5. Preparation of Financial Statements

This chapter discusses the following themes.

5 . 1 Calculation of operating results of a business organization

- Trading account
- Profit and loss account

5.2 Identifying the financial position of a business organization

Let us Prepare Financial Statements

Sahan Abenayake is a businessman who has succeeded in business in his own. A conversation he had with one of his schoolmates is as follows. The school-mate, Namal Jayasinghe, is an Accountant by profession.

Sahan : Hello! Mr. Namal. It is a pleasure to meet you.

Namal : Hello. You are a businessman now, aren't you? How is your business progressing?

Sahan : It is not yet one year for my business. I started it with my own money. After sometime I took a loan of Rs. 200,000 from the bank.

Namal : Your business seems stable. Do you record the transactions of your business?

Sahan : Yes, to some extent. I also collect invoices, folios, vouchers and other information about cash receipts and payments. I would like to know your opinion on these matters.

Namal : Yes. It is important that you collect invoices, folios, and vouchers separately. Then you have to record them. It is necessary to prepare final accounts at least once a year.

We must always try to make our business successful. We must maximize profit for the amount we invest in the organization. It is good to maintain the business at a good financial strength.

Sahan : Isn't it costly and time consuming to maintain accounts.

Namal : Yes it is. However isn't it important to know the position of your organization to make it successful? Proper maintenance of accounts is important to get bank loans, to pay taxes and to make future plans for the organization.

From reading the above conversation it is clear that maintaining proper financial records are important to a business organization. Let us observe how financial statements are prepared for an organization.

Introduction

At the end of any activity it is necessary to see if it has been successful or not. It helps to make future activities successful. It can further provide information to interested parties to make their own decisions.

Therefore in profit oriented organizations it is necessary to calculate the profits or losses for a given time period. Further it must be helpful to extract actual and truthful information about the financial position of the organization.

Your attention is drawn on the following basic terms in this chapter.

- Sales income
- Trading account
- Profit and Loss account
- Expenditure
- Balance Sheet
- Liabilities
- Cost of Sales
- Gross Profit
- Income
- Net Profit
- Assets
- Ownership

5.1 Calculation of Operating Results of a Business Organisation

The stake holders of any organisation are more concerned about the final product of accounting. It is the final accounts of the company. Following two financial statements are most important among them.

- Trading and Profit and Loss account
- Balance Sheet

Trading profit and loss account is used to calculate the profit or loss of the operational results for the accounting period. The profit calculated in this manner can be shown in two steps. They are,

- Trading profit/ gross profit
- Net profit/loss

Trading Account

Organisations which are involved in selling goods and services prepare the trading account to calculate the gross profit. It includes two main aspects.

- Sales income
- Cost of sales

Sales Income

Total sales include sales on cash and credit sales. Some of the goods sold on credit may be returned back to the organisation. Goods returned as such will be deducted from the sales of the business. This allows the calculation of net sales to the business.

		Rs.
Example :	**Cash sales**	145,000
	Credit sales	68,000
		213,000
	Less – Goods returned	3,000
	Net sales	210,000

Cost of Sales

Following items are considered when calculating the cost of sales.

- Opening stocks
- Carriage inwards
- Closing stocks
- Custom duty
- Purchases
- Purchases returns

The closing stocks of one period become the opening stocks for the next accounting period.

Example : The accounting period starts on 01/01/20xx and ends on 31/12/20xx. The opening stock as at 01/01/20xx is Rs.8000. It is the same as the closing stock of Rs. 8000 as at 31/12/20xx.

An organisation which starts business activities newly, will not have an opening stock. But in other organisations when the opening stocks are sold it becomes a part of cost of sales for that accounting period.

The opening stock will not be sufficient for sales for a given accounting period. Therefore the organisations have to purchase new stocks. Goods purchased on cash are known as cash purchases while goods purchased on credit will be termed as credit purchases.

Some of these credit purchases may have to be returned from time to time. Such purchase returns will be deducted from the total purchases of the organisation. The net amount calculated is called the net purchases.

Example :

Cash Purchases	78,000
Credit Purchases	46,000
	124,000
Less - Purchase returns	4,000
Net Purchases	120,000

When purchases are considered all the expenses that directly relate to purchases have to be considered. There will be a cost of transporting goods to the business which is termed as carriage inwards. Loading charges have to be paid. All such expenses will be included in the cost of sales.

