prepares the following financial statements:

1. Trading and Profit and Loss Account
2. Balance Sheet[1]

Trading and Profit and Loss account, also known as Income statement, shows the financial performance in the form of profit earned or loss sustained by the business. Balance Sheet shows financial position in the form of assets, liabilities and capital. These are prepared on the basis of trial balance and additional information, if any.

Example 1

Observe the following trial balance of Ankit and signify correctly the various elements of accounts and you will notice that the debit balances represent either assets or expenses/ losses and the credit balance represent either equity/liabilities or revenue/gains.
[This trial balance of Ankit will be used throughout the chapter to understand the process of preparation of financial statements]

Trial Balance of Ankit as on March 31, 2026

Account Title	*L.F.*	*Debit Amount* ₹	*Credit Amount* ₹
Cash		1,000	
Capital			12,000
Bank		5,000	
Sales			1,25,000
Wages		8,000	
Creditors			15,000
Salaries		25,000	
10% Long term loan (raised on April 01, 2016)			5,000
Furniture		15,000	
Commission received			5,000
Rent of building		13,000	
Debtors		15,500	
Bad debts		4,500	
Purchases		75,000	
		1,62,000	1,62,000

[1] The balance sheet and profit and loss account are now called position statement and statement of profit and loss in the company's financial statements. Since Chapters 8 and 9 deal with the preparation of financial statements of sole proprietorship firm, the terms balance sheet and profit and loss account are retained.

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Analysis of Trial Balance of Ankit as on March 31, 2026

Account Title	*Elements*	*L.F.*	*Debit Amount* ₹	*Credit Amount* ₹
Cash	Asset		1,000	
Capital	Equity			12,000
Bank	Asset		5,000	
Sales	Revenue			1,25,000
Wages	Expense		8,000	
Creditors	Liability			15,000
Salaries	Expense		25,000	
10% Long-term loan (raised on April 01, 2016)	Liability			5,000
Furniture	Asset		15,000	
Commission received	Revenue			5,000
Rent of building	Expense		13,000	
Debtors	Asset		15,500	
Bad debts	Expense		4,500	
Purchases	Expense		75,000	
			1,62,000	1,62,000

8.4 Trading and Profit and Loss Account

Trading and Profit and Loss account is prepared to determine the profit earned or loss sustained by the business enterprise during the accounting period. It is basically a summary of revenues and expenses of the business and calculates the net figure termed as profit or loss. Profit is revenue *less* expenses. If expenses are more than revenues, the figure is termed as *loss*. Trading and Profit and Loss account summarises the performance for an accounting period. It is achieved by transferring the balances of revenues and expenses to the trading and profit and loss account from the trial balance. Trading and Profit and Loss account is also an account with *Debit and Credit* sides. It can be observed that debit balances (representing expenses) and losses are transferred to the debit side of the Trading and a Profit and Loss account and credit balance (representing revenues/gains) are transfered to its credit side.

8.4.1 Relevant Items in Trading and Profit and Loss Account

The different items appearing in the trading and profit and loss account are explained hereunder:

Items on the debit side

(i) *Opening stock* : It is the stock of goods in hand at the beginning of the accounting year. This is the stock of goods which has been carried

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forward from the previous year and remains unchanged during the year and appears in the trial balance. In the trading account it appears on the debit side because it forms the part of cost of goods sold for the current accounting year.

(ii) *Purchases less returns* : Goods, which have been bought for resale appears as purchases on the debit side of the trading account. They include both cash as well as credit purchases. Goods which are returned to suppliers are termed as purchases return. It is shown by way of deduction from purchases and the computed amount is known as *Net purchases*.

(iii) *Wages* : Wages refer to renumeration paid to workers who are directly engaged in factory for loading, unloading and production of goods and are debited to trading account.

(iv) *Carriage inwards/Freight inwards:* These expenses are the items of transport expenses, which are incurred on bringing materials/goods purchased to the place of business. These items are paid in respect of purchases made during the year and are debited to the trading account.

(v) *Fuel/ Water/ Power/ Gas* : These items are used in the production process and hence are part of expenses.

(vi) *Packaging material and Packing charges* : Cost of packaging material used in the product are direct expenses as it refers to small containers which form part of goods sold. However, the packing refers to the big containers that are used for transporting the goods and is regarded as an indirect expense debited to profit and loss account.

(vii) *Salaries* : These include salaries paid to the administration, godown and warehouse staff for the services rendered by them for running the business. If salaries are paid in kind by providing certain facilities (called perks) to the employees such as rent free accommodation, meals, uniform, medical facilities should also be regarded as salaries and debited to the profit and loss account.

(viii) *Rent paid* : These include office and godown rent, municipal rates and taxes, factory rent, rates and taxes. The amount of rent paid is shown on the debit side of the profit and loss account.

(ix) *Interest paid* : Interest paid on loans, bank overdraft, renewal of bills of exchange, etc. is an expense and is debited to profit and loss account.

(x) *Commission paid:* Commission paid or payable on business transactions undertaken through the agents is an item of expense and is debited to profit and loss account.

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(xi) *Repairs* : Repairs and small renewals/ replacements relating to plant and machinery, furniture, fixtures, fittings, etc. for keeping them in working condition are included under this head. Such expenditure is debited to profit and loss account.

(xii) *Miscellaneous expenses* : Though expenses are classified and booked under different heads, but certain expenses being of small amount clubbed together and are called miscellaneous expenses. In normal usage these expenses are called *Sundry expenses* or *Trade expenses*.

Items on the credit side

(i) *Sales less returns* : Sales account in trial balance shows gross total sales(cash as well as credit) made during the year. It is shown on the credit side of the trading account. Goods returned by customers are called return inwards and are shown as deduction from total sales and the computed amount is known as net sales.

(ii) *Other incomes* : Besides salaries and other gains and incomes are also recorded in the profit and loss account. Examples of such incomes are rent received, dividend received, interest received, discount received, commission received, etc.

8.4.2 Closing Entries

The preparation of trading and profit and loss account requires that the balances of accounts of all concerned items are transferred to it for its compilation.

- Opening stock account, Purchases account, Wages account, Carriage inwards account and direct expenses account are closed by transferring to the debit side of the trading and profit and loss account.

