Chapter 6 – Preparation of Final Accounts of Sole Proprietors

Unit 1 – Final Accounts of Non-Manufacturing Entities

Financial Statements

Financial Statements are prepared at the end of an Accounting Period to show the financial performance, i.e., profit earned or loss incurred during the accounting period and financial position (Assets and Liabilities) of the business as on that date.

A complete set of Financial Statements includes:

1. Income Statement, or Trading and Profit & Loss A/c
2. Position Statement, or Balance Sheet

Classification of Capital and Revenue Items

After preparing the Trial Balance, the accounts appearing therein are transferred either to the Trading and Profit & Loss A/c, or to the Balance Sheet. The items of Revenue nature are transferred to the Trading and Profit & Loss A/c, and the items of Capital nature are transferred to the Balance Sheet. Therefore, it is important to understand the parameters of classification of capital items and revenue items.

Expenditure

Expenditure is the amount spent or liability incurred for acquiring

1. Assets,
2. Goods, or
3. Services.

Expenditure may be categorised into:

1. Capital Expenditure
2. Revenue Expenditure
3. Deferred Revenue Expenditure

Capital Expenditure

Any expenditure which is incurred for the following purposes is termed as "Capital Expenditure":

1. Acquiring the Asset, or
2. Increasing the value of a Fixed Asset, thereby increasing the earning capacity of the business.

Examples related to "Acquiring the Asset" are purchase of building, machinery, furniture, etc.

Examples of "Increasing the value of a Fixed Asset":

1. Suppose a book store has a computer with 500 GB of Hard Disk space. Now, purchase and installation of a 1 TB Hard Disk would increase the value of the Computer, and hence the cost of 1 TB Hard Disk is a Capital Expenditure.
2. In a book store, increasing the book holding capacity of the racks or shelves would lead to an increase in the value of racks, as well as an increase in the earning capacity of the business, therefore, cost incurred on increasing the book holding capacity

The benefit of a Capital Expenditure is received for more than one accounting period, i.e. more than one accounting year. That is why, the entire amount of Capital Expenditure is not charged against the revenues of one accounting year (Matching Concept).

Revenue Expenditure

Any expenditure, the full benefit of which is received during one accounting period, i.e. one accounting year, is termed as a Revenue Expenditure. Such expenditure does not result in an increase in the earning capacity of the business but only helps in maintaining the existing earning capacity.

Examples:

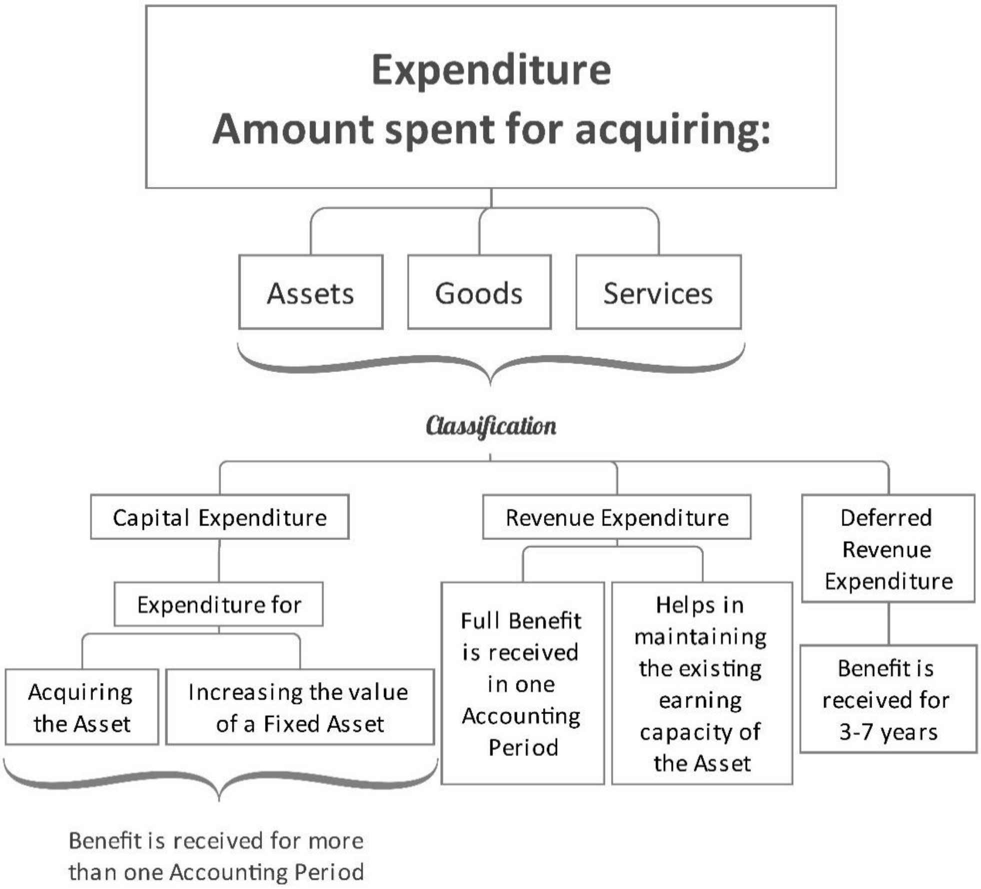
1. Salaries paid to employees is a revenue expenditure because the full benefit of the services of the employees was received during one accounting period, i.e. one accounting year.
2. In a book store, if a rack or a shelf breaks, then, the amount of expenditure incurred to repair that rack or shelf is "Revenue Expenditure" as it does not lead to an increase in the value of the asset, or an increase in the earning capacity of the business, but it only maintains the existing earning capacity.

Deferred Revenue Expenditure

There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number of years. Such expenditures are termed as "Deferred Revenue Expenditures". The benefit of such an expenditure generally lasts between 3 to 5 years.

It is written off just like depreciation over the period of its estimated benefit. The un-written off portion of such expenditure is called a Fictitious Asset.

