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## LESSON

# 3

## FINAL ACCOUNTS

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### 3.0 AIMS AND OBJECTIVES

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After studying this lesson, you will be able to:

- Analyze Trading Account
- Understand how to prepare Profit and Loss Account and Balance Sheet

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### 3.1 INTRODUCTION

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The preparation of Final Accounts of the business firm involves two different stages viz. Preparation of Accounting and Positional Statements of the enterprise. The preparation of accounting statements involves two different categories viz. Trading Account and Profit & Loss Account.

The preparation of the positional statement involves only one statement viz. Balance Sheet. In this chapter the accounting statements as well as Balance Sheet will be elaborately discussed to the tune of adjustments. First the Trading Account contents and format are discussed to determine the profit and loss under the Trading Account of the business firm, i.e. Gross profit.

Second part of this chapter deals with the preparation of Profit & Loss Account in order to determine the operating profit & loss of the enterprise.

Third part of the chapter involves in the preparation of financial position of the enterprise in terms of Liabilities and Assets.

### 3.2 PREPARATION OF TRADING ACCOUNT

This is first financial statement prepared by the owner of the enterprise to determine the gross profit during the year through the matching concept of accounting. The gross profit of the enterprise is calculated through the comparison of purchase expenses, manufacturing expenses and other direct expenses with the sales.

It is prepared normally for one year in accordance with accounting period concept i.e., operating cycle of the enterprise which should not exceed 15 months with reference to the Companies Act 1956.

#### Trading Account for the year ended .....

Dr		Cr	
To Opening Stock	XXXX	By Cash Sales	XXXX
To Cash Purchases	XXXX	Add Credit Sales	XXXX
Add Credit Purchases	XXXX	By Total Sales	XXXX
To Total Purchases	XXX	Less Sales Return	XXX
Less Purchase Return	XXX	By Net Sales	XXXX
To Net Purchases	XXXX	By Closing Stock	XXXX
To Wages	XXXX	By Gross Loss C/d**	XXXX
To Carriage Inward	XXXX		
To Factory lighting	XXXX		
To Fuel, Coal, Oil	XXXX		
To duty on Import of Materials	XXXX		
To Octroi duty	XXXX		
To Gross Profit* C/d	XXXX		

\*Gross profit is the resultant of an excess of the credit side total over the total of debit side. It means that the gross profit is the excess of incomes in the credit side over the expenses in the debit side.

$$\text{Gross Profit} = [\text{INCOMES (CREDIT)} - \text{EXPENSES (DEBIT)}]$$

\*\*Gross Loss is the outcome of an excess of the debit side total over the total of credit side. It means that the gross loss is the excess of expenses in the debit side over the incomes in the credit side.

$$\text{Gross Loss} = [\text{EXPENSES (DEBIT)} - \text{INCOMES (CREDIT)}]$$

#### Illustration 1: With no Opening Stock and Closing Stock

Prepare the Trading Account for M/s Shan & Co Ltd., for the year ended 31st Mar, 2006.

Total Purchases during the year Rs. 10, 000

Total Sales during the year Rs. 15, 000

In this problem, the Gross profit is simply found by deducting the sales volume from the purchases.

$$\text{Gross Profit} = \text{Sales} - \text{Purchases}$$

First step open the Trading account for the year ended 31st Mar, 2006

**Solution:****Trading Account for the ended 31st Mar, 2006**

Dr	Rs.	Rs.	Cr
To Purchases	10,000	To Sales	15,000
To Gross Profit c/d	5,000*		
Balancing figure (Rs.15,000-Rs.10,000)			

\*Gross profit Rs. 5, 000 is the resultant of excess income over the expenses.

The total of the credit side more than the debit side total of the Trading Account. Illustration 2 with Opening stock, various kinds of purchases and sales, closing stock.

From the following information, prepare the Trading Account for the year ended 31<sup>st</sup> Mar, 2006.

	Rs.
Stock on 1st April 2005 (Opening Stock)	4, 000
Purchases	
(i) Cash purchases	20, 000
(ii) Credit purchases	50, 000
Sales	
(i) Cash sales	20, 000
(ii) Credit sales	60, 000
Stock on 31st Mar, 2006 (Closing Stock)	6, 000

In this problem, the sales and purchases are given in two different categories viz. cash and credit. The credit and cash purchases and sales of a firm should be added to determine the total volume of purchases and sales made during the year.

The purpose of crediting the closing stock in the trading account is to find out the materials or goods consumed for trading purposes. In order to find out the total amount of goods or materials consumed during a year, three different components to be separately considered.

- Opening Stock
- Purchases and
- Closing Stock

**Opening Stock:** It is a stock of goods or raw materials available at the opening of the accounting period, which is nothing but a closing stock of the yester accounting period utilized for trading during the current year.

**Purchases:** Purchase of goods or raw materials is either for resale or manufacturing.

**Closing Stock:** It is a stock nothing but an outcome of lesser volume of sales than the aggregate of opening stock and purchases.

Material consumed could be calculated.

$$\text{Material consumption} = \text{Opening stock} + \text{Purchases} - \text{Closing stock}$$

The closing stock is credited in the Trading Account instead of deducting it directly from the aggregate of opening stock and purchases during the year. The posting of the closing stock under the credit side of the Trading Account not only facilitates the firm to find out the consumption during the year as well as reduces the cost of goods sold incurred during the year.

Trading Account for the year ended 31st Mar, 2006

Dr	Rs	Rs	Cr
To Opening stock	4,000	By Credit sales 20,000	
To Credit purchases 20,000		By Cash sales 60,000	
To Cash purchases 50,000		By Total sales	80,000
To Total purchases	70,000	By Closing stock	6,000
To Gross profit c/d	12,000		
	86,000		86,000
		By Gross profit B/d	12,000

### 3.3 PREPARATION OF PROFIT & LOSS ACCOUNT

It is a second statement of accounting in connection with the earlier to determine the Net profit/loss of the enterprise out of the early found Gross profit/loss. This is an accounting statement that matches the administrative, selling and distribution expenses with the gross profit and other incomes of the enterprise.

This is an account prepared for one operating cycle of the firm i.e. 12 months in period. The transactions are recorded in accordance with golden rules of nominal account. In the profit & loss account, the expenses and losses are debited and incomes and gains are credited. The reason for bringing down the gross loss /gross profit of the trading account into the debit and credit side of Profit & Loss A/c respectively, are only to the tune of nominal accounting ruling with reference to debit all expenses and losses and credit all incomes and gains.