This is done by recording the following entry :

Trading A/c		Dr.
To Opening stock A/c		
To Purchases A/c		
To Wages A/c		
To Carriage inwards A/c		
To All other direct expenses A/c		

- The purchases returns or return outwards are closed by transferring its balance to the purchases account. The following entry is recorded for this purpose :

Purchases return A/c		Dr.
To Purchases A/c		

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- Similarly, the sales returns or returns inwards account is closed by transferring its balance to the sales account as :

  Sales A/c Dr.
  To Sales return A/c

- The sales account is closed by transferring its balance to the credit side of the trading and profit and loss account by recording the following entry:

  Sales A/c Dr.
  To Trading A/c

Items of expenses, losses, etc. are closed by recording the following entries:

Profit and Loss A/c Dr.
To Expenses (individually) A/c
To Losses (individually) A/c

Items of incomes, gains, etc. are closed by recording the following entry:

Incomes (individually) A/c Dr.
Gains (individually) A/c Dr.
To Profit and Loss A/c

The posting for closing the seven accounts of expenses and revenues as they appear in the trial balance (in our example 1) are given below:

(i) *For closing the accounts of expenses*

Trading A/c	Dr.	83,000		
To Purchases A/c			75,000	
To Wages A/c			8,000	
(ii) Profit and Loss A/c	Dr.	43,500		
To Salaries			25,000	
To Rent of building			13,000	
To Bad debts			4,500	

(i) *For closing the accounts of revenues*

Sales A/c	Dr.	1,25,000		
To Trading A/c			1,25,000	
(ii) Commission received A/c	Dr.	5,000		
To Profit and Loss A/c			5,000	

The posting done in ledger will appear as follows :

Purchases Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Balance b/d		75,000		Trading		75,000
			75,000				75,000

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Wages Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Balance b/d		8,000		Trading		8,000
			8,000				8,000

Salaries Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Balance b/d		25,000		Profit and Loss		25,000
			25,000				25,000

Rent of Building Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Balance b/d		13,000		Profit and Loss		13,000
			13,000				13,000

Bad Debts Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Balance b/d		4,500		Profit and Loss		4,500
			4,500				4,500

Sales Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Trading		1,25,000		Balance b/d		1,25,000
			1,25,000				1,25,000

Commission Received Account

Dr. **Cr.**

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Profit and Loss		5,000		Balance b/d		5,000
			5,000				5,000

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As result of the foregoing discussion, we will now learn how the trading and profit and loss account can be prepared from the trial balance, the format of which is shown in figure 8.2. However, this list is not exhaustive. In real sense, there can be many more of other items, which we will be dealing at the later stage and there you will notice how this format undergoes a change with respect to each one of them.

Trading and Profit and Loss Account of ABC
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Opening stock	.....	Sales	.....
Purchases	.....		
Wages	.....		
Carriage inwards/ Freight inwards/cartage	.....		
Gross profit c/d[1]			
Gross loss b/d[2]			
	xxx		xxx
		Gross loss c/d[1]	.....
		Gross profit b/d	.....
Rent/rates and taxes	.....	Inerest received	.....
Salaries	.....		.....
Repairs and renewals	.....	Net loss[2]	
Bad debts	.....		
Net profit[2] (transferred to capital account)	.....		
	xxx		xxx

[1,2]*either of the items computed*

Fig. 8.2 : *A format trading and profit and loss account*

8.4.3 Concept of Gross Profit and Net Profit

The trading and profit and loss can be seen as combination of two accounts, viz. Trading account and Profit and Loss account. The trading account or the first part ascertains the *gross profit* and profit and loss account or the second part ascertains *net profit*.

Trading Account

The trading account ascertains the result from basic operational activities of the business. The basic operational activity involves the manufacturing, purchasing and selling of goods. It is prepared to ascertain whether the selling

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of goods and/or rendering of services to customers have proved profitable for the business or not. Purchases is one of the main constituents of expenses in business organisation. Besides purchases, the remaining expenses are divided into two categories, viz. *direct expenses and indirect* expenses.

Direct expenses means all expenses directly connected with the manufacture, purchase of goods and bringing them to the point of sale. Direct expenses include carriage inwards, freight inwards, wages, factory lighting, coal, water and feul, royalty on production, etc. In our example-1, besides purchases, four more items of expenses are listed. These are wages, salaries, rent of building and bad debts. Out of these items, wages is treated as *direct expense* while the other three are treated as *indirect expenses*.

Similarly, *sales* constitute the main item of revenue for the business. The excess of sales over purchases and direct expenses is called *gross profit*. If the amount of purchases including direct expenses is more than the sales revenue, the resultant figure is *gross loss*. The computation of gross profit can be shown in the form of equation as :

Gross Profit = Sales – (Purchases + Direct Expenses)

The gross profit or the gross loss is transferred to profit and loss account.

The *indirect expenses* are transferred to the debit side of the second part, viz. profit and loss account. All revenue/gains other than *sales* are transferred to the credit side of the profit and loss account. If the total of the credit side of the profit and loss account is more than the total of the debit side, the difference is the *net profit* for the period of which it is being prepared. On the other hand, if the total of the debit side is more than the total of the credit side, the difference is the *net loss* incurred by the business firm. In an equation form, it is shown as follows :

Net Profit = Gross Profit + Other Incomes – Indirect Expenses

Net profit or net loss so computed is transferred to the capital account in the balance sheet by way of the following entry :

(i) *For transfer of net profit*

Profit and Loss A/c		Dr.
To Capital A/c		

(ii) For transfer of net loss

Capital A/c		Dr.
To Profit and Loss A/c		

We are now redrafting the trading and profit and loss account to show gross profit and net profit of Ankit for the year ended March 31, 2017. The redrafted trading and profit and loss account will look like as shown is shown in figure 8.3.

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Trading and Profit and Loss Account of Ankit
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Purchases	75,000	Sales	1,25,000
Wages	8,000		
Gross profit c/d	**42,000**		
	1,25,000		1,25,000
Salaries	25,000	Gross profit b/d	**42,000**
Rent of building	13,000	Commission received	5,000
Bad debts	4,500		
Net Profit (transfered to capital account)	**4,500**		
	47,000		47,000

Fig. 8.3 : *Showing the computation of gross profit and net profit of Ankit*

Gross profit, which represents the basic operational activity of the business is computed as ₹ 42,000. The gross profit is transferred from trading account to profit and loss account. Besides gross profit, business has earned an income of ₹ 5,000 as commission received and has spent ₹ 42,500 (₹ 25,000 + ₹13,000 + ₹4,500) on expenses/losses including salaries, rent and bad debts. Therefore, the net profit is calculated as ₹ 4,500.