Example: Suppose you open a new book store and on the first day, you arrange for a glamorous inauguration ceremony with Shah Rukh Khan as the Chief Guest. You invite the entire city and give them coupons of say 50% discount on any purchase made on that day. Suppose the total amount of expenditure that you incurred on this inauguration ceremony is ₹10,00,000. However, because of this huge inauguration ceremony, the entire city will remember your book store for a long time, say, 5 years. Hence, we can say that the benefit of this inauguration ceremony would last for at least 5 years. Such an expenditure, due to which, the revenue is expected to be received in more than 1 accounting year, is known as "Deferred Revenue Expenditure". Now, as per matching concept, the costs of a particular accounting period should be charged against the revenues of that particular accounting period. Since, this inauguration ceremony is expected to provide benefit to the book store for 5 years, the expenses incurred for this ceremony should also be distributed evenly among 5 years. Therefore, every year, ₹2,00,000 should be charged against the revenue of that year. Therefore, in the first year of the book store, ₹2,00,000 would be charged against the revenue of the first year and ₹8,00,000 would be left to be charged in subsequent years. ₹2,00,000 is known as the "amount written off" and ₹8,00,000 is known as the "amount not written off". The amount of Deferred Revenue Expenditure which is not written off, i.e. ₹8,00,000 is a Fictitious Asset.



Expenses

Expense is the cost incurred in producing and selling the goods and services.

Examples: Cost of Goods Sold, Salaries, Wages, Rent, Advertisement, etc.

Therefore, all Revenue Expenditures are Expenses. In common parlance, the terms "Revenue Expenditure" and "Expenses" are used interchangeably.

Receipts

Receipts is the amount received or receivable for selling assets, goods or services.

Receipts are further categorised into:

1. Revenue Receipts, and
2. Capital Receipts

Revenue Receipts

Any amount received or receivable from "Business Operations" is a Revenue Receipt.

Examples:

1. **Book Store –**
   "Business Operation" of a Book Store is the sale of books.
   Therefore, sale of books is a "transaction in the normal course of business", or a "transaction of revenue in nature".
   Any receipt from the sale of books is termed as "Revenue Receipt".

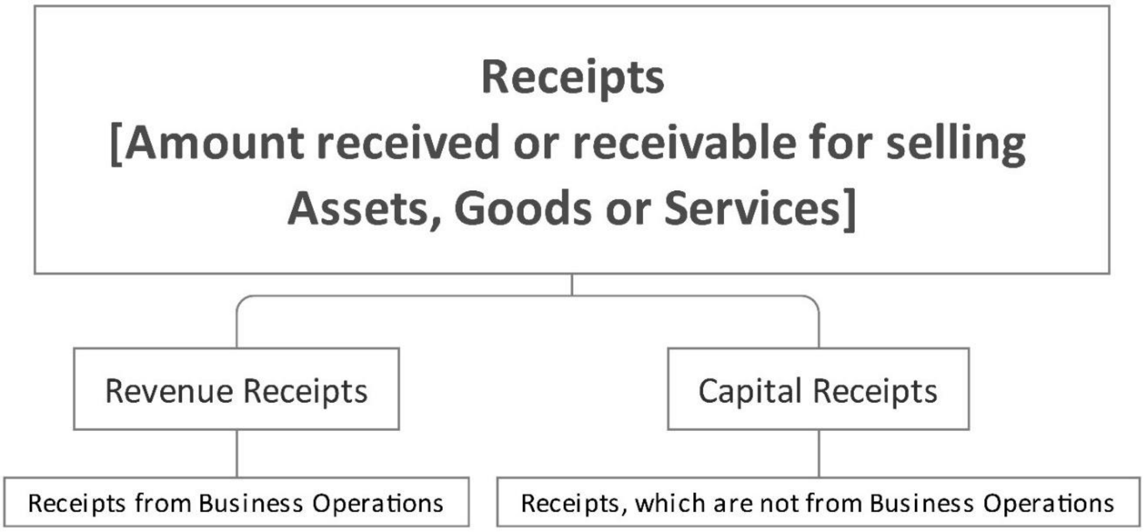
2. **Lawyer –**
   "Business Operation" of a lawyer is the legal services provided by him to his clients.
   Therefore, provision of legal services is a "transaction in the normal course of business" or a "transaction of revenue in nature".
   Any receipt from the provision of legal services is termed as "Revenue Receipt".

Capital Receipts

Any amount received or receivable against transactions which are not revenue in nature is a "Capital Receipt".

Examples:

1. A computer used by a book store may become obsolete and it may want to sell it. The sale of computer is not a transaction in the normal course of business, therefore, receipt from the sale of computer is termed as "Capital Receipt".
2. Sale of Machinery
3. Sale of Furniture, etc.



How to Solve Questions on Classification of Capital and Revenue Items

On seeing an item of Expenditure, ask the following four questions from your heart:

1. Is it going to increase my existing earning capacity?
2. Is it going to decrease my current operating expenses?
3. Is its benefit going to last for more than a year?
4. Is it for the purchase of a Fixed Asset or for making it ready for use?

If the answer of either of the above questions is "YES", then that expenditure is Capital Expenditure, otherwise it is Revenue Expenditure!

Question 1

Classify the following expenditures as capital or revenue expenditure:

1. *Amount spent on making a few more exits in a Cinema Hall to comply with Government orders.*
   (RTP November, 2019; RTP May, 2018)
2. *Travelling expenses of the directors for trips abroad for purchase of capital assets.*

(RTP November, 2019; RTP May, 2018)

3. *Amount spent to reduce working expenses.*

   (RTP May, 2020; RTP November, 2019; RTP May, 2018)
4. *Amount paid for removal of stock to a new site.*

   (RTP November, 2019; RTP May, 2018)
5. *Cost of repairs on second-hand car purchased to bring it into working condition.*

   (RTP November, 2019; RTP May, 2018)
6. *Complete repaint of existing building.*

   (RTP November, 2018)
7. *Installation of a new central heating system.*

   (RTP November, 2018)
8. *Repainting of a delivery van.*

   (RTP November, 2018)
9. *Providing drainage for a new piece of water-extraction equipment.*

   (RTP November, 2018)
10. *Legal fees on the acquisition of land.*

    (RTP November, 2018)
11. *Carriage costs on a replacement part for a piece of machinery.*