The expenses which are matched with the credit total of the Profit and Loss Account classified into various categories:

- (i) Administrative Expenses
- (ii) Selling & Distribution Expenses
- (iii) Financial Expenses
- (iv) Legal Expense.



## Profit and Loss Account for the year ended.....

Dr	Rs	Rs	Cr
To Gross Loss B/d	XXXX	By Gross Profit B/d	XXXX
Balancing figure			
Office and Administrative Expenses			
To Salaries			
To Rent, Rates and Taxes		By Rent received	
To Office Lightning			
To Printing and Stationery			
To Insurance premium			
To postage			
To General expenses			
To miscellaneous expenses			
Selling and Distribution Expenses			
To Salary to sales staff			
To commission charges		By commission received	
To Advertising expenses			
To Carriage outward			
To Bad debts			
To Packing expenses			
Financial Expenses			
To interest on capital		By interest on drawings	
To interest on loans		By interest on investments	
To trade discount allowed		By trade discount received	
To cash discount allowed		By cash discount received	
Maintenance Expenses			
To Depreciation on Fixed assets			
To Repairs and maintenance of Productive assets			
To loss on sale of assets		By profit on sale of assets	
Other Expenses			
To Provision for debts			
To Net profit c/d*		By Net loss c/d**	

The balancing process of the Profit and Loss Account leads to two different categories.

\*Net profit is the result of excess of income in the credit side over the expenses in the debit side of the Profit and Loss account.

\*\* Net Loss is an outcome of excess of expenses in the debit side over the incomes in the credit side.

**Illustration 2:** From the following information, prepare the Profit and Loss Account

	Debit	Credit
	Rs	Rs
Gross profit from the Trading Account	1, 00, 000	
Manager Salary	30, 000	
Office lighting	5, 000	
Office Rent	15, 000	
Local Taxes	1, 000	
Salary paid to salesmen	20, 000	
Commission charges paid	10, 000	
Legal charges paid	3, 000	
Bad debts	1, 500	
Advertising charges	25, 000	
Package charges	7, 500	
Discount allowed	3, 000	
Discount received		4, 000
Dividend received		2, 000
Rent received		1, 000
Depreciation charges	10, 000	
Repairs and Maintenance	2, 500	
Interest on loans	1, 500	500

**Profit and Loss Account for the year ended .....**

Dr	Rs	Rs	Cr
To Manager Salary	30,000	By Gross profit B/d	1,00,000
To Office lighting	5,000	By Discount received	4,000
To Office Rent	15,000	By Dividend received	2,000
To Salary paid salesman	20,000	By Rent received	1,000
To commission charges	10,000	By Interest received	500
To Legal charges	3,000	By Net Loss c/d*	24,500
To Bad debts	1,500		
To Advertising charges	25,000		
To Package charges	7,500		
To Depreciation charges	10,000		
To Repairs and maintenance	2,500		
To Interest on loan	1,500		
To Local taxes	1000		
	1,32,000		1,32,000

\*Net loss is the excess of the expenses total in the debit side Rs. 24, 500 over the incomes total in the credit side of the Profit and Loss Account.

### 3.4 PREPARATION OF BALANCE SHEET

Balance Sheet is the third financial statement which reveals the financial status of the enterprise through the total amount of resources raised and applied in the form of assets. This is the fundamental statement of the firm which explores the firm financial stature through the resources mobilized and investments applied i.e. Liabilities and Assets respectively. From the early, according to Double entry concept or Duality concept, the Balance Sheet can be divided into two distinct sides, known as Liabilities and Assets. The Balance Sheet can be disclosed in two different orders.

- (i) in the order of long lastingness - permanence
- (ii) in the order of liquidity.

Proforma Balance Sheet as on dated.....

(In the order of Long lastingness)

Liabilities		Rs	Assets		Rs
Capital	XXXX		Land & Building		XXXX
Less: Drawings	XXX		Plant & Machinery		XXXX
Add: Net profit	XXXX		Furniture & fittings		XXXX
		XXXX	Fixtures & tools		XXXX
Long term borrowings		XXXX	Marketable securities		XXXX
Sundry creditor		XXX	Closing stock		XXXX
Bills payable		XXX	Sundry debtors		XXXX
Bank overdraft		XXX	Bills receivable		XXXX
Outstanding expenses		XXX	Pre paid expenses		XXXX
Pre received income		XXX	Cash at Bank		XXXX
			Cash in hand		XXXX
Total liabilities		XXXX	Total Assets		XXXX
			Cash in hand		XXXX
Total liabilities		XXXX	Total Assets		XXXX

The downward arrow shows the order/arrangement of the assets and liabilities on the basis of permanence or long lastingness.

The upward arrow shows the order/arrangement of the assets and liabilities on the basis of liquidity.

Methods of determining the accounting income includes:

- (i) Cash method of accounting
- (ii) Mercantile method of accounting.

#### 3.4.1 Cash Method of Accounting

Under this method, cash receipts are matched with the cash payments irrespective of the time period in order to determine the income.

#### 3.4.2 Mercantile Method of Accounting

Under this method, time period is given greater importance than the actual receipts and payments. It records the receipts and expenses pertaining to the specified period whether they are actually

received/paid or not. The receipts as well as payments of the other periods should be ignored/eliminated in determining the income of the stipulated duration. It is popularly known in other words as "Accrual Accounting System".

Next stage is to classify the types of income of the enterprise:

To determine income of the business, what should be in character? Either in accounting income or taxable income.

Taxable income can be computed from the transactions of the enterprise but they are subject to frequent modifications on the tax provisions from one year to another year. This cannot be uniquely found out unlike the accounting income. The accounting income should have to be found out only to the tune of accounting principles and concepts.

The process of final accounts diagram is illustrated in the next page for easier understanding not only to adopt the mercantile system of accounting but also to implement the duality principle of accounting throughout the transactions.

### *Adjustments*

The adjustment entries are classified into three segments viz. on expenses, incomes and others.

*On expenses:* The adjustment entries on expense can be classified into two categories:

- (i) *Outstanding Expenses:* These are incurred expenses but not paid in cash e.g. Rent of the office is Rs. 22,000 for 11 months only. The enterprise has failed to remit the payment of last month rent amounted Rs. 2,000. According to mercantile system of accounting, the rent of the office, whether fully paid or not, it should be totally considered for the entire duration to determine the income of the enterprise. Finally, what is to be done? The amount of actual rental should be added with the rent which has not been paid by the enterprise i.e. (Rs. 22,000 + Rs. 2,000 = Rs. 24,000).