Illustration 1

Prepare a trading account from the following particulars for the year ended March 31, 2017:

	₹
Opening stock	37,500
Purchases	1, 05,000
Sales	2,70,000
Wages	30,000

Solution

Trading Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Opening stock	37,500	Sales	2,70,000
Purchases	1,05,000		
Wages	30,000		
Gross profit	97,500		
	2,70,000		2,70,000

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Illustration 2

Prepare a trading account of M/s Prime Products from the following particulars pertaining to the year 2025-26.

	₹
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, 2026

Dr. **Cr.**

Expenses/Losses		*Amount* ₹	*Revenues/Gains*		*Amount* ₹
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

Illustration 3.

Prepare a trading account of M/s Anjali from the following information related to March 31, 2026.

	₹
Opening stock	60,000
Purchases	3, 00,000
Sales	7, 50,000
Purchases return	18,000
Sales return	30,000
Carriage on purchases	12,000
Carriage on sales	15,000
Factory rent	18,000
Office rent	18,000
Dock and Clearing charges	48,000
Freight and Octroi	6,500
Coal, Gas and Water	10,000

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Solution

Books of Anjali
Trading Account
for the year ended March 2026

Dr. **Cr.**

Expenses/Losses		*Amount* ₹	*Revenues/Gains*		*Amount* ₹
Opening stock		60,000	Sales	7,50,000	
Purchases	3,00,000		*Less* : Sales return	(30,000)	7,20,000
Less : Purchases return	(18,000)	2,82,000			
Carriage on purchases		12,000			
Factory rent		18,000			
Dock and Clearing charges		48,000			
Freight and Octroi		6,500			
Coal, Gas and Water		10,000			
Gross profit		2,83,500			
		7,20,000			7,20,000

Illustration 4

From the following information, prepare a profit and loss account for the year ending March 31, 2026.

	₹
Gross profit	60,000
Rent	5,000
Salary	15,000
Commission paid	7,000
Interest paid on loan	5,000
Advertising	4,000
Discount received	3,000
Printing and stationery	2,000
Legal charges	5,000
Bad debts	1,000
Depreciation	2,000
Interest received	4,000
Loss by fire	3,000

Profit and Loss Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Rent	5,000	Gross profit	60,000
Salary	15,000	Discount received	3,000
Commission	7,000	Interest received	4,000
Interest paid on loan	5,000		
Advertising	4,000		
Printing and Stationery	2,000		
Legal charges	5,000		

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Bad debts	1,000		
Depreciation	2,000		
Loss by fire	3,000		
Net profit (transferred to the capital account)	18,000		
	67,000		67,000

Test Your Understanding - I

I State True or False :

(i) Gross profit is total revenue.

(ii) In trading and profit and loss account, opening stock appears on the debit side because it forms the part of the cost of sales for the current accounting year.

(iii) Rent, rates and taxes is an example of direct expenses.

(iv) If the total of the credit side of the profit and loss account is more than the total of the debit side, the difference is the net profit.

II Match the items given under 'A' with the correct items under 'B'

(i) Closing stock is credited to	(a) Trial balance
(ii) Accuracy of book of account is tested by	(b) Trading account
(iii) On returning the goods to seller, the buyer sends	(c) Credit note
(iv) The financial position is determined by	(d) Balance sheet
(v) On receiving the returned goods from the buyer, the seller sends	(e) Debit note

8.4.4 Cost of Goods Sold and Closing Stock–Trading Account Revisited

The trading and profit and loss account prepared in figure 8.3 presents useful information as to the profitability from the basic operations of the business enterprise. It is reproduced for further perusal.

Trading Account of Ankit
for the year ended March 31, 2017

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Purchases	75,000	Sales	1,25,000
Wages	8,000		
Gross profit	42,000		
	1,25,000		1,25,000

Fig. 8.4 : *An illutrative trading account of Ankit*

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If there is no opening or closing stock, the total of purchases and direct expenses is taken as *Cost of goods sold*. In our example, notice that purchases amount to ₹ 75,000 and wages amounts to ₹ 8,000. Hence, the cost of goods sold will be computed using the following formula :

Cost of Goods Sold = Purchases + Direct Expenses
= ₹75,000 + ₹ 8,000
= ₹ 83,000

As there is no unsold stock, the presumption here is that all the goods purchased have been sold. But in practice, there is some unsold goods at the end of the accounting period.

In our example, let us assume that out of the goods purchased amounting to ₹ 75,000 in the current year, Ankit is able to sell goods costing ₹ 60,000 only. In such a situation, the business will have an unsold stock of goods costing ₹ 15,000 in hand, also called closing stock. The amount of cost of goods sold will be computed as per the following equation :

Cost of Goods Sold = Purchases + Direct Expenses – Closing Stock
= ₹ 75,000 + ₹ 8,000 – ₹ 15,000

As a result, the amount of gross profit will also change with the existence of closing stock in business from ₹ 42,000 (as computed in figure 8.4) to ₹ 57,000 (refer figure 8.5).

Trading Account of Ankit
for the year ended March 31, 2026

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Purchases	75,000	Sales	1,25,000
Wages	8,000	Closing stock	15,000
Gross profit c/d	57,000		
	1,40,000		1,40,000
Salaries	25,000	Gross profit b/d	57,000
Rent of building	13,000	Commission received	5,000
Bad debts	4,500		
Net Profit (transfered to capital account)	19,500		
	62,000		62,000

Fig. 8.5 : *The trading account of Ankit*

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It may be noted that closing stock does not normally form part of trial balance, and is brought into books with the help of the following journal entry :

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

This entry opens a new account of asset, i.e. closing stock ₹ 15,000 which is transferred to the balance sheet. The closing stock shall be an opening stock for the next year and shall be sold during the year. In most cases, therefore, the business shall have opening stock as well as closing stock every year, and the cost of goods sold should be worked as per the following equation:

Cost of Goods Sold = Opening Stock+Purchases Direct Expenses–Closing Stock

Look at Illustration 5 and see how it has been computed.