    (RTP November, 2018)
12. *₹10,000 spent as import duty on machinery purchased.*

    (RTP May, 2019)
13. *Amount received from debtors during the year.*

    (RTP May, 2019)
14. *Cost of testing whether the equipment is functioning properly.*

    (RTP May, 2019)
15. *Insurance claim received on account of a machinery damaged by fire.*

    (RTP May, 2019)
16. *Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready.*

    (MTP May, 2020; May, 2019 – 2 Marks)
17. *Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land.*

    (RTP May, 2020)
18. *Rings and Pistons of an engine were changed at a cost of ₹5,000 to get fuel efficiency.*

    (RTP May, 2020)
19. *Compensation of ₹2.5 crores paid to workers, who opted for voluntary retirement.*

    (RTP May, 2020)
20. *M/s. XYZ & Co. runs a cafe. They renovated. some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 15 to 18. The total expenditure incurred was ₹30,000.*

    (November, 2019 – 2 Marks)

Answer

1. Revenue Expenditure
2. Capital Expenditure
3. Capital Expenditure
4. Revenue Expenditure

5. Capital Expenditure
6. Revenue Expenditure
7. Capital Expenditure
8. Revenue Expenditure
9. Capital Expenditure
10. Capital Expenditure
11. Revenue Expenditure
12. Capital Expenditure
13. Revenue Receipt
14. Capital Expenditure
15. Capital Receipt
16. Capital Expenditure
17. Revenue Expenditure
18. Capital Expenditure
19. Revenue Expenditure – Since magnitude is very large, defer it over future years.
20. Capital Expenditure

Final Accounts

Income Statement

Income Statement is divided into two parts:

1. Trading Account, and
2. Profit & Loss Account

Trading Account

Trading Account is prepared for calculating Gross Profit.

$$Gross\ Profit = Net\ Sales - Cost\ of\ Goods\ Sold$$

$$Net\ Sales = Sales - Sales\ Returns$$

$$Cost\ of\ Goods\ Sold = Adjusted\ Purchases + Direct\ Expenses$$

$$Adjusted\ Purchases = Opening\ Stock + Net\ Purchases - Closing\ Stock$$

$$Net\ Purchases = Purchases - Purchases\ Returns$$

Direct Expenses are expenses in relation to:

1. Purchase of Goods; or
2. Manufacture of Goods; or
3. Bringing the Goods to the Godown.

A general format of a Trading A/c is given below:

Particulars		**₹**	**Particulars**		**₹**
To Opening Stock		xxx	By Sales	xxx	
To Purchases	xxx		Less: Returns Inwards	xxx	xxx
Less: Returns Outwards	xxx	xxx	By Closing Stock		xxx
To Direct Expenses:			By Gross Loss c/d*		xxx
Freight & Carriage		xxx			
Customs & Insurance		xxx			
Wages		xxx			
Gas, Water & Fuel		xxx			
Factory Expenses		xxx			
To Gross Profit c/d*		xxx			
		xxx			xxx

* Only one of these will appear.

Profit & Loss Account

Profit & Loss Account is prepared for determination of Net Profit. It is debited with all the Indirect Expenses and credited with all the Indirect Gains. If the Profit & Loss A/c has a credit balance, it is called "Net Profit"; if it has a debit balance, it is called "Net Loss".

A general format of a Profit & Loss A/c is given below:

Particulars	**₹**	**Particulars**	**₹**
To Gross Loss b/d*	xxx	By Gross Profit b/d*	xxx
To Salaries	xxx	By Discount Received	xxx
To Office Rent, Rates and Taxes	xxx	By Commission Received	xxx
To Printing and Stationery	xxx	By Net Loss (transferred to Capital A/c)	xxx
To Telephone Charges	xxx		
To Postage and Telegrams	xxx		
To Insurance	xxx		
To Audit Fees	xxx		
To Electricity Charges	xxx		
To Discount Allowed	xxx		
To Net Profit (transferred to Capital A/c)	xxx		
	xxx		xxx

Balance Sheet

Balance Sheet is a Position Statement which shows the Financial Position of the organisation. The left side is the Liabilities Side, which shows what the business owes and to whom on the date the Balance Sheet is prepared. The right side is the Assets Side, which shows what the business owns on the date the Balance Sheet is prepared.

The liabilities to be shown in the balance sheet are first classified as non-current and current, and then, Non-Current Liabilities are shown first, followed by the Current Liabilities. Similarly, assets to be shown in the balance sheet are first classified as non-current and current, and then, Non-Current Assets are shown first, followed by Current Assets.

We have already discussed the classification of Assets. Let's discuss the classification of Liabilities.

Liability

Liability means the amount owed (payable) by the business organisation.

Classification of Liabilities:

1. On the basis of Internal and External
   a. Internal Liability
   b. External Liability
2. On the basis of Non-Current and Current
   a. Non-Current Liability
   b. Current Liability

On the basis of Internal and External

Internal Liability

Liability towards the owners of the business is termed as Internal Liability. Example: The Capital invested in the business by the owner is an Internal Liability for the Business.

External Liability

Liability towards the outsiders, i.e. other than the owners (proprietor) is termed as External Liability.

Example:

1. Suppose in the business of a Book Store, if the books from the wholesalers or the publishers are purchased on credit (Credit Purchase), i.e. payment is to be made at a date later than the date of purchase, the amount which the Business will owe the wholesalers or the publishers is known as External Liability.
2. Suppose a business organisation takes a loan from bank; then, the amount of loan is the external liability.

On the basis of Non-Current and Current

Non-Current Liability

Non-Current Liability is that liability which is payable after a period of more than a year from the end of the Accounting Period.