#### *Treatment of the transaction:*

Debit the expense account

Credit the liability i.e. of the person to whom the amount to be paid,

*Profit & Loss A/c:* Add the outstanding amount with the total expenses already paid

*Balance sheet:* Include it as an item of responsibility under the liabilities side.

- (ii) *Prepaid expenses:* Normally, some of the expenses paid for availing the services are not fully extracted during the term; which left/unused should be normally carried forward to the next term. It means that the expense which is paid in advance to make use of the service for forthcoming period to whom is known as Debtor; the person who keeps the money of the enterprise for the definite duration is nothing but an asset.

Debit the asset - Advance payment for service

Credit the expense

*Profit & Loss A/c:* Deduct the prepaid amount from the total expenses already paid.

*Balance Sheet:* Include it as an item of application under the assets side.

Next major segment in the adjustment entry is on Incomes:

- Income Outstanding
- Perceived Income

(iii) **Income outstanding:** It happens during the enterprise then and there; which means income earned but not received. It happens in the case of certain income of dividend on shares, interest on loans granted not yet received. The income earned but not received is also an income that should be credited in the income account to know the total volume of the income pertaining to the accounting period.

The income earned but not received is nothing but an asset not yet received. The income not yet received from whom should be debited as an asset due to the enterprises' money income with the other person/institution.

**Profit & Loss A/c:** Add the income outstanding amount to the total incomes already received.

**Balance Sheet:** Include it as an item of unrealized income under the assets side i.e., the firms' money with the others.

(iv) **Income received in advance:** Any income received in advance cannot be considered as an income which should be calculated and deducted from the total income received; known as advance receipt. It is the income of the other period; should be eliminated from the income received in accordance with the mercantilist accounting system in determining the income. The income which is received in advance pertaining to the period of non-rendered service should be removed from the total income received, in order to determine the original income of the period should be known exactly. The amount received in advance of non-rendered service is the responsibility to return nothing but the liability of the firm.

Debit the Income account

Credit the Income received in advance - Liability of the balance sheet.

**Profit & Loss A/c:** Deduct the Income received in advance from the total incomes which were already received.

**Balance Sheet:** Include it as an item of responsibility for non-rendered service under the liabilities side.

(v) **Bad debts:** Bad debts is the result of credit sales which only due to the inability of customers/consumers to settle the overdue. The inability may be due to poor repaying capacity or insolvent during the moment of the sales. The bad debt due to the inability cannot be deducted from the sales volume which was already transacted. The debts cannot be recovered has to be treated as a loss of the firm.

Debit all losses of the firm. The losses due to bad debts should be appropriately effected as well as adjusted in the individuals' account i.e. in the consumers' account who received the goods on credit.

**Profit & Loss A/c:** Non-recovery of credit sales is deemed to be losses – should be debited to Profit & Loss A/c.

**Balance Sheet:** Non recovery of credit sales should be deducted from the volume of credit sales transacted by the firm under the Assets side in order to determine the original amount of credit outstanding.

**Check Your Progress**

1. If the closing stock is given, the effect of the entry is
  - (a) Profit & Loss A/c -Credit Balance Sheet- Liabilities
  - (b) Profit & Loss A/c-Debit Balance Sheet- Liabilities
  - (c) Trading A/c- Credit Balance Sheet-Assets
  - (d) Trading A/c- Debit Profit & Loss A/c- Credit
2. The income received in advance is
  - (a) Asset of the enterprise
  - (b) Income of the enterprise
  - (c) Liability of the enterprise
  - (d) Expense of the enterprise
3. The depreciation charge is only to the tune of
  - (a) Convention of Consistency
  - (b) Time period concept
  - (c) Business entity concept
  - (d) Convention of conservatism
4. The value of the asset shown in the Balance Sheet is
  - (a) Book Value
  - (b) Market value
  - (c) Realisable value
  - (d) Original value
5. Rent paid in advance is to be effected
  - (a) Deduct the amount from the Original rent paid - P&L A/c
  - (b) Include the rent paid in advance as an item of current asset- Balance Sheet
  - (c) Deduct the rent paid in advance in the Trading A/c
  - (d) Both (a) & (b)

**Illustration 3:** From the following information extracted from the books of Jain & Co, Prepare Trading, Profit & Loss A/c for the year ended and Balance sheet as on that date.



Particulars	Debit Rs	Credit Rs
Purchase	90,300	
Sales	1,37,200	
Return inward	2,200	
Stock 1.1.96	40,000	
Drawing	5,000	
Building	30,000	
Machinery	20,000	
Furniture	8,000	
Debtors	25,000	
Wages	3,000	
Carriage inwards	2,000	
Rent and Rates	1,500	
Bad debts	1,000	
Cash	3,500	
Investment	10,000	
Postages	2,500	
Insurance	2,000	
Return outwards		1,300
Capital		50,000
Creditors		24,000
Interest		500
Commission		3,250
Provision for Bad debts		750
Bank OD		40,000
Salaries	11,000	
Total	2,57,000	2,57,000

**Additional Information:**

- Value of the stock on 31. 12. 96 Rs. 65,000
- Goods worth Rs 800 for his personal use of the proprietor
- Rs. 400 of insurance paid is nothing but advance payment
- Salary Rs. 1000 for the month of Dec 1996 has not yet paid outstanding
- Charge depreciation
  - Building 2% per annum
  - Machinery 10% per annum
  - Furniture 15% per annum
- Maintain provision for doubtful debts @ 5% on sundry debtors. Prepare Trading and Profit & Loss Account of Jain & Co for the year ended 1995-96.

## Trading and Profit &amp; Loss A/c

Dr	Rs	Rs	Rs	Rs	Cr
To Opening stock		40,000	By Sales	1,37,200	
To Purchases	90,300		(-) Return Inward	2,200	
(-)Purchase Return	1,300				1,35,000
(-) Goods taken by proprietor	800		By Closing Stock		65,000
To Net purchases		88,200			
To Wages		3,000			
To Carriage inward		2,000			
To Gross Profit c/d (Balancing figure)		66,800			
		2,00,000			2,00,000
To Rent & Rates		1,500	By Gross profit B/d		66,800
To Bad Debts		1000	By Commission		3,250
To Postages		2,500	By Interest		500
To Insurance	2,000				
(-) Prepaid	400				
		1,600			
To Salaries	11,000				
(+)O/s of Salary	1,000				
		12,000			
To New Provision 5% on Sundry Debtors- Rs.25,000	1,250				
(-)Old Provision	750				
		500			
To Depreciation					
Building 2%	600				
Machinery 10%	2,000				
Furniture 15%	1,200	3,800			
To Net profit c/d (Balancing figure)		47,650			
		70,550			70,550