Illustration 5

Compute cost of goods sold for the year 2017 with the help of the following information and prepare trading account

	₹
Sales	20, 00,000
Purchases	15, 00,000
Wages	1, 00,000
Stock (Apr. 01, 2016)	3, 00,000
Stock (March 31, 2017)	4,00,000
Freight inwards	1,00,000

Solution

Computation of Cost of Goods Sold

Particulars	*Amount* ₹
Opening stock	3,00,000
Add Purchases	15,00,000
Direct expenses :	
Freight inwards	1,00,000
Wages	1,00,000
	20,00,000
Less Closing stock	(4,00,000)
Cost of goods sold	16,00,000

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Trading Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Opening stock	3,00,000	Sales	20,00,000
Purchases	15,00,000	Closing stock	4,00,000
Freight inwards	1,00,000		
Wages	1,00,000		
Gross profit	4,00,000		
	24,00,000		24,00,000

Illustration 6

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

	₹		₹
Stock on Apr. 01, 2016	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, 2017 is ₹ 4,500

Books of H. Balaram
Trading Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
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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8.5 Operating Profit (EBIT)

It is the profit earned through the normal operations and activities of the business. Operating profit is the excess of operating revenue over operating expenses. While calculating operating profit, the incomes and expenses of a purely financial nature are not taken into account. Thus, operating profit is profit before interest and tax (EBIT). Similarly, abnormal items such as loss by fire, etc. are also not taken into account. It is calculated as follows:

Operating profit = Net Profit + Non Operating Expenses – Non Operating Incomes

Refer to the trial balance of Ankit in example 1 (Page no. 294), you will notice that it depicts an item relating to 10% interest on long-term loan raised on April 01, 2017. The amount of interest works out to ₹ 500 (₹ 5,000 × 10/100), which has been shown on the debit side of the trading and profit and loss account (figure 8.6).

Trading and Profit and Loss Account of Ankit
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Purchases	75,000	Sales	1,25,000
Wages	8,000	Closing stock	15,000
Gross profit c/d	57,000		
	1,40,000		1,40,000
Salaries	25,000	Gross profit b/d	57,000
Rent of building	13,000	Commission received	5,000
Bad debts	4,500		
Interest	500		
Net Profit (transferred to capital account)	19,000		
	62,000		62,000

Fig. 8.6 : *Showing the treatment of interest on profit*

The operating profit will be :

Operating profit = Net profit + Non-operating expenses – Non-operating incomes
Operating profit = ₹ 19,000+ 500 – nil
= ₹ 19,500

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Test Your Understanding - II

Choose the correct option in the following questions :

1. The financial statements consist of:
   (i) Trial balance
   (ii) Profit and loss account
   (iii) Balance sheet
   (iv) (i) & (iii)
   (v) (ii) & (iii)
2. Choose the correct chronological order of ascertainment of the following profits from the profit and loss account :
   (i) Operating Profit, Net Profit, Gross Profit
   (ii) Operating Profit, Gross Profit, Net Profit
   (iii) Gross Profit, Operating Profit, Net Profit
   (iv) Gross Profit, Net Profit, Operating Profit
3. While calculating operating profit, the following are not taken into account.
   (i) Normal transactions
   (ii) Abnormal items
   (iii) Expenses of a purely financial nature
   (iv) (ii) & (iii)
   (v) (i) & (iii)
4. Which of the following is correct :
   (i) Operating Profit = Operating profit – Non-operating expenses – Non-operating incomes
   (ii) Operating profit = Net profit + Non-operating Expenses + Non-operating incomes
   (iii) Operating profit = Net profit + Non-operating Expenses – Non-operating incomes
   (iv) Operating profit = Net profit – Non-operating Expenses + Non-operating incomes

Illustration 7

Following balance is extracted from the books of a trader ascertain gross profit, operating profit and net profit for the year ended March 31, 2026.

Particulars	*Amount* ₹
Sales	75,250
Purchases	32,250
Opening stock	7,600
Sales return	1,250
Purchases return	250
Rent	300
Stationery and printing	250
Salaries	3,000
Misc. expenses	200
Travelling expenses	500
Advertisement	1,800

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Commission paid	150
Office expenses	1,600
Wages	2,600
Profit on sale of investment	500
Depreciation	800
Dividend on investment	2,500
Loss on sale of old furniture	300

Closing stock (March 31, 2026) valued at ₹ 8,000

Trading and Profit and Loss Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses		*Amount* ₹	*Revenues/Gains*		*Amount* ₹
Opening stock		7,600	Sales	75,250	
Purchases	32,250		*Less* : Sales return	(1,250)	74,000
Less: Purchases return	(250)	32,000	Closing stock		8,000
Wages		2,600			
Gross profit c/d		**39,800**			
		82,000			82,000
Rent		300	Gross profit b/d		39,800
Stationery and printing		250			
Salaries		3,000			
Misc. expenses		200			
Travelling expenses		500			
Advertisement expenses		1,800			
Commission paid		150			
Office expenses		1,600			
Depreciation		800			
Operating profit c/d		**31,200**			
		39,800			39,800
Loss on sale of old furniture		300	Operating profit b/d		**31,200**
Net Profit (transferred to capital account)		33,900	Profit on sale of investment	500	
			Dividend on investment		2,500
		34,200			34,200

8.6 Balance Sheet

The balance sheet is a statement prepared for showing the financial position of the business summarising its assets and liabilities at a given date. The assets reflect debit balances and liabilities (including capital) reflect credit balances.

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It is prepared at the end of the accounting period after the trading and profit and loss account have been prepared. It is called balance sheet because it is a statement of balances of ledger accounts that have not been transferred to trading and profit and loss account and are to be carried forward to the next year with the help of an opening entry made in the journal at the beginning of the next year.

8.6.1 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 III Part I of the Companies Act 2013* 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 8.7.

Balance Sheet of .....as at March 31, 2026

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
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

Fig. 8.7 : *Format of a balance sheet*

Refer to our example -1 you will observe that the trial balance of Ankit depicts 14 accounts, out of which 7 accounts have been transferred to the trading and profit and loss account (refer figure 8.3). These are the accounts of revenues and expenses. The analysis of figure 8.3 shows that the business has incurred total expenses of ₹ 1,25,500 and revenues generated are ₹ 1,30,000 making a profit of ₹ 4,500. The remaining *seven items* in the trial balance reflects the capital, assets and liabilities. We are reproducing the trial balance (example -1) to show how the accounts of assets and liabilities of Ankit would be presented in the balance sheet.