Example:

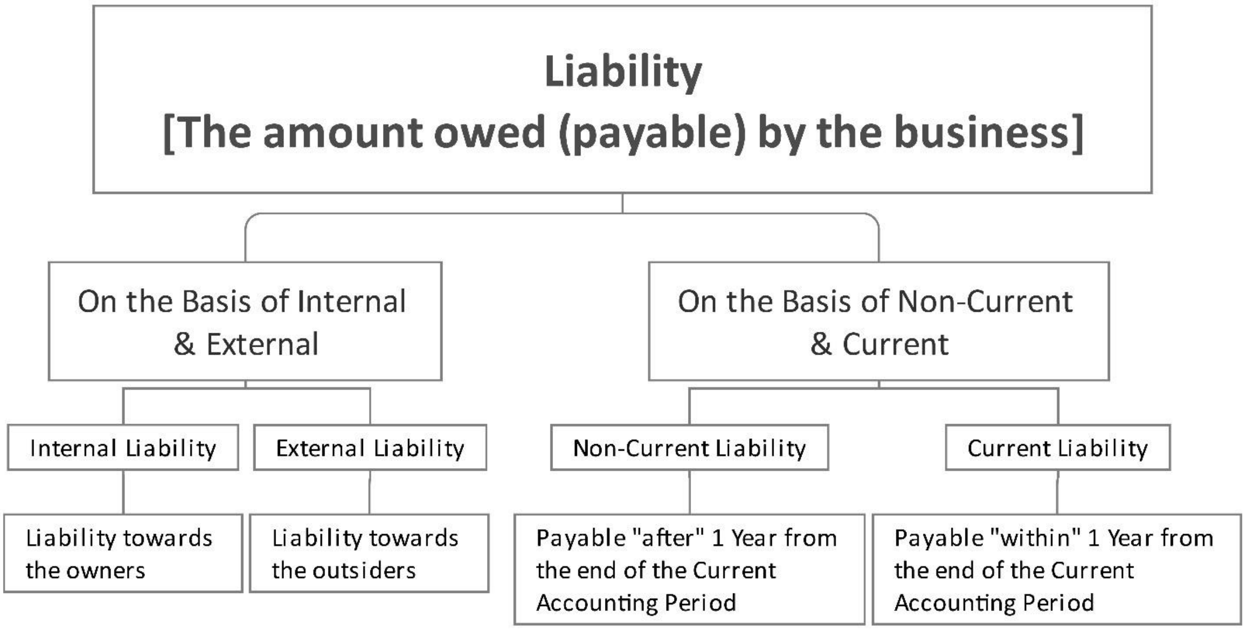
Suppose the current accounting period is from 01.04.2017 to 31.03.2018. Let's say on 01.06.2017, Business Organisation takes a loan from a Bank, which is to be repaid after 5 years, i.e. on 31.05.2022. Clearly, it is a liability of the business towards Bank. Now, 1 year from the end of the Accounting Period ends on 31.03.2019. Since the loan is to be repaid on 31.05.2022, which is later than 31.03.2019 (more than a year from the end of Accounting Period), this loan is a Non-Current Liability.

Current Liability
Current Liability is that liability which is payable within 12 months (or 1 year) from the end of the accounting period.

Example:

Business: Book Store

For a Book Store, suppose the current accounting period is from 01.04.2017 to 31.03.2018. Let's say on 01.09.2017, some goods are purchased on credit and the payment is to be made after 8 months, i.e. on 30.04.2018. Clearly, it is a liability of the business towards Suppliers. Now, 1 year from the end of the Accounting Period ends on 31.03.2019. Now, since 30.04.2018 is within 12 months (or 1 year) from the end of 31.03.2018, this liability is a Current Liability.



A general format of a Balance Sheet is given below:

Liabilities	**₹**	**Assets**	**₹**
Capital A/c:		Tangible Fixed Assets:	
Balance	xxx	Land and Building	xxx
Add: Net Profit/Less: Net Loss	xxx	Plant and Machinery	xxx
Less: Drawings	xxx	Furniture and Fixture	xxx
Long Term Loans:		Vehicles	xxx
Term Loans	xxx	Intangibles:	
Other Loans	xxx	Goodwill	xxx
Short Term Loans:		Patent Rights	xxx
Overdrafts	xxx	Designs and Brand Names	xxx
Other Loans	xxx	Investments:	
Current Liabilities:		Long Term Investments	xxx
Trade Payables	xxx	Current Assets:	
Outstanding Expenses	xxx	Inventory in Trade	xxx
Advances Taken	xxx	Trade Receivables	xxx
Provisions	xxx	Prepaid Expenses	xxx
		Cash in Hand	xxx
		Cash at Bank	xxx
	xxx		xxx

Summary of Adjustments

Item	Journal Entry	If Appearing in Trial Balance		If Not Appearing in Trial Balance	
		Treatment in Trading/P&L	**Treatment in Balance Sheet**	**Treatment in Trading/P&L**	**Treatment in Balance Sheet**
Closing Stock	Closing Stock A/c Dr. To Purchases A/c	No Treatment	Asset Side	Credit to Trading A/c	Asset Side
Outstanding Expenses	Expenses A/c Dr. To Outstanding Expenses A/c	No Treatment	Liabilities Side	Add to Expenses in P&L A/c	Liabilities Side
Prepaid Expenses	Prepaid Expenses A/c Dr. To Expenses A/c	No Treatment	Asset Side	Less from Expenses in P&L A/c	Asset Side
Accrued Income	Accrued Income A/c Dr. To Income A/c	No Treatment	Asset Side	Add to Income in P&L A/c	Asset Side
Unearned Income/ Income Received in Advance	Income A/c Dr. To Unearned Income A/c	No Treatment	Liabilities Side	Less from Income in P&L A/c	Liabilities Side
Bad Debts	Bad Debts A/c Dr. To Debtors	Debit to P&L A/c	No Treatment	Debit to P&L A/c	Less from Debtors

Depreciation

The entries for charging depreciation and transferring it to Profit & Loss A/c are recapitulated below:

1. When Provision for Depreciation A/c is not maintained:
   a. Depreciation A/c Dr.
      To Asset A/c
      (Being Depreciation charged to Asset)
   b. Profit & Loss A/c Dr.
      To Depreciation A/c
      (Being Depreciation transferred to Profit & Loss A/c)
2. When Provision for Depreciation A/c is maintained:
   a. Depreciation A/c Dr.
      To Provision for Depreciation A/c
      (Being the provision for depreciation made)
   b. Profit & Loss A/c Dr.
      To Depreciation A/c

(Being depreciation transferred to Profit & Loss A/c)

Adjustment of Depreciation when Provision for Depreciation A/c is not maintained
When the depreciation appears in the Trial Balance, it means that the concerned asset has already been reduced with the amount of depreciation. In such case, the balance of Depreciation A/c is simply taken to the debit side of the Profit & Loss A/c. The concerned asset is shown in the balance sheet at the same figure at which it appears in the Trial Balance.