## Balance Sheet as on 31st Dec, 1996

Liabilities	Rs	Rs	Assets	Rs	Rs
Capital	50,000		Building	30,000	
(+)Net Profit transferred from P&L Account	47,650		(-) Depreciation 2%	600	
(-)Drawings Cash + Goods Rs5000+Rs.800	5,800				29,400
		91,850	Machinery	20,000	
Bank OD		40,000	(-) Depreciation 10%	2,000	
Creditors		24,000			18,000
Salary O/s		1,000	Furniture	8,000	
			(-)Depreciation 15%	1,200	
					6,800
			Debtors	25,000	
			(-)Provision	1,250	
					23,750
			Investment		10,000
			Closing stock		65,000
			Prepaid Insurance		400
			Cash in hand		3,500
		1,56,850			1,56,850

*Illustration 4:* From the following figures extracted from the books of M/s Amal & Vimal 31st Mar, 02

Particulars	Debit (Rs)	Credit (Rs)
Opening stock	30,000	
Purchases	1,10,000	
Sales		2,50,000
Building	55,000	
Wages	23,000	
Carriage inwards	3,000	
Bills payable		10,000
Furniture	9,000	
Salaries	42,000	
Advertisement	24,000	
Coal and coke	2,000	
Cash at bank	14,000	
Pre paid wages	1,000	
Depreciation fund investment	25,000	
Machinery at cost (Rs. 10,000 New)	60,000	
Sundry debtors	20,000	
Bad debts	3,000	
Depreciation fund		25,000
Sundry creditors		24,000
Rent rate and taxes	4,000	
Trade expense	4,000	
Capital		
Amal		50,000
Vimal		40,000
Petty expenses	4,000	
Provision for doubtful debts	1,000	
Gas and water	1,200	
Cash in hand	800	
Outstanding rent		400
Bank loan		34,600
	4,35,000	4,35,000

*Adjustment entries:*

- The partners share profit and losses Amal 2/5 and Vimal 3/5
- Closing stock Rs. 15,000
- Stock valued at Rs. 10,000 was destroyed by fire but insurance company admitted a claim of 8,500 only and the claim is not yet paid.
- Wages include Rs. 2,000 for installation of anew machinery on 1st Dec., 2005
- Depreciate the machinery at 10% per annum.

## Trading account of M/s Vimal &amp; Amal &amp; Co for the year ended 2001-02

Dr	Rs	Rs	Rs	Rs Cr
To Opening Stock		30,000	By Sales	2,50,000
To Purchases		1,10,000	By Closing Stock	15,000
To Wages	23,000		By Goods Destroyed	10,000
(-)-Erection	2,000			
		21,000		
To Coal and coke		2,000		
To Gas and water		1,200		
To Carriage inwards		3,000		
To Gross profit c/d		1,07,800		
		2,75,000		2,75,000

## Profit &amp; Loss Account of M/s Vimal &amp; Amal &amp; Co. for the year ended 2001-02

Dr	Rs	Rs	Rs	Rs Cr
To Salaries		42,000	By Gross profit B/d	1,07,800
To Advertisement		24,000		
To Bad debts		3,000		
To Trade expenses		4,000		
To Rent, rates & Taxes		4,000		
To Depreciation(d)		5,400		
To Insurance Loss	10,000			
Admitted claim	8,500			
		1,500		
To petty expenses		4,000		
To Net profit				
Amal	7,960			
Vimal	11,940			
		19,900		
Total		1,07,800	Total	1,07,800

## Balance Sheet of M/s Vimal &amp; Amal &amp; Co. as on dated 31st Mar, 2002

Liabilities	Rs	Rs	Assets	Rs	Rs
Capital Amal	50,000		Depreciation investment		25,000
(+) Net profit	7,960		Plant and Machinery	1000	
	62,000		(-) Depreciation	5,400	
Capital Vimal	40,000	57,960	Furniture		9,000
(+) Net profit	11,940		Building		55,000
		51,940	Closing stock		15,000
Depreciation fund		25,000	Sundry debtors	20,000	
Bank Loan		34,600	Provision for bad debts		
Sundry creditors		24,000			19,000
			Outstanding Insurance claim		8,500
Outstanding rent		400	Prepaid wages		1000
Bills payable		10,000	Cash at bank		14,000
			Cash in hand		800
		2,03,900			2,03,900

**Illustration 5:**SS Jain Bros for the year ended 31<sup>st</sup> Dec. 2003

Particulars	Debit Rs	Credit Rs
Capital		6,00,000
Drawings	12,000	
Buildings	2,00,000	
Furniture and fittings	30,000	
Depreciation on Reserve		
Buildings		10,000
Furniture		3,000
Depreciation for the year	13,000	
Purchases	4,00,000	
Sundry creditors		40,000
Sales		5,00,000
Debtors	1,20,000	
Establishment charges	20,000	
Electricity charges	6,575	
Postage and telegram	1,284	
Travelling and conveyance	3,816	
Advance for sales commission	1,000	
Insurance	2,500	
Rent received		12,000
Motor van (purchased 1.1.03)	80,000	
Motor van maintenance	23,425	
Fixed deposit (1.9.2003)	1,00,000	
Cash in hand	1,823	
Cash at bank	1,47,977	

Due to the difference in the trial balance, an examination of the goods was conducted which reveals following errors.

Rs. 25 paid to the conveyance was debited to motor van maintenance account.

Rs. 2, 000 drawn from bank towards for establishment charges was omitted to posted in to ledger.

Cash column in the cash book on the receipt side stands excess total by Rs. 400

**Adjustment entries:**

- Establishment of charges have been paid only up to Nov & provision of Rs 2, 000 has to be made for Dec.
- Electricity charges are O/s Rs. 25

- (c)  $\frac{1}{2}$  commission on total sales is payable to salesmen, towards which Rs. 1000 as paid in advance.
- (d) Fixed deposit earns interest at 9% per annum
- (e) Provide depreciation 20% per annum on motor car
- (f) Closing stock 31st Dec., 2003.

To prepare the trial balance, the following necessary corrections should be made on the respective accounting heads given.

- (i) Rs. 25 paid to the conveyance was debited to motor van maintenance account- The errors to be rectified which is known as error without affecting the trial balance. Rs. 25 should be deducted from the Motor maintenance account for the wrong entry debited already but at the same time right entry has to be made under the conveyance account through the addition of Rs. 25 i.e., Rs. 25 to be debited.