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Trial Balance of Ankit as on March 31, 2026

Account Title	*L.F.*	*Debit Amount* ₹	*Credit Amount* ₹
Cash		**1,000**	
Capital			**12,000**
Bank		**5,000**	
Sales			1,25,000
Wages		8,000	
Creditors			15,000
Salaries		25,000	
10% Long-term loan (raised on April 01, 2016)			**5,000**
Furniture		**15,000**	
Commission received			5,000
Rent of building		13,000	
Debtors		**15,500**	
Bad debts		4,500	
Purchases		75,000	
		1,62,000	1,62,000

Fig. 8.8 : *Showing the accounts of assets and liabilities in the trial balance of Ankit*

Balance Sheet of Ankit as at March 31, 2026

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Capital	12,000		Furniture	15,000
Add Profit	4,500	16,500	Cash	1,000
10 % Long-term loan		5,000	Bank	5,000
Creditors		15,000	Debtors	15,500
		36,500		36,500

Fig. 8.9 : *Showing the balance sheet of Ankit*

8.6.2 Relevant Items in the Balance Sheet

Items which are generally included in a balance sheet are explained below :

(1) *Current Assets:* Current assets are those which are either in the form of cash or a can be converted into cash within a year. The examples of such assets are cash in hand/bank, bills receivable, stock of raw materials, semi-finished goods and finished goods, sundry debtors, short term investments, prepaid expenses, etc.

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(2) *Current Liabilities*: Current liabilities are those liabilities which are expected to be paid within a year and which are usually to be paid out of current assets. The examples of such liabilities are bank overdraft, bills payable, sundry creditors, short-term loans, outstanding expenses, etc.

(3) *Fixed Assets:* Fixed assets are those assets, which are held on a long-term basis in the business. Such assets are not acquired for the purpose of resale, e.g. land, building, plant and machinery, furniture and fixtures, etc. Some times the term 'Fixed Block' or 'Block Capital' is also used for them.

(4) *Intangible Assets :* These are such assets which cannot be seen or touched. Goodwill, Patents, Trademarks are some of the examples of intangible assets.

(5) *Investments:* Investments represent the funds invested in government securities, shares of a company, etc. They are shown at cost price. If, on the date of preparation the balance sheet, the market price of investments is lower than the cost price, a footnote to that effect may be appended to the balance sheet.

(6) *Long-term Liabilities* : All liabilities other than the current liabilities are known as long-term liabilities. Such liabilities are usually payable after one year of the date of the balance sheet. The important items of long term liabilities are long-term loans from bank and other financial institutions.

(7) *Capital:* It is the excess of assets over liabilities due to outsiders. It represents the amount originally contributed by the proprietor/ partners as increased by profits and interest on capital and decreased by losses drawings and intrest on drawings.

(8) *Drawings* : Amount withdrawn by the proprietor is termed as drawings and has the effect of reducing the balance on his capital account. Therefore, the drawings account is closed by transferring its balance to his capital account. However it is shown by way of deduction from capital in the balance sheet.

8.6.3 Marshalling and Grouping of Assets and Liabilities

A major concern of accounting is about preparing and presenting the financial statement. The information so provided should be decision useful for the users. Therefore, it becomes necessary that the items appearing in the balance sheet should be properly *grouped* and presented in a particular order.

Marshalling of Assets and Liabilities

In a balance sheet, the assets and liabilities are arranged either in the order of *liquidity* or *permanence*. Arrangement of assets and liabilities in a particular order is known as Marshalling.

In case of *permanence*, the most permanent asset or liability is put on the top in the balance sheet and thereafter the assets are arranged in their reducing level of permanence.

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In the balance sheet of Ankit you will find that furniture is the most permanent of all the assets. Out of debtors, bank and cash, debtors will take maximum time to convert back into cash. Bank is less liquid than cash. Cash is the most liquid of all the assets. Similarly, on the liabilities side, the capital, being the most important source of finance will tend to remain in the business for a longer period than the long-term loan. Creditors being a liquid liability will be discharged in the near future. The balance sheet of Ankit in the order of permanence is shown in figure 8.10(a).

Balance Sheet of Ankit as on March 31, 2026 (in order of permanence)

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Capital	12,000		Furniture	15,000
Add Profit	4,500	16,500	Debtors	15,500
10 % Long-term loan		5,000	Bank	5,000
Creditors		15,000	Cash	1,000
		36,500		36,500

Fig. 8.10 (a) : *Items of balance sheet shown in the order of permanance*

In case of *liquidity*, the order is reversed. The information presented in this manner would enable the user to have a good idea about the life of the various accounts. The assets account of the relatively permanent nature would continue in the business for a longer time whereas the less permanent or more liquid accounts will change their forms in the near future and are likely to become cash or cash equivalent.

The balance sheet of Ankit in the order of liquidity is shown in figure 8.10(b)

Balance Sheet of Ankit as at March 31, 2026
(in order of liquidity)

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Creditors		15,000	Cash	1,000
10 % Long-term loan		5,000	Bank	5,000
Capital	12,000		Debtors	15,500
Add Profit	4,500	16,500	Furniture	15,000
		36,500		36,500

Fig. 8.10 (b) : *Items of balance sheet shown in the order of liquidity*

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Grouping of Assets and Liabilities

The items appearing in the balance sheet can also be properly grouped. The term grouping means putting together items of similar nature under a common heading. For example, the balance of accounts of cash, bank, debtors, etc. can be grouped and shown under the heading of 'current assets' and the balances of all fixed assets and long-term investment under the heading of 'non-current assets'.

Balance Sheet of Ankit as at March 31, 2026
(in order of permanence)

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Owners Funds			*Non Current Assets*	
Capital	12,000		Furniture	15,000
Add Profit	4,500	16,500	*Current Assets*	
Non-Current Liabilities			Debtors	15,500
Long-term loan		5,000	Bank	5,000
Current Liabilities			Cash	1,000
Creditors		15,000		
		36,500		36,500

Fig. 8.10 (c): *Showing assets and liabilities arranged in logical groups*

Do it Yourself

Arrange the following items in the order of both permanence and liquidity. Also group them under logical heads :

Liabilities	*Assets*
Long-term loans	Building
Bank overdraft	Cash in hand
Bills payable	Cash at bank
Owner's equity	Bills receivable
Short-term loans	Sundry debtors
Sundry creditors	Land
	Finished goods
	Work in progress
	Raw material

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Illustration 8

From the following balances prepare a trading and profit and loss account and balance sheet for the year ended March 31, 2026

Account Title	*Amount* ₹	*Account Title*	*Amount* ₹
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