The opening stocks, purchases and related expenses of purchases are included in the cost of goods to be sold. But it is not the cost of sales. To calculate the cost of sales the closing stocks have to be deducted from the cost of goods to be sold. The remaining stock of the cost of goods to be sold at the end of the accounting period is known as the closing stocks.

Calculating Cost of Sales

Example : • Following information relates to a business organisation. Remaining stock as at 01.01.20xx is Rs. 13,000. Purchases Rs. 120,000. Carriage inwards is Rs.7,000 and the closing stock is Rs. 15,000.

Remaining stock at 01.01.20xx	13,000
Add – Purchases	120,000
Carriage inwards	7,000
Cost of goods to be sold	140,000
Less - Closing stock 31.12.20xx	15,000
Cost of sales	125,000

Let us consider the calculation of gross profit. It is calculated by considering sales income and cost of sales. In other words the cost of sales has to be deducted from the sales income of the organisation.

Sales	210,000
Less – Cost of sales	125,000
Gross Profit	**85,000**

Trading account is used to calculate the gross profit. The sales income is credited to the trading account. If there are any sales returns it is deducted from the sales figure. Cost of sales is in the debit side of the trading account. When cost of sales is calculated first the opening stocks, purchases and cost of purchasing is added to show the cost of goods to be sold. Then by deducting the closing stocks from the cost of goods to be sold the cost of sales is calculated.

By balancing the trading account we arrive at gross profit or gross loss of the organisation. Based on following data, let us prepare a trading account in horizontal format.

Example : ⊙ Following information relates to Kosala's Business.

	Rs.
Sales	567,000
Purchases	295,000
Purchases returns	5,000
Sales returns	7,000
Carriage inwards	11,000
Stocks as at 01/01/20xx	8,000
Stocks as at 31/12/20xx	12,000

Trading Account for the year ended 31/12/20xx

Kosala's Business

	Rs.	Rs.		Rs.	Rs.
		8,000	Sales		567,000
Stocks as at 01/01/20xx	295,000		Less: Sales returns		7,000
Purchases	5,000				
Less: Purchase returns	290,000				560,000
Carriage inwards	11,000				
		301,000			
Cost of goods to be sold		309,000			
Less : Stocks as at 31/12/20xx		(12,000)			
Cost of sales		297,000			
Gross Profit c/d		263,000			
		560,000			560,000
			Gross Profit b/f		263,000

- Sales returns are not shown in the debit side of the trading account. It is shown as a deduction from sales. It allows showing the net sales clearly in the trading account.

- Similarly the purchase returns are not shown at the credit side of the trading account. It is shown as a deduction of purchases. It shows the net purchases clearly.

- The closing stocks are not credited to the trading account. It is shown as a deduction from the cost of goods to be sold. Therefore the cost of sales is clearly shown in the debit side of the trading account.

The gross profit of the trading account is transferred to the profit and loss account of the organisation.

Activity 01

Following information is extracted from Sanduni's record books. Based on the information, prepare the trading account and calculate the gross profit as at 31/12/20xx.

Stocks as at 01/01/20xx	30,000
Purchases	325,000
Sales	475,000
Purchase returns	10,000
Sales returns	5,000
Carriage inwards	90,000

Consider the following information as well.

Ending stocks as at 31/12/20xx was Rs.21,000

Profit and Loss Account

After calculating the gross profit or loss, the net profit or loss has to be calculated. It is calculated through the Profit and Loss account.

As same as in the trading account the income and expenditure for the accounting period is considered in the P & L account. In preparing this account, the accrual concept is taken into consideration.

The main items included in the P & L account are income and revenue expenses. Let us consider the income and revenue expenses.

Income that should be included in the Profit and Loss Account

There are two types of income included in the Profit and Loss account.

- Trading income
- Non - trading income

Trading income is the income earned through main business activities of the organisation.

Example : ⊙ If it is a trading organisation; gross profit, discount received, commissions received etc. are trading income.

Non trading income is the income received through sources other than the main business activity.

Example : ⊙ Investment income, rent income, interest income, profit on sale of non-current assets etc.

The trading and non trading income shown above is included in the total operational income of the organisation.

Expenditure that should be included in the Profit and Loss Account

The revenue expenditure that should be included in the P & L account is the expenses not included in calculating the cost of sales in the trading account.