To put it in to nutshell, Rs 25 should be deducted from the total of Motor maintenance account in order to cancel the wrong debit entry i.e.

$$\text{Rs. } 23,425 - \text{Rs. } 25 = \text{Rs. } 23,400$$

To effect the correct entry, Rs. 25 should be to the original conveyance account i.e.

$$\text{Rs. } 3,816 + \text{Rs. } 25 = \text{Rs. } 3,841/-$$

- (ii) Rs. 2,000 was drawn from the bank omitted in the establishment charges account; which is meant for the purpose.

Rs. 2,000 should be added to the establishment charges account total in order to identify the total of establishment charges.

$$\text{Total establishment charges} = \text{Rs. } 22,000 + \text{Rs. } 2000 = \text{Rs. } 24,000$$

- (iii) Cash column in the cash book on the receipt side excess total Rs. 400 i.e. Rs. 400 excess total should corrected on the given balance of cash in hand in order to determine the real volume of cash in hand.

$$\text{Real volume of cash in hand} = \text{Rs. } 1,823 - \text{Rs. } 400 = \text{Rs. } 1423$$

Now we have to illustrate the corrected trial balance by incorporating the above given changes.



## Trial Balance

Particulars	Debit Rs	Credit Rs
Capital		6,00,000
Drawings	12,000	
Buildings	2,00,000	
Furniture & Fittings	30,000	
Depreciation Reserve		13,000
Purchases	4,00,000	
Sundry creditors		40,000
Sales		5,00,000
Debtors	1,20,000	
Establishment charges Rs.20,000	22,000	
Electricity charges	6,575	
Postage & telegram	1,284	
Travelling & Conveyance	3,841	
Advance for salesmen commission	1,000	
Insurance	2,500	
Rent received		12,000
Motor van (purchased 1.1.2003)	80,000	
Motor van maintenance	23,400	
Fixed deposit	1,00,000	
Cash in hand	1,423	
Cash at bank	1,47,977	
Depreciation	13,000	
Total	11,65,000	11,65,000

## Trading account for the year ended 31st Dec, 2003

Dr	Rs	Rs	Rs	Rs Cr
To Purchases		4,00,000	By Sales	5,00,000
			By Closing stock	1,00,000
To Gross profit c/d		2,00,000		
		6,00,000		6,00,000

## Profit &amp; Loss account for the year ended 31st Dec, 2003

To Insurance		2,500	By Gross profit B/d		2,00,000
To motor maintenance		23,400	By Rent received		12,000
To establishment charge	22,000		By Interest received		3,000
To Dec provision	2,000				
		24,000			
To Travelling & conveyance		3,841			
To Postage and telegram		1,284			
To electricity charges	6,575				
(+) O/s E.B charges	25				
		6,600			
To depreciation		13,000			
To sales commission paid	1,000				
(+) O/s commission	1,500				
		2,500			
To Depreciation on motor van @ 20%		16,000			
To Net profit c/d		1,21,875			
		2,15,000			2,15,000

## Balance sheet as on dated 31st Dec, 2003

Liabilities	Rs	Rs	Assets	Rs	Rs
Capital	6,00,000		Cash in hand		1,423
(+) Net profit	1,21,875		Cash at bank		1,47,977
	7,21,875		Fixed Deposit		1,00,000
(-) Drawings	12,000		Interest		3,000
		7,09,875	Motor van		64,000
Sundry creditors		40,000	Sundry debtors		1,20,000
Provision for establishment charges		2,000	Building	2,00,000	
Electrical charges		25	(-) Reserve	10,000	1,90,000
O/s Commission		1,500	Furniture	30,000	
			(-) Reserve	3,000	27,000
			Closing stock		1,00,000
		7,53,400			7,53,400

**Illustration 6:****Pandit Broths for the year ended 31st Mar, 2006**

Particulars		Debit Rs	Credit Rs
Capital	A.Pandit		1,00,000
	B.Pandit		1,00,000
Drawings	A.Pandit	16,000	
	B.Pandit	16,000	
Buildings		80,000	
Furniture & fittings		20,000	
Purchases		2,00,000	
Sales			3,00,000
Stock 1.4.2005		50,000	
Wages & salaries		44,000	
Rates & Taxes		1,600	
Office expenses		60,000	
Sundry debtors		25,000	
Sundry creditors			12,000
Cash in hand		400	
Cash at Bank O/D			29,000
Freight inwards		28,000	
Total		5,41,000	5,41,000

**Adjustment:**

- Closing stock Rs. 1, 14, 500
- There was fire in the premises on 25th Nov, 2005, which damaged the portion of the stock the loss was estimated Rs. 17, 500
- A. Pandit is the incharge of purchases of stock item & he is to be paid 2. 5% on such purchases.
- A steel table purchased 1st Feb Rs. 3, 000 debited to purchase account
- B. Pandit who looks after all aspect other than purchases is entitled to the commission of 5% on Net profits of after charging commission
- Depreciation is to be charged at 2. 5% per annum on building & 10% on furniture fittings profits or losses or share equally for the partners.

## Trading account for the year ended 2005-06

Dr	Rs	Rs	Rs	Rs Cr
To Opening Stock		50,000	By Sales	3,00,000
Purchases	2,00,000		By Closing stock	1,14,500
(-)Purchase of table	3,000		By Goods Loss by fire	17,500
	1,97,000			
(+)Commission to A.Pandit	4,925			
		2,01,925		
To Carriage inwards		28,000		
To Wages & Salary		44,000		
To Gross profit c/ d		1,08,075		
Total		4,32,000	Total	4,32,000

## Profit &amp; Loss account for the ended 2005-06

Dr				Cr
To Rates & Taxes		1,600	By Gross profit B/d	1,08,075
To office expenses		60,000		
To Depreciation on Building		2,000		
To Depreciation				
Existing Furniture $20,000 \times 10 / 100$	2,000			
New Furniture $3000 \times 10 / 100 \times 2 / 12$	50			
		2050		
To Loss on fire		17,500		
To commission B.Pandit		1187		
To Net profit C/d				
A.Pandit	11,869			
B.Pandit	11,869	23,738		
		1,08,075		1,08,075

## Balance sheet as on dated 31st Mar, 2006

Liabilities			Assets		
Capital(A.Pandit)	1,00,000		Building	80,000	
(+) Commission	4,925		– Depreciation 2.5%	2,000	
		1,04,925			78,000
(+)Net profit	11,869		Furniture	23,000	
	1,16,794		– Depreciation 10%	2,050	
(-)Drawings	16,000				20,950
		1,00,794	Closing stock		1,14,500
Capital( B.Pandit)	1,00,000		Sundry Debtors		25,000
(+)Commission	1,187		Cash in hand		400
	1,01,187				
(+) Net profit	11,869				
	1,13,056				
(-)Drawings	16,000	97,056			
Bank overdraft		29,000			
Sundry creditors		12,000			
		2,38,850			2,38,850

### 3.5 LET US SUM UP

Trading Account is first financial statement prepared by the owner of the enterprise to determine the gross profit during the year through the matching concept of accounting. The purpose of crediting the closing stock in the trading account is to find out the materials or goods consumed for trading purposes. In order to find out the total amount of goods or materials consumed during a year, three different components to be separately considered.