When the depreciation is given outside the Trial Balance as an adjustment, it means that the concerned asset has not been reduced. Therefore, first, the entry for charging depreciation is passed, and the entry for transferring it to the Profit & Loss A/c is passed. Depreciation A/c is shown on the debit side of the Profit & Loss A/c, while the asset is shown in the balance sheet after reducing the amount of depreciation from it.

Adjustment of Depreciation when Provision for Depreciation A/c is maintained
When depreciation appears in the Trial Balance, it means depreciation is already charged and the Provision for Depreciation A/c is already increased with the amount of depreciation. Depreciation A/c is simply shown on the debit side of the Profit & Loss A/c, and the Provision for Depreciation A/c is shown by way of deduction from the Asset in the Balance Sheet.

When depreciation is given outside the Trial Balance, it means that the depreciation is not yet charged. Therefore, first, the entry for charging depreciation is passed, and the entry for transferring it to the Profit & Loss A/c is passed. Depreciation A/c is shown on the debit side of the Profit & Loss A/c, while the Provision for Depreciation A/c is shown in the balance sheet by way of deduction from the Asset.

Bad Debts
Bad Debts is the amount which a debtor is unable to pay. It a loss to the organisation and hence is transferred to the Profit & Loss A/c.

When Bad Debts appear in the Trial Balance, it means that the entry for Bad Debts has already been passed, and the balance of Debtors A/c has already been reduced. The balance of Bad Debts is transferred to the Profit & Loss A/c and the Debtors are shown in the Balance Sheet at the same figure at which they appear in the Trial Balance.

When Bad Debts are given outside the Trial Balance as an adjustment, the entry for Bad Debts is needed to be passed. Thereafter, Bad Debts are shown on the debit side of the Profit & Loss A/c and the debtors are shown in the Balance Sheet after reducing them with the amount of Bad Debts.

Provision for Bad/Doubtful Debts
When a business organisation figures that a certain debtor would not be able to pay certain amount, it makes a provision for it by debiting the Profit & Loss A/c, and crediting the Provision for Doubtful Debts A/c. Thereafter, in the subsequent period, when the bad debts actually happen, Bad Debts A/c is debited and the concerned Debtor's A/c is credited. Then, instead of transferring the Bad Debts to the Profit & Loss A/c, it is transferred to the Provision for Doubtful Debts A/c to the extent it is available. Any excess amount of Bad Debts over and above the Provision already created is transferred to the Profit & Loss A/c.

Provision for Discount on Debtors
Just like a provision is made for doubtful debts, a provision is made for the possible discount that may be allowed to the debtors in subsequent period, when they make the payment. A provision is made by debiting Profit & Loss A/c and crediting Provision for Discount on Debtors A/c. Thereafter, in the subsequent period, when discount is allowed to the debtors, Discount A/c is debited and the Debtors A/c

is credited. Thereafter, instead of transferring the Discount A/c to the Profit & Loss A/c, it is transferred to the Provision for Discount on Debtors A/c to the extent it is available. Any excess amount of Discount over and above the Provision already created is transferred to the Profit & Loss A/c.

Note: Provision for discount on debtors is calculated on sundry debtors after deducting bad debts and the provision for doubtful debts.

Manager's Commission

Sometimes a business organisation may give an additional incentive to the manager known as Manager's Commission. It is usually calculated at a percentage on the net profit, either before charging such commission or after charging such commission.

Journal Entries passed are:

Manager's Commission A/c Dr.
To Commission Payable/Outstanding Commission A/c
(Being the commission payable to Manager provided)

Profit and Loss A/c Dr.
To Manager's Commission A/c
(Being the commission payable to Manager is transferred to P&L A/c)

Calculation:

When commission is payable as a percentage of profit before charging such commission:

$$Net\ Profit\ before\ charging\ such\ commission \times \frac{Rate}{100}$$

When commission is payable as a percentage of profit after charging such commission:

$$Net\ Profit\ before\ charging\ such\ commission \times \frac{Rate}{100 + Rate}$$

Abnormal or Accidental Losses

In order to incorporate the effect of Abnormal or Accidental Losses, the Trading A/c is credited with the amount of Loss and the Abnormal Loss A/c is debited. Thereafter, Profit & Loss A/c is debited and the Abnormal Loss A/c is credited. If the losses are insured, then the Insurance Co. A/c is debited with the amount of claim admitted and the balance is debited to the Profit & Loss A/c.

Goods Taken for Personal Use

Goods taken for personal use by the owner are drawings.

The accounting treatment of drawings under various cases is given below:

Particulars	Accounting Entries
1. Drawings made by Cash	Drawings A/c Dr. To Cash/Bank A/c
	Capital A/c Dr. To Drawings A/c
2. Withdrawal of Goods by the Proprietor	Drawings A/c Dr. To Purchases A/c
	Capital A/c Dr. To Drawings A/c

3. Income Tax Paid by the Sole Proprietor out of the Entity's (Business's) Cash	Drawings A/c Dr. To Cash/Bank A/c
	Capital A/c Dr. To Drawings A/c

Goods Distributed as Free Samples

Goods distributed as free samples are advertisement expenses. The journal entry passed is:

Advertisement Expenses A/c Dr.
To Purchases A/c
(Being goods given as free samples)

Profit & Loss A/c Dr.
To Advertisement Expenses A/c
(Being Advertisement Expenses transferred to P&L A/c)

Question 2

The following are the balances extracted from the books of Shri Raghuram as on 31.03.2018, who carries on business under the name and style of M/s Raghuram and Associates at Chennai:

Particulars	***Dr. (₹)***	***Cr. (₹)***
Capital		*14,11,400*
Purchases	*12,00,000*	
Purchase Returns		*18,000*
Sales		*15,00,000*
Sales Returns	*24,000*	
Freight Inwards	*62,000*	
Carriage Outwards	*8,500*	
Rent of Godown	*55,000*	
Rates and Taxes	*24,000*	
Salaries	*72,000*	
Discount allowed	*7,500*	
Discount received		*12,000*
Drawings	*20,000*	
Printing and Stationery	*6,000*	
Insurance premium	*48,000*	
Electricity charges	*14,000*	
General expenses	*11,000*	
Bank charges	*3,800*	
Bad debts	*12,200*	
Repairs the Motor vehicle	*13,000*	
Interest on loan	*4,400*	
Provision for Bad-debts		*10,000*
Loan from Mr. Rajan		*60,000*
Sundry creditors		*62,000*
Motor vehicles	*1,00,000*	
Land and Buildings	*5,00,000*	
Office equipment	*2,00,000*	
Furniture and Fixtures	*50,000*	
Stock as on 31.03.2017	*3,20,000*	
Sundry debtors	*2,80,000*	
Cash at Bank	*22,000*	
Cash in Hand	*16,000*	
Total	*30,73,400*	*30,73,400*

Prepare Trading and Profit and Loss Account for the year ended 31.03.2018 and the Balance Sheet as at that date after making provision for the following:

1. *Depreciate Building by 5%, Furniture and Fixtures by 10%, Office Equipment by 15% and Motor Car by 20%.*
2. *Value of stock at the close of the year was ₹4,10,000.*
3. *One month rent for godown is outstanding.*
4. *Interest on loan from Rajan is payable @ 10% per annum. This loan was taken on 01.07.2017.*
5. *Reserve for bad debts is to be maintained at 5% of Sundry debtors.*
6. *Insurance premium includes ₹42,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 01.04.2017 to 30.06.2018.*

(RTP May, 2020; May, 2018 – 20 Marks)

Question 3

The following is the Trial Balance of T on 31st March, 2018:

Particulars	***Dr. (₹)***	***Cr. (₹)***
Capital		*6,00,000*
Drawings	*70,000*	
Fixed Assets (Opening)	*1,40,000*	
Fixed Assets (Additions 01.10.2018)	*2,00,000*	
Opening Stock	*60,000*	
Purchases	*16,00,000*	
Purchases Returns		*69,000*
Sales		*22,00,000*
Sales Returns	*99,000*	
Debtors	*2,50,000*	
Creditors		*2,20,000*
Expenses	*50,000*	
Fixed Deposit with Bank	*2,00,000*	
Interest on Fixed Deposit		*20,000*
Cash		*8,000*
Suspense A/c		*2,000*
Depreciation	*14,000*	
Rent (17 months upto 31.8.2018)	*17,000*	
Investments 12% (01.8.2017)	*2,50,000*	
Bank Balance	*1,69,000*	
	31,19,000	*31,19,000*

Stock on 31st March, 2018 was valued at ₹1,00,000. Depreciation is to be provided at 10% per annum on fixed assets purchased during the year. A scrutiny of the books of account revealed the following matters:

1. *₹20,000 drawn from bank was debited to Drawings account, but out of this amount withdrawn ₹12,000 was used in the business for day-to-day expenses.*
2. *Purchase of goods worth ₹16,000 was not recorded in the books of account upto 31.03.2018, but the goods were included in stock.*
3. *Purchase returns of ₹1,000 was recorded in Sales Return Journal and the amount was correctly posted to the Party's A/c on the correct side.*
4. *Expenses include ₹6,000 in respect of the period after 31st March, 2018.*

Give the necessary Journal Entries in respect of (i) to (iv) and prepare the Final Accounts for the year ended 31st March, 2018.

(RTP May, 2019)

Question 4

The following is the trial balance of Hari as at 31st December, 2017:

Particulars	***Dr. (₹)***	***Cr. (₹)***
Hari's capital account		*76,690*
Stock 1st January, 2017	*46,800*	
Sales		*3,89,600*
Returns inward	*8,600*	
Purchases	*3,21,700*	
Returns outward		*5,800*
Carriage inwards	*19,600*	
Rent & taxes	*4,700*	
Salaries & wages	*9,300*	
Sundry debtors	*24,000*	
Sundry creditors		*14,800*
Bank loan @ 14% p.a.		*20,000*
Bank interest	*1,100*	
Printing and stationary expenses	*14,400*	
Bank balance	*8,000*	
Discount earned		*4,440*
Furniture & fittings	*5,000*	
Discount allowed	*1,800*	
General expenses	*11,450*	
Insurance	*1,300*	
Postage & telegram expenses	*2,330*	
Cash balance	*380*	
Travelling expenses	*870*	
Drawings	*30,000*	
	5,11,330	*5,11,330*

The following adjustments are to be made:

1. *Included amongst the debtors is ₹3,000 due from Ram and included among the creditors ₹1,000 due to him.*
2. *Provision for bad and doubtful debts be created at 5% and for discount @ 2% on sundry debtors.*
3. *Depreciation on furniture & fittings @ 10% shall be written off.*
4. *Personal purchases of Hari amounting to ₹600 had been recorded in the purchases day book.*
5. *Interest on bank loan shall be provided for the whole year.*
6. *A quarter of the amount of printing and stationary expenses is to be carried forward to the next year.*
7. *Credit purchase invoice amounting to ₹400 had been omitted from the books.*
8. *Stock on 31.12.2017 was ₹78,600.*

Prepare (i) Trading & profit and loss account for the year ended 31.12.2017 and (ii) Balance sheet as on 31st December, 2017.