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Trading and Profit and Loss Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses	*Amount* ₹	*Revenues/Gains*	*Amount* ₹
Purchases *less* return	1,60,000	Sales *less* return	5,20,000
Commission on purchases	2,000		
Carriage on goods purchased	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

Balance Sheet as at March 31, 2026

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
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

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Illustration 9

From the following balances prepare trading and profit and loss account and balance sheet for the year ended March 31, 2026

Account Title	*Amount* ₹	*Account Title*	*Amount* ₹
Opening stock	15,310	Capital	2,50,000
Purchases	82,400	Drawings	48,000
Sales	256,000	Sundry debtors	57,000
Returns (Dr.)	4,000	Sundry creditors	12,000
Returns (Cr.)	2,400	Depreciation	4,200
Factory rent	18,000	Charity	500
Custom duty	11,500	Cash balance	4,460
Coal, gas & power	6,000	Bank balance	4,000
Wages and salary	36,600	Bank charges	180
Discount (Dr.)	7,500	Establishment expenses	3,600
Commission (Cr.)	1,200	Plant	42,000
Bad debts	5,850	Leasehold building	1,50,000
Bad debts recovered	2,000	Sales tax collected	2,000
Apprenticeship premium	4,800	Goodwill	20,000
Production expenses	2,600	Patents	10,000
Adminstrative expenses	5,000	Trademark	5,000
Carriage	8,700	Loan (Cr.)	25,000
		Interest on loan	3,000

The value of closing stock on March 31, 2026 was ₹ 25,400

Solution

Trading and Profit and Loss Account
for the year ended March 31, 2026

Dr. **Cr.**

Expenses/Losses		*Amount* ₹	*Revenues/Gains*		*Amount* ₹
Opening stock		15,310	Sales:	2,56,000	
Purchases:	82,400		*Less* Returns	(4,000)	2,52,000
Less Returns :	(2,400)	80,000			
Factory rent		18,000	Closing stock		25,400
Custom duty		11,500			
Coal, gas, power		6,000			
Wages and salary		36,600			
Production expenses		2,600			
Carriage		8,700			
Gross profit c/d		98,690			
		2,77,400			2,77,400

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Discount (Dr.)	7,500	Gross profit b/d	98,690
Bad debts	5,850	Commission	1,200
Administrative expenses	5,000	Bad debts recovered	2,000
Depreciation	4,200	Apprenticeship premium	4,800
Charity	500		
Bank charges	180		
Establishment expenses	3,600		
Interest on loan	3,000		
Net profit (transferred to capital account)	76,860		
	1,06,690		1,06,690

Balance Sheet as at March 31, 2026

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Sales tax collected		2,000	Cash balance	4,460
Sundry creditors		12,000	Bank balance	4,000
Loan		25,000	Sundry debtors	57,000
Capital	2,50,000		Closing stock	25,400
Add Net profit	76,860		Leasehold building	1,50,000
	3,26,860		Plant	42,000
			Patents	10,000
Less Drawings	(48,000)	2,78,860	Goodwill	5,000
			Trade mark	20,000
		3,17,860		3,17,860

8.7 Opening Entry

The balances of various accounts in balance sheet are carried forward from one accounting period to another accounting period. In fact, the balance sheet of an accounting period becomes the opening trial balance of the next accounting period. Next year an opening entry is made which opens these accounts contained in the balance sheet.

Refer the balance sheet shown in figure 8.10(c). The opening entry with regard to it will be recorded as follows :

Furniture A/c	Dr.	15,000	
Debtors A/c	Dr.	15,500	
Bank's A/c	Dr.	5,000	
Cash A/c	Dr.	1,000	
To Capital A/c			16,500
To 10 % Long-term loan A/c			5,000
To Creditors A/c			15,000

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Key Terms Introduced in the Chapter

- Balance Sheet
- Bills Payable
- Capital
- Capital Receipts
- Carriage Outwards
- Closing Entries
- Current Assets
- Purchases Return
- Return Inwards
- Revenue Expenditure
- Discount Allowed
- Cash
- Factory Expenses
- Fixed Assets
- Gross Profit
- Income Tax
- Interest on Drawings
- Net Profit
- Order of Performance and Liquidity
- Revenue Receipts
- Sales
- Grouping and Marshalling
- Bank Overdraft
- Bills Receivable
- Capital Expenditure
- Carriage Inwards
- Cash at Bank
- Closing Stock
- Currents Liabilities
- Rent
- Return Outwards
- Depreciation
- Discount Received
- Trade Expenses
- Financial Statements
- Freight
- Gross Loss
- Interest on Capital
- Net Loss
- Revenue Expenditure
- Salaries
- Sales Return
- Opening Entries

Summary with Reference to Learning Objectives

1 *Meaning, usefulness and types of financial statements :* After the agreement of the trial balance, a business enterprise proceeds to prepare financial statements. Financial statements are the statements, which present periodic reports on the process of business enterprises and the results achieved during a given period.

Financial statements includs trading and profit and loss account, balance sheet and other statements and explanatory notes, which form part thereof. Information provided by financial statements is useful to management to plan and control the business operations. Financial statement are also useful to creditors, shareholders and employees of the enterprise.

2 *Meaning need and preparation of trading and profit and loss account* : The profit and loss account highlights the profit earned or loss sustained by the business entity in the course of business operation during a given period.

The need for preparing the trading and profit and loss account is to ascertain the net result of business operations during a given period. The profit and loss account shows the items of revenue expenses and losses on the debit side, while items of gain and gross profit are shown on the credit side. For the preparation of the trading and profit and loss account, closing entries are recorded to transfer balances of account of items of expenses and revenues. Net profit or net loss shown by the profit and loss account is transferred to the capital account.

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3 *Meaning, characteristic, need and structure of the balance sheet* : The balance sheet is a statement of assets and liabilities of a business enterprise and shows the financial position at a given date Informations contained in a balance sheet is true only on that date. The balance sheet is a part of the final account. But it is not an account, it is only a statement. In a balance sheet the totals of assets and liabilities are always equal. It portrays the accounting equation.

A balance sheet has to be prepared to know the financial position of the business, and the nature and values of its assets and liabilities. All the accounts which have not been closed till the preparation of the profit and loss account are shown in the balance sheet. Assets and liabilities shown in the balance sheet are marshalled in order of liquidity or in order of permanence.