- Opening stock
- Purchases and
- Closing Stock

Profit & Loss Account is a second statement of accounting in connection with the earlier to determine the Net profit/loss of the enterprise out of the early found Gross profit/loss. Balance sheet is the third financial statement which reveals the financial status of the enterprise through the total amount of resources raised and applied in the form of assets.

### 3.7 KEYWORDS

**Trading Account:** It is the accounting statement of revenues and expenses.

**Balance Sheet:** It is nothing but a positional statement of assets and liabilities of the firm on a particular date.

**G. P. (Gross Profit):** Resultant of excess of trading incomes over the expenses.

*G. L. (Gross Loss)*: Resultant of excess of trading expenses over the incomes/revenues.

*N. P. (Net Profit)*: Resultant of excess of Profit & Loss incomes/revenues over the expenses.

*N. L. (Net Loss)*: Resultant of excess of Profit & Loss expenses over the incomes.

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### 3.8 REVIEW QUESTIONS

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1. Illustrate the interrelationship in between the accounting statements and statement of position.
2. Highlight the effect of the following entries:
  - (a) Closing stock
  - (b) Interest received in advance
  - (c) Rent outstanding
3. Explain the various accounting concepts and conventions through additional information or adjustments.
4. Illustrate various kinds of drawing and their treatment in the financial statements.
5. Why land and building is given greater priority under the order of permanence?
6. Why cash in hand is given greater priority under the order of liquidity?

<b>Check Your Progress: Model Answers</b>				
1. (c)	2. (c)	3. (b)	4. (a)	5. (d)

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### 3.9 SUGGESTED READINGS

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M.P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, *Advanced Accountancy*.

V.K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

R. Narayanswamy, *Financial Accounting - A Managerial Perspective*, HPI.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.



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## LESSON

# 4

## COSTING AND COST ACCOUNTING CONCEPTS

### CONTENTS

- 4.0 Aims and Objectives
- 4.1 Introduction
- 4.2 Nature and Scope of Cost Accounting
- 4.3 Objectives of Cost Accounting
- 4.4 Cost Classification
- 4.5 Methods of Costing
- 4.6 Techniques of Costing
- 4.7 Preparation of Cost Sheet – Problems and Solutions
  - 4.7.1 Direct Cost Classification
  - 4.7.2 Indirect Cost Classification
  - 4.7.3 Stock of Raw Materials
  - 4.7.4 Stock of Semi Finished Goods
  - 4.7.5 Stock of Finished Goods
- 4.8 Let us Sum up
- 4.9 Keywords
- 4.10 Questions for Discussion
- 4.11 Suggested Readings

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### 4.0 AIMS AND OBJECTIVES

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After studying this lesson, you will be able to:

- Ascertain the cost of a product through various processes
- Identify the expenses incurred during the manufacturing a product only should be registered for the computation of cost of a product
- Understand the procedures involved in the process of computing the cost of a product.

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## 4.1 INTRODUCTION

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Cost accounting is the classification, recording and appropriate allocation of expenditure for the determination of the products or services, and for the suitable presentation of data for the purpose of control and management. The cost accounting normally includes the cost of job or contract, batch, process and so on. It normally illustrates the following compartments of the cost aspect of the organisation viz. production, administration, selling and distribution. The cost accounting not only reveals the amount of costs, which are relevant with the product or service, but also establishes the ways and means to control through budgets and standard cost in order to maintain the profitability of the firm.

Cost accountancy is the combination of both the application of costing and cost accounting principles, methods, techniques to science, art and practice of cost control and ascertainment of profitability.

Cost accountancy consists of three compartments. First component Science means that he must have systematic knowledge of cost principles for the discharge of responsibilities. Art, is the next component in the cost accountancy reveals the ability and skill required for the discharge of responsibilities cost accountant in order to resolve the problems. Practice is the third component of cost accountancy, which comprises the continuous efforts of the accountant in the field of cost accounting not only to disseminating the information but also facilitating the organisation to take decisions.

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## 4.2 NATURE AND SCOPE OF COST ACCOUNTING

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The scope of the cost accounting could be classified into three major segments viz. Cost Ascertainment, Cost accounting and Cost control.

**Cost Ascertainment:** It highlights the linking up of the production with various expenses involved in the various stages of manufacture. The linking up of the expenses involved in the manufacture with the production is subject to the system, methods and to techniques.

System means that there are various systems of costing viz. Historical costs or Actual cost, Standard costs and so on.

Method means that there are various methods involved along with measurement of production which are as follows operation costing, batch costing, process costing and so on.

Technique means that the linking up gets varied from the one to another viz. marginal cost technique, total cost technique and direct cost technique.

**Cost Accounting:** It is the process of accounting for cost, which begins with recording of expenditure and ends with the preparation of statistical data.

**Cost Control:** It is corrective measure action at the executive level to tune the actuals with the standards, which were set already.

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## 4.3 OBJECTIVES OF COST ACCOUNTING

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The objectives could be broadly classified into the following:

- (i) Ascertainment and analysis of the cost and income of the product function and responsibility

- (ii) Exercising the cost controls through an effective comparison in between the actual and standards only in order to correct the deviation
- (iii) Facilitating the management to take decisions

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#### 4.4 COST CLASSIFICATION

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The costs are classified into various categories according to the purpose and requirements of the firm. Some of the most important classifications are as follows:

- (i) By nature or element or analytical segmentation
- (ii) By functions
- (iii) Direct and indirect cost
- (iv) By variability
- (v) By controllability
- (vi) By normality
- (vii) By time
- (viii) According to planning and control
- (ix) According to managerial decisions

##### *Nature or Element or Analytical Segmentation*

The costs are classified into three major categories Materials, Labour, and Expenses.