These expenses are debited to the P & L account under the following categories. They are,

* Organization and administration expenses
* Selling and distribution expenses
* Finance and other expenses

Organization expenses are the expenses incurred to maintain the organisation. Rent paid, electricity expenses, rates, building maintenance, building depreciation etc. are examples.

Administration expenses are incurred for administrative activities. Office expenses, administrative salaries, postage and telephone expenses, machinery depreciation are examples for administration expenses.

Expenses incurred on sales and transport of goods is termed as selling and distribution expenses. Advertising, sales commission, salaries of salesmen, discounts given, bad debts are examples for selling and distribution expenses.

Expenses incurred for funding of the organisation are accounted under financial expenses. Bank loan interest, bank over draft interest, bank charges are examples for financial expenses.

There may be expenses that do not fall into any of the above categories. They are termed as other expenses. Loss on damaged goods, loss on money distortions, loss due to fire and donations are examples of other expenses.

By preparing the trading account the gross profit or loss is accounted in the financial statements. In practice both trading account and the profit and loss account are prepared together. For study purposes we prepare the trading account separately. Based on the following example the profit and loss account will be prepared separately. It is prepared in a horizontal format.

Example : ⊙ The accounting year for Kosal's Business ends on 31/12/20xx. Account balances after preparing trading account are as follows.

Gross profit	221,000
Discount received	6,000
Commission received	3,500

Building rent and rates	20,000
Insurance premium	5,000
Advertising expenses	17,800
Bank charges	2,000
Investment income	4,500
Profit on sale of machinery	13,200
Administrative salaries	48,000
Printing and stationery expenses	2,500
Discounts allowed	3,200
Salesmen salaries	35,000
Bad debts	6,200
Motor vehicles annual depreciation	8,000
Building annual depreciation	7,500
Money distortion loses	9,000
Bank loan interest	7,000
Bank over draft interest	3,400

The Profit and Loss account of Kosala's Business can be prepared using the above information. It is as follows.

Kosala's Business

Profit and Loss account for the year ended 31/12/20xx

	Rs.	Rs.		Rs.	Rs.
Oraganisation and Administration expenses			Gross Profit B/F		221,000
Building rent and rates	20,000		Discount received	6,000	
Insurance premiums	5,000		Commission received	3,500	
Administration salaries	48,000		Investment income	4,500	
Printing and stationery	2,500		Profit on sale of machinery	13,200	27,200
Building annual depreciation	7,500	83,000			
Selling and distribution expenses					
Advertising expenses	17,800				
Discount allowed	3,200				
Salesmen salaries	35,000				
Bad debts	6,200				
Motor vehicles depreciation	8,000	70,200			
Financial and other expenses					
Bank loan interest	7,000				
Bank over draft interest	3,400				
Money distortion loses	9,000				
Bank charges	2,000	21,400			
		174,600			
Net profit transferred to the capital account		73,600			
		248,200			248,200

It is clear that the net profit is transferred to the capital account. It is transferred through the General Journal.

If it is a net profit the journal entry

Profit and Loss account	Debit	
Capital account		Credit

If it is a net loss the journal entry

Capital account	Debit	
Profit and loss account		Credit

Activity - 02

The book keeper of Samanthi's business organization has forwarded the following balances as at 31/12/20xx

Gross profit for the year	95,000
Discount received	4,000
Commission received	9,000
Dividends received	12,000
Discount allowed	3,000
Rent income	24,000
Building depreciation	5,000
Carriage outwards cost	6,000
Loan interest paid	7,000
Bank charges	500
Rates	1,000
Insurance	1,500
Monetary donations	2,000
Advertising expenses	6,000
Salaries	10,000
Bad debts	2,000

Following information was not included in the accounts.

i. Accrued loan interest 1,000

ii. Accrued insurance 2,000

iii. Prepaid advertisement expenses 1,000

iv. Dividend to be received 12,000

v. A building of the business has been rented out from 01/06/20xx. Monthly rent is Rs.2,000.

You are required to :

i. Prepare the profit and loss account and calculate the net profit / loss.

5.2 Identifying the Financial Position of the Organisation

Different interested parties of an organisation are concerned about the financial position of the company. Financial position is the total amount of assets and liabilities for a particular date. How much assets are available, what type of assets are they, are they financed by owners equity or by loans are some of the questions that may arise to an interested person.

Balance Sheet

The Balance Sheet