Questions for Practice

Short Answers

1. What are the objectives of preparing financial statements ?
2. What is the purpose of preparing trading and profit and loss account?
3. Explain the concept of cost of goods sold?
4. What is a balance sheet. What are its characteristics?
5. Distinguish between capital and revenue expenditure and state whether the following statements are items of capital or revenue expenditure :
   (a) Expenditure incurred on repairs and whitewashing at the time of purchase of an old building in order to make it usable.
   (b) Expenditure incurred to provide one more exit in a cinema hall in compliance with a government order.
   (a) Registration fees paid at the time of purchase of a building
   (b) Expenditure incurred in the maintenance of a tea garden which will produce tea after four years.
   (c) Depreciation charged on a plant.
   (d) The expenditure incurred in erecting a platform on which a machine will be fixed.
   (e) Advertising expenditure, the benefits of which will last for four years.
6. What is an operating profit?

Long Answers

1. What are financial statements? What information do they provide.
2. What are closing entries? Give four examples of closing entries.
3. Discuss the need of preparing a balance sheet.
4. What is meant by Grouping and Marshalling of assets and liabilities. Explain the ways in which a balance sheet may be marshalled.

Numerical Questions

1. From the following balances taken from the books of Simmi and Vimmi Ltd. for the year ending March 31, 2026, calculate the gross profit.

	(₹)
Closing stock	2,50,000
Net sales during the year	40,00,000
Net purchases during the year	15,00,000

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Opening stock	15,00,000
Direct expenses	80,000

(*Ans.* Gross profit ₹11,70,000)

2. From the following balances extracted from the books of M/s Ahuja and Nanda. Calculate the amount of :
   (a) Cost of goods available for sale
   (b) Cost of goods sold during the year
   (c) Gross Profit

	₹
Opening stock	25,000
Credit purchases	7,50,000
Cash purchases	3,00,000
Credit sales	12,00,000
Cash sales	4,00,000
Wages	1,00,000
Salaries	1,40,000
Closing stock	30,000
Sales return	50,000
Purchases return	10,000

(*Ans.* (a) ₹ 11,65,000 ; (b) ₹11,35,000 ; (c) ₹4,15,000

3. Calculate the amount of gross profit and operating profit on the basis of the following balances extracted from the books of M/s Rajiv & Sons for the year ended March 31, 2026.

	₹
Opening stock	50,000
Net sales	11,00,000
Net purchases	6,00,000
Direct expenses	60,000
Administration expenses	45,000
Selling and distribution expenses	65,000
Loss due to fire	20,000
Closing stock	70,000

(*Ans.* Gross profit ₹4,60,000, Operating profit ₹3,50,000)

4. Operating profit earned by M/s Arora & Sachdeva in 2025-26 was ₹17,00,000. Its non-operating incomes were ₹1,50,000 and non-operating expenses were ₹3,75,000. Calculate the amount of net profit earned by the firm.
(*Ans.* Net profit ₹14,75,000)

5. The following are the extracts from the trial balance of M/s Bhola & Sons as on March 31, 2026

Account title	*Debit* ₹	*Credit* ₹
Opening stock	2,00,000	
Purchases	8,10,000	
Sales		10,10,000
	10,10,000	10,10,000

(only relevant items)

Closing Stock as on date was valued at ₹3,00,000.

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You are required to record the necessary journal entries and show how the above items will appear in the trading and profit and loss account and balance sheet of M/s Bhola & Sons.

6. Prepare trading and profit and loss account and balance sheet as on March 31, 2026 :

Account Title	*Amount* ₹	*Account Title*	*Amount* ₹
Machinery	27,000	Capital	60,000
Sundry debtors	21,600	Bills payable	2,800
Drawings	2,700	Sundry creditors	1,400
Purchases	58,500	Sales	73,500
Wages	15,000		
Sundry expenses	600		
Rent & taxes	1,350		
Carriage inwards	450		
Bank	4,500		
Openings stock	6,000		

Closing stock as on March 31, 2026 ₹22,400

[*Ans.* Gross profit ₹15,950, Net profit ₹14,000, Total balance sheet ₹75,500]

7. The following trial balance is extracted from the books of M/s Ram on March 31, 2026. You are required to prepare trading and profit and loss account and the balance sheet as on date :

Account title	*Amount* ₹	*Account title*	*Amount* ₹
Debtors	12,000	Apprenticeship premium	5,000
Purchases	50,000	Loan	10,000
Coal, gas and water	6,000	Bank overdraft	1,000
Factory wages	11,000	Sales	80,000
Salaries	9,000	Creditors	13,000
Rent	4,000	Capital	20,000
Discount	3,000		
Advertisement	500		
Drawings	1,000		
Loan	6,000		
Petty cash	500		
Sales return	1,000		
Machinery	5,000		
Land and building	10,000		
Income tax	100		
Furniture	9,900		

(*Ans.* Gross profit: ₹ 12,000, Net profit: ₹ 500, Total balance sheet: ₹ 43,400)

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8. The following is the trial balance of Manju Chawla on March 31, 2026. You are required to prepare trading and profit and loss account and a balance sheet as on date :

Account title	*Debit Amount* ₹	*Credit Amount* ₹
Opening stock	10,000	
Purchases and sales	40,000	80,000
Returns	200	600
Productive wages	6,000	
Dock and Clearing charges	4,000	
Donation and charity	600	
Delivery van expenses	6,000	
Lighting	500	
Sales tax collected		1,000
Bad debts	600	
Misc. incomes		6,000
Rent from tenants		2,000
Royalty	4,000	
Capital		40,000
Drawings	2,000	
Debtors and Creditors	6,0000	7,000
Cash	3,000	
Investment	6,000	
Patents	4,000	
Land and Machinery	43,000	

Closing stock ₹ 2,000.

(*Ans.* Gross Profit: ₹ 18,400, Net profit: ₹ 18,700, Total balance sheet: ₹ 64,700)

9. The following is the trial balance of Mr. Deepak as on March 31, 2026. You are required to prepare trading account, profit and loss account and a balance sheet as on date :

Account title	*Debit Amount* ₹	*Account title*	*Credit Amount* ₹
Drawings	36,000	Capital	2,50000
Insurance	3,000	Bills payable	3,600
General expenses	29,000	Creditors	50,000
Rent and taxes	14,400	Discount recived	10,400
Lighting (factory)	2,800	Purchases return	8,000
Travelling expenses	7,400	Sales	4,40,000
Cash in hand	12,600		
Bills receivable	5,000		

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Sundry debtors	1,04,000		
Furniture	16,000		
Plant and Machinery	1,80,000		
Opening stock	40,000		
Purchases	1,60,000		
Sales return	6,000		
Carriage inwards	7,200		
Carriage outwards	1,600		
Wages	84,000		
Salaries	53,000		

Closing stock ₹ 35,000.