##### *Functions*

Under this methodology, the costs are classified into various divisions or functions of the enterprise viz. Production cost, Administration cost, Selling and Distribution cost and so on. The detailed classification is that total of production cost sub classified into cost of manufacture, fabrication or construction and another classification of cost is commercial cost of operations; which is other than the cost of manufacturing and production. The major components of commercial costs are known as administrative cost of operations and selling and distribution cost of operations

##### *Direct and Indirect Cost*

- **Direct cost:** This classification of costs is incurred for the manufacture of a product or service; can be conveniently and easily identified.
- **Material cost for the product manufacture:** Direct material-For garments factory- cloth is the direct material for ready made garments.
- **Labour cost for production:** Labour who directly involved in the production of a product as well as attributable to single product. Expenses and so on.
- **Indirect cost:** The costs which are incurred for and cannot be easily identified for any single cost centre or cost unit known as indirect cost. Indirect material cost, indirect labour cost and Indirect expenses are the three different components of the indirect expenses.

- **Indirect material:** Cost of the thread cannot be conveniently measured for single unit of the product.
- **Indirect Labour:** Salary paid to the supervisor.

### Variability

The costs are grouped according to the changes taken place in the level of production or activity. It may be classified into three categories.

- **Fixed cost:** It is cost, which do not vary irrespective level of an activity or production. Rent of the factory, salary to the manager and so on.
- **Variable cost:** It is a cost, which varies in along with the level of an activity or production, e.g., Material consumption and so on.
- **Semi variable cost:** It is a cost which is fixed up to certain level of an activity, then later it fluctuates or varies in line with the level of production. It is known in other words as step cost. e.g. Electricity charges.

### Controllability

The cost are classified into two categories in accordance with controllability, as follows:

- **Controllable costs:** Cost, which can be controlled through some measures known as controllable costs. All variable cost are considered to be controllable in segment to some extent.
- **Uncontrollable costs:** Costs, which cannot be controlled, are known as uncontrollable costs. All fixed costs are very difficult to control or bring down; they rigid or fixed irrespective to the level of production.

### Normality

Under this methodology, the costs which are normally incurred at a given level of output in the conditions in which that level of activity normally attained.

- **Normal cost:** It is the cost, which is normally incurred at a given level of output in the conditions in which that level of output is normally achieved
- **Abnormal cost:** It is the cost, which is not normally incurred at a given level of output in the conditions in which that level of output is normally attained.

### Time

According to this classification, the costs are classified into Historical costs and Predetermined costs:

- **Historical costs:** The costs are accumulated or ascertained only after the incurrence known as Past cost or Historical costs.
- **Predetermined costs:** These costs are determined or estimated in advance to any activity by considering the past events, which are normally affecting the costs.

### Planning and Control

The following are the two major classifications viz. standard cost and budgetary control.

- **Standard Cost:** Standard cost is a cost scientifically determined by way of assuming a particular level of efficiency in utilization of material, labour and indirect expenses.

The prepared standards are compared with the actual performance of the firm in studying the variances in between them. The variances are studied and analysed through an exclusive analysis.

- **Budget:** A budget is detailed plan of operation for some specific future period. It is an estimate prepared in advance of the period to which it applies. It act as a business barometer as it is complete programme of activities of the business for the period covered.

The control is exercised through continuous comparison of actual results with the budgets. The ultimate aim of comparing with each other is to either to secure individuals' action towards the objective or to provide a basis for revision.

#### *According to Managerial Decisions*

The major classifications are sunk cost and marginal cost.

Marginal cost is the amount at any given volume of output by which aggregate costs are changed if the volume of output is decreased or increased by one unit.

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## 4.5 METHODS OF COSTING

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The methods of costing in ascertainment of the costs are different from one industrial practice to another. The methods of costing are normally classified into two major categories viz. Specific order costing and Operation costing.

**Specific order costing:** It is one of the methods of costing, pertaining to the specific job or work, which is normally entrusted upon the industry to complete the entire process of manufacturing. Under this type of costing specific cost of the jobs, contracts, batch can be ascertained to the tune of their own nature and characteristics.

**Operation Costing:** It is another major classification in connection with the process or operation required for the manufacture of a product. This is more applicable in the case of products, which are normally manufactured as well as expected to come across many stages of production process or operations in the industry.

The following are the detailed classifications of the costing:

1. **Job order costing:** Under this method of costing, the cost inputs of every or specific jobs are collected and assimilated together for the determination of the total cost of the job, which is most useful to analyse the cost of the job not only alone but also to compare with other kind of jobs. It paves way through job card to conduct an analysis in the angle of cost factor influence.
2. **Contract costing:** This is a method of costing preferably required for the jobs which are normally having longer gestation period to complete i-e by the civil engineers and mechanical engineers.
3. **Batch costing:** It is another most important classification in which small orders costs are ascertained. This is mostly preferred by the companies or factories, which normally engage in the manufacture of small articles in the form of batch. Each batch considered as a unit cost and exclusively costed. Under this method, the cost per unit could be ascertained as follows:

$$\frac{\text{Cost of the batch}}{\text{Number of units in a batch}}$$

It is applied in the case of biscuits, chalk piece, pencil, cigarette, garments manufactures. It could be put in simple sense that this method of costing is more applicable in the case of Fast Moving Consumer Goods industries.

4. **Process costing:** This is another method of costing, which is mostly suited for the continuous process of manufacturing of a finished product. The production of a finished product requires many stages of production in the form of processes, which takes normally the inputs for one process from the output of another/yester process. The cost of a finished product is normally prepared through the preparation of separate process accounts, which normally reveals the cost of each process, highlights the cost of the specific process, known as finally continuous costing
5. **Operation costing:** This is a suitable method of costing for the industries, which manufacture the standard or identical products. This method is applied in the following industries of brewery, oil drilling, cement works and so on.
6. **Service costing:** This is suitable method for the industries, which render service rather than manufacturing of goods. This is applied in the case of service industries viz. transport corporations, municipalities, power supply organisation and so on. This method is suited to ascertain the cost of rendering service.

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#### 4.6 TECHNIQUES OF COSTING

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The following are the various techniques of costing, which are nothing but vital tools of ascertaining costs.

1. **Uniform costing:** It is the use of same costing principles and practices by several undertakings for common control and comparison of costs.
2. **Marginal costing:** It is another tool of costing, by studying the difference in between the fixed and variable cost in order to determine the influence of change in the level of output on the cost per unit.
3. **Historical costing:** It is another technique of costing through which the costs of the yester horizon are ascertained.
4. **Direct costing:** It is the practice of charging all direct variable and fixed costs which are in relation with the operations, processes or products by leaving all other costs which are normally written off against the profits.
5. **Absorbion costing:** It is unlike the marginal costing technique, includes the fixed cost of operations along with the variable cost of production.
6. **Standard costing:** It is a another tool of costing which normally facilitates the firm to determine the deviation in between the actual and standards in order to exercise the control of deviations through correctionary measures.