(RTP November 2018; MTP November 2018 – 12 Marks (Similar))

Question 5

The following are the balances as at 31st March, 2017 extracted from the books of Mr. XYZ:

Particulars	**₹**	***Particulars***	**₹**
Plant and Machinery	*19,550*	*Bad debts recovered*	*450*
Furniture and Fittings	*10,250*	*Salaries*	*22,550*
Bank Overdraft	*80,000*	*Salaries payable*	*2,450*
Capital Account	*65,000*	*Prepaid rent*	*300*
Drawings	*8,000*	*Rent*	*4,300*
Purchases	*1,60,000*	*Carriage inward*	*1,125*
Opening Stock	*32,250*	*Carriage outward*	*1,350*
Wages	*12,165*	*Sales*	*2,15,300*
Provision for doubtful debts	*3,200*	*Advertisement Expenses*	*3,350*
Provision for Discount on Debtors	*1,375*	*Printing and Stationery*	*1,250*
Sundry Debtors	*1,20,000*	*Cash in hand*	*1,450*
Sundry Creditors	*47,500*	*Cash at bank*	*3,125*
Bad debts	*1,100*	*Office Expenses*	*10,160*
		Interest paid on loan	*3,000*

Additional Information:

1. *Purchases include sales return of ₹2,575 and sales include purchases return of ₹1,725.*
2. *Goods withdrawn by Mr. XYZ for own consumption ₹3,500 included in purchases.*
3. *Wages paid in the month of April for installation of plant and machinery amounting to ₹450 were included in wages account.*
4. *Free samples distributed for publicity costing ₹825.*
5. *Create a provision for doubtful debts @ 5% and provision for discount on debtors @ 2.5%.*
6. *Depreciation is to be provided on plant and machinery @ 15% p.a. and on furniture and fittings @ 10% p.a.*
7. *Bank overdraft is secured against hypothecation of stock. Bank overdraft outstanding as on 31.3.2017 has been considered as 80% of real value of stock (deducting 20% as margin) and after adjusting the marginal value 80% of the same has been allowed to draw as an overdraft.*

Prepare a Trading and Profit and Loss Account for the year ended 31st March, 2017, and a Balance Sheet as on that date. Also, show the rectification entries.

(RTP November, 2019; RTP May, 2018)

Rectification of Errors After Preparing Final Accounts

Question 6

Miss Daisy was unable to agree the Trial Balance last year and wrote off the difference to the profit and loss account of that year. On verifying the old books by a Chartered Accountant next year, the following mistakes were found.

1. *Purchase account was undercast by ₹8,000.*
2. *Sale of goods to Mr. Rahim for ₹2,500 was omitted to be recorded.*
3. *Receipt of cash from Mr. Asok was posted to the account of Mr. Anbu ₹1,200.*
4. *Amount of ₹4,167 of sales was wrongly posted as ₹4,617.*
5. *Repairs to Machinery was debited to Machinery Account ₹1,800.*
6. *A credit purchase of goods from Mr. Paul for ₹3,000 entered as sale.*

Suggest the necessary rectification entries.

(May, 2018 – 10 Marks)

Question 7

The following mistakes were located in the books of a concern after its books were closed and a Suspense Account was opened in order to get the Trial Balance agreed:

1. *Sales Day Book was overcast by ₹1,000.*
2. *A sale of ₹5,000 to X was wrongly debited to the Account of Y.*
3. *General expenses ₹180 was posted in the General Ledger as ₹810.*
4. *A Bill Receivable for ₹1,550 was passed through Bills Payable Book. The Bill was given by P.*
5. *Legal Expenses ₹1,190 paid to Mrs. Neetu was debited to her personal account.*
6. *Cash received from Ram was debited to Shyam ₹1,500.*
7. *While carrying forward the total of one page of the Purchases Book to the next, the amount of ₹1,235 was written as ₹1,325.*

Find out the nature and amount of the Suspense Account and Pass entries (including narration) for the rectification of the above errors in the subsequent year's books.

(RTP May, 2020; November, 2018 – 10 Marks)

Question 8

The following errors were committed by the Accountant of Geete Dye-Chem.

1. *Credit sale of ₹400 to Trivedi & Co. was posted to the credit of their account.*
2. *Purchase of ₹420 from Mantri & Co. passed through Sales Day Book as ₹240.*

How would you rectify the errors assuming that:

1. *they were detected before preparation of Trial Balance.*
2. *they were detected after preparation of Trial Balance but before preparing Final Accounts, the difference was taken to Suspense A/c.*
3. *they were detected after preparing Final Accounts.*

(RTP November, 2020; RTP November, 2019; RTP May, 2018)

Solution

1. This is one sided error. Trivedi & Co. account is credited instead of debit. Amount posted to the wrong side and therefore while rectifying the account, double the amount (₹800) will be taken.

Before Trial Balance	After Trial Balance	After Final Accounts
No Entry Debit Trivedi A/c with ₹800	Trivedi & Co. A/c Dr. 800 To Suspense A/c 800	Trivedi & Co. A/c Dr. 800 To Suspense A/c 800

2. Purchase of ₹420 is wrongly recorded through sales day book as ₹240.

Correct Entry	Entry made wrongly
Purchase A/c Dr. 420 To Mantri & Co. 420	Mantri & Co. A/c Dr. 240 To Sales A/c 240

Rectification Entry:

Before Trial Balance	After Trial Balance	After Final Accounts
Sales A/c Dr. 240 Purchase A/c Dr. 420 To Mantri & Co. 660	Sales A/c Dr. 240 Purchase A/c Dr. 420 To Mantri & Co. 660	P & L Adj. A/c Dr. 660 To Mantri & Co. 660

Unit 2 – Final Accounts of Manufacturing Entities

In order to determine manufacturing costs of finished products, manufacturing entities prepare a "Manufacturing A/c" before "Trading and Profit & Loss A/c" and "Balance Sheet". Manufacturing costs of finished goods are then transferred to the Trading A/c.

In the earlier unit, we studied that the direct expenses are expenses incurred in relation to:

1. Purchase of Goods,
2. Manufacture of Goods,
3. Bringing the Goods to godown.

Obviously, if we are preparing a Manufacturing A/c, all the expenses relating to the manufacture of goods will be shown in the Manufacturing A/c, and not the Trading A/c.

Manufacturing Cost is calculated as follows:

Particulars	**₹**
Raw Material Consumed	xxx
Add: Direct Manufacturing Wages	xxx
Direct Manufacturing Expenses	xxx
Direct Manufacturing Cost	xxx
Indirect Manufacturing Expenses or Manufacturing Overhead	xxx
Total Manufacturing Cost	xxx

Raw Material Consumed = Opening Inventory of Raw Material + Purchases – Closing Inventory of Raw Material

Direct Manufacturing Expenses

Direct Manufacturing Expenses include Direct Material and Direct Wages, of course. Other than that, costs which are incurred for a specific product or saleable service are known as Direct Manufacturing Expenses. For example:

1. Royalties for using license or technology if based on units produced,
2. Hire charge of the plant and machinery used on hire, if based on units produced, etc.