(*Ans.* Gross profit: ₹1,83,000, Net profit : ₹ 85,000, Total balance sheet: ₹ 3,52,600)

10. Prepare trading and profit and loss account and balance sheet from the following particulars as on March 31, 2026.

Account Title	*Debit Amount* ₹	*Credit Amount* ₹
Purchases and Sales	3,52,000	5,60,000
Return inwards and Return outwards	9,600	12,000
Carriage inwards	7,000	
Carriage outwards	3,360	
Fuel and power	24,800	
Opening stock	57,600	
Bad debts	9,950	
Debtors and Creditors	1,31,200	48,000
Capital		3,48,000
Investment	32,000	
Interest on investment		3,200
Loan		16,000
Repairs	2,400	
General expenses	17,000	
Wages and salaries	28,800	
Land and buildings	2,88,000	
Cash in hand	32,000	
Miscellaneous receipts		160
Sales tax collected		8,350

Closing stock ₹ 30,000.

(*Ans.* Gross profit: ₹ 1,22,200, Net profit : ₹92,850, Total balance sheet: ₹5,13,200)

11. From the following trial balance of Mr. A. Lal, prepare trading, profit and loss account and balance sheet as on March 31, 2026.

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Account Title	*Debit Amount* ₹	*Credit Amount* ₹
Stock as on April 01, 2016	16,000	
Purchases and Sales	67,600	1,12,000
Returns inwards and outwards	4,600	3,200
Carriage inwards	1,400	
General expenses	2,400	
Bad debts	600	
Discount received		1,400
Bank over draft		10,000
Interest on bank overdraft	600	
Commission received		1,800
Insurance and taxes	4,000	
Scooter expenses	200	
Salaries	8,800	
Cash in hand	4,000	
Scooter	8,000	
Furniture	5,200	
Building	65,000	
Debtors and Creditors	6,000	16,000
Capital		50,000

Closing stock ₹ 15,000.

(*Ans.* Gross profit : ₹ 40,600, Net profit: ₹ 27,200, Total balance sheet: ₹ 1,03,200)

12. Prepare trading and profit and loss account and balance sheet of M/s Royal Traders from the following balances as on March 31, 2026.

Debit balances	*Amount* ₹	*Credit balances*	*Amount* ₹
Stock	20,000	Sales	2,45,000
Cash	5,000	Creditors	10,000
Bank	10,000	Bills payable	4,000
Carriage on purchases	1,500		Capital
2,00,000			
Purchases	1,90,000		
Drawings	9,000		
Wages	55,000		
Machinery	1,00,000		
Debtors	27,000		
Postage	300		
Sundry expenses	1,700		
Rent	4,500		
Furniture	35,000		

Closing stock ₹8,000.

(*Ans.* Gross loss ₹ 13,500, Net loss ₹ 20,000, Total balance sheet: ₹ 1,85,000)

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13. Prepare trading and profit and loss account from the following particulars of M/s Neema Traders as on March 31, 2026.

Account Title	*Debit Amount* ₹	*Account Title*	*Credit Amount* ₹
Buildings	23,000	Sales	1,80,000
Plant	16,930	Loan	8,000
Carriage inwards	1,000	Bills payable	2,520
Wages	3,300	Bank overdraft	4,720
Purchases	1,64,000	Creditors	8,000
Sales return	1,820	Capital	2,36,000
Opening stock	9,000	Purchases return	1,910
Machinery	2,10,940		
Insurance	1,610		
Interest	1,100		
Bad debts	250		
Postage	300		
Discount	1,000		
Salaries	3,000		
Debtors	3,900		

Stock on March 31, 2026 ₹16,000.

(*Ans.* Gross profit ₹17,850, Net profit ₹ 10,590, Total of balance sheet ₹2,69,830)

14. From the following balances of M/s Nilu Sarees as on March 31, 2026. Prepare trading and profit and loss account and balance sheet as on date.

Account Title	*Debit Amount* ₹	*Account Title*	*Credit Amount* ₹
Opening stock	10,000	Sales	2,28,000
Purchases	78,000	Capital	70,000
Carriage inwards	2,500	Interest	7,000
Salaries	30,000	Commission	8,000
Commission	10,000	Creditors	28,000
Wages	11,000	Bills payable	2,370
Rent & taxes	2,800		
Repairs	5,000		
Telephone expenses	1,400		
Legal charges	1,500		
Sundry expenses	2,500		
cash in hand	12,000		
Debtors	30,000		
Machinery	60,000		
Investments	90,000		
Drawings	18,000		

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Closing stock as on March 31, 2026 ₹22,000.

(*Ans.* Gross profit ₹ 1,56,500, Net profit ₹ 1,10,300, Total balance sheet ₹2,14,000)

15. Prepare trading and profit and loss account of M/s Sports Equipments for the year ended March 31, 2026 and balance sheet as on that date :

Account Title	*Debit Amount* ₹	*Credit Amount* ₹
Opening stock	50,000	
Purchases and sales	3,50,000	4,21,000
Sales returns	5,000	
Capital		3,00,000
Commission		4,000
Creditors		1,00,000
Bank overdraft		28,000
Cash in hand	32,000	
Furniture	1,28,000	
Debtors	1,40,000	
Plants	60,000	
Carriage on purchases	12,000	
Wages	8,000	
Rent	15,000	
Bad debts	7,000	
Drawings	24,000	
Stationery	6,000	
Travelling expenses	2,000	
Insurance	7,000	
Discount	5,000	
Office expenses	2,000	

Closing stock as on March 31, 2026 ₹2,500

(*Ans.* Gross loss ₹ 1,500, Net loss ₹ 41,500 , Total balance sheet ₹3,62,500)

Checklist to Test Your Understanding

1. *Test Your Understanding - I*

I	(i) T	(ii) T	(iii) F	(iv) T	
II	(i) b	(ii) a	(iii) e	(iv) c	(v) d

2. *Test Your Understanding - II*

1. (v) 2. (iii) 3. (iv) 4. (iii)

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