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#### 4.7 PREPARATION OF COST SHEET - PROBLEMS AND SOLUTIONS

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There are various definitions for it.

"It is a statement of costs incurred at every level of manufacturing a product or service".



"It is a statement prepared to depict the output of a particular accounting period alongwith break up of costs".

The cost of the product or service should have to come across many stages. To find the total cost of the product or service, the costs incurred are grouped under various categories.

#### *Advantages of Preparing the Cost Sheet*

1. It is a only statement reveals the cost of the output as well as unit cost of the output
2. It facilitates the manufacturer to access the control on the costs through breakups in the cost
3. It extends room for the management to study the variations of the cost with the help of an effective comparison of standard costs
4. The businessman is able to get an insight on the various components of cost as well as able to exercise the control on the excessive costs incurred
5. It poses the firm to supply the goods against the orders with reasonable accuracy in submitting the orders.

To find out the unit cost of the product, the statement of cost plays pivotal role in determining the cost of production, cost of goods sold, cost of sales and selling price of the product at every stage.

During the preliminary stage of preparing the cost statement of the product, there are two things to be borne in our mind at the moment of classification.

- Direct cost classification
- Indirect cost classification

#### **4.7.1 Direct Cost Classification**

Under this classification, the direct costs of the product or service are added together to know the volume of total direct cost. The total volume of direct cost is known as "Prime Cost"

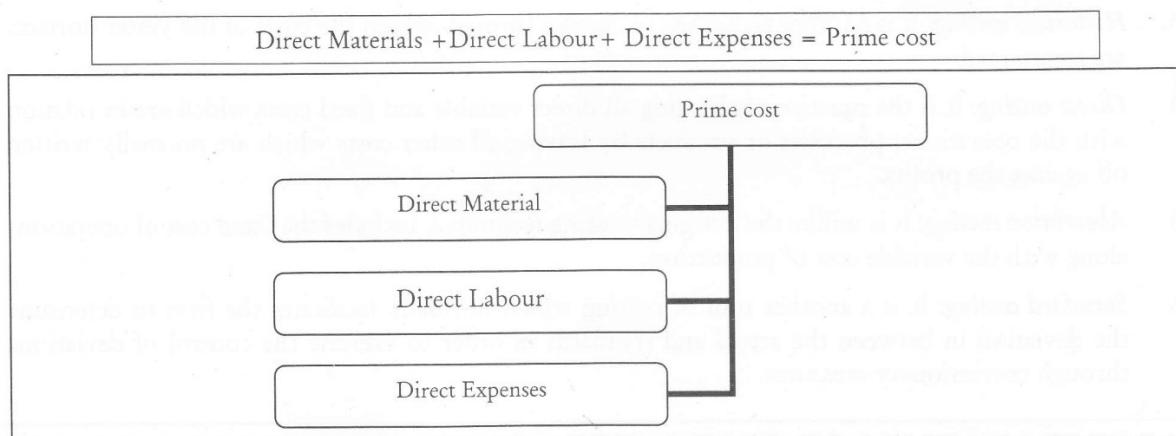


Figure 4.1

The next stage in the unit costing to find out the factory cost. The factory cost could be computed by the combination of the indirect cost classification.

**Note:** Property tax on the plant is to included under the factory overheads. The tax is paid by the firm on the plant which is engaging in the production process.

#### 4.7.2 Indirect Cost Classification

Among the classification of the overheads, the first and foremost is factory overheads. The factory overheads and work overheads are synonymously used. The factory overheads are nothing but the indirect costs incurred at the factory site. To find out the total factory cost or works cost incurred in the factory could be derived by adding the both direct cost and indirect cost incurred during the factory process.

$$\text{Factory Cost} = \text{Prime cost} + \text{Factory Overheads}$$

Factory overheads are nothing but the indirect expenses incurred during the industrial process.

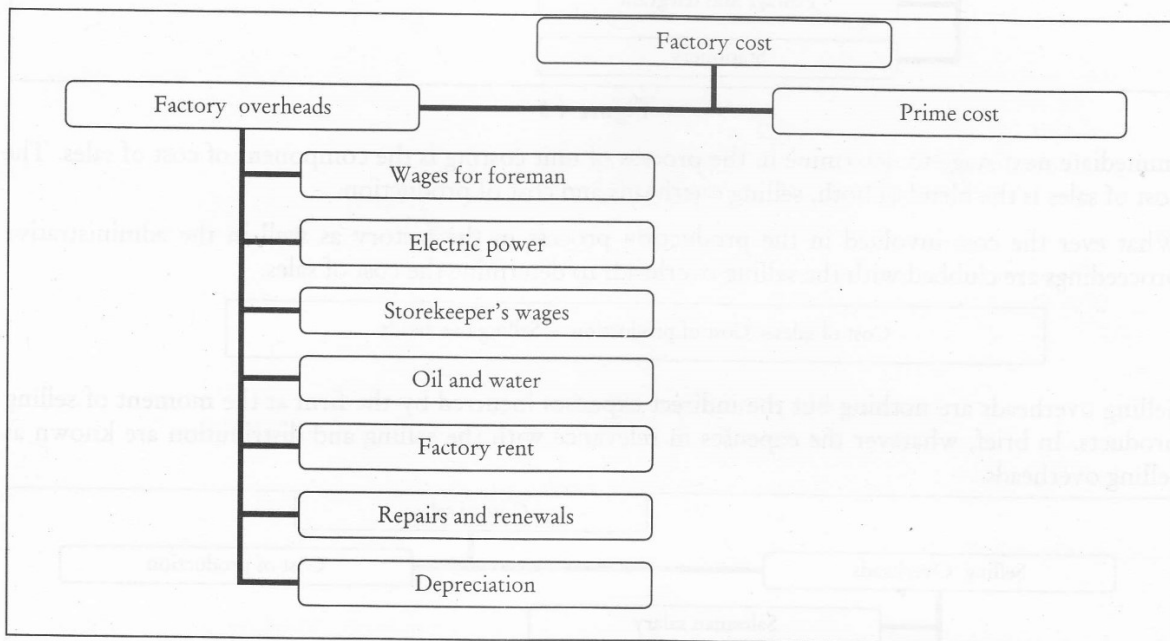


Figure 4.2

The next stage in the process of the unit costing is to find out the cost of the production. The cost of production is the combination of both the factory cost and administrative overheads.

$$\text{Cost production} = \text{Factory cost} + \text{Administrative overheads}$$

Administrative overheads is the indirect expenses incurred during the office administration for the smooth flow production of finished goods.