Question 1

1,00,000 units were produced in a factory. Per unit material cost was ₹10 and per unit labour cost was ₹5. That apart it was agreed to pay royalty @ ₹3 per unit to the Japanese collaborator who supplied technology.

Required:

Calculate Manufacturing Cost.

(ICAI Study Material)

Indirect Manufacturing Expenses or Overhead Expenses

Overhead = Indirect Material + Indirect Wages + Indirect Expenses

Indirect material is the material which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc.

Indirect wages are those wages which cannot be directly linked to the units produced, for example, wages for maintenance works, holding pay, etc.

Indirect expenses are those expenses which cannot be directly linked to the units produced, for example, training expenses, depreciation of plant and machinery, depreciation of factory shed, insurance premium for plant and machinery, factory shed, etc.

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

By-Products

By-Product is a secondary product which is produced while producing the main product. No additional raw material or additional production process is required for producing such by-product. It is generally valued at its net realizable value as it is difficult to ascertain its cost of production.

Manufacturing Account

Following is the general format of a Manufacturing Account:

Particulars	Units	(₹)	Particulars	Units	(₹)
To Raw Materials Consumed:			By By-products at net realisable value		xxx
Opening Inventory	xxx		By Closing work-in-process		xxx
Add: Purchases	xxx		By Trading A/c		xxx
	xxx		Cost of production		
Less: Closing Inventory	xxx	xxx			
To Direct Wages		xxx			
To Direct Expenses		xxx			
To Factory Overheads					
Royalty	xxx				
Hire Charges	xxx	xxx			
To Indirect Expenses:					
Repairs & Maintenance	xxx				
Depreciation	xxx				
Factory Cost	xxx	xxx			
To Opening Work-in-process		xxx			
		xxx			xxx

The following general rules should be kept in mind:

1. The Manufacturing Account should have columns showing the quantities and values. Sometimes, all the quantities are not given and the quantities applicable to one or more of the items have to be worked out. For example, if the question does not state the total number of items sold, the quantity can be worked out by adding opening inventory and units manufactured and deducting

closing inventory. It is, therefore, useful to have quantity columns in the account so that it can be seen that both sides balance.

2. The Manufacturing Account will show the following:
    a. Opening and Closing balance of Raw Materials;
    b. Opening and Closing balance of Work-in-process;
    c. Quantity of Finished Goods manufactured.
3. The Trading Account will show the following:
    a. Quantities of finished goods manufactured and sold;
    b. Opening and closing inventory.

    It will not show the quantity of raw materials or work-in-progress.
4. For determining the value of closing inventory, assume that the goods are sold on "first-in-first-out" basis. However, if the question mentions otherwise, follow the instructions of the question.

Question 2

Mr. Vimal runs a factory which produces soaps. Following details were available in respect of his manufacturing activities for the year ended on 31.3.2016:

Particulars	**₹**
Opening Work-in-Process (10,000 units)	*16,000*
Closing Work-in-Process (12,000 units)	*20,000*
Opening inventory of Raw Materials	*1,70,000*
Closing inventory of Raw Materials	*1,90,000*
Purchases	*8,20,000*
Hire charges of machine @ ₹0.60 per unit manufactured	
Hire charges of factory	*2,20,000*
Direct wages-Contracted @ ₹0.80 per unit manufactured and @ ₹0.40 per unit of Closing W.I.P.	
Repairs and Maintenance	*1,80,000*
Units Produced - 5,00,000 units	

Required:

Prepare a Manufacturing Account of Mr. Vimal for the year ended 31.3.2016.

(ICAI Study Material)

Question 3

Mr. Pankaj runs a factory which produces motor spares of export quality. The following details were obtained about his manufacturing expenses for the year ended on 31.3.2016.

Particulars		**₹**
W.I.P.	*Opening*	*3,90,000*
	Closing	*5,07,000*
Raw Materials	*Purchases*	*12,10,000*
	Opening	*3,02,000*
	Closing	*3,10,000*
	Returned	*18,000*
	Indirect Material	*16,000*
Wages	*Direct*	*2,10,000*
	Indirect	*48,000*
Direct Expenses	*Royalty on Production*	*1,30,000*

	Repairs and Maintenance	*2,30,000*
	Depreciation on Factory Shed	*40,000*
	Depreciation on Plant & Machinery	*60,000*
By-Product at selling price		*20,000*

You are required to prepare Manufacturing Account of Mr. Pankaj for the year ended on 31.3.2016.

(ICAI Study Material)

Question 4

Following are the Manufacturing A/c, Creditors A/c and Trading A/c provided by Ms. Shivi related to 2016-17. There are certain figures missing from these accounts.

Raw Material A/c

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Opening Stock A/c	*1,00,000*		*By Raw Material Consumed*	....
	To Creditors A/c	....		*By Closing Stock A/c*	....

Creditors A/c

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Bank A/c	*22,00,000*		*By balance b/d*	*15,00,000*
	To balance c/d	*6,00,000*			

Manufacturing A/c

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Raw Materials Consumed	....		*By Trading A/c*	*17,94,000*
	To Wages	*3,50,000*			
	To Depreciation	*2,00,000*			
	To Direct Expenses	*2,44,000*			

Additional Information:

1. *Purchase of machinery worth ₹10,00,000 has been omitted. Machinery are chargeable at a depreciation rate of 10%.*
2. *Wages include the following:*
   a. *Paid to Factory Workers - ₹3,00,000*
   b. *Paid to labour at office - ₹50,000*
3. *Direct Expenses include following:*
   a. *Electricity charges of ₹80,000 of which 30% pertained to office.*
   b. *Fuel Charges of ₹20,000*
   c. *Freight Inwards of ₹35,000*
   d. *Delivery charges to customers - ₹20,000.*

You are required to prepare revised Manufacturing A/c, and Raw Material A/c.

(ICAI Study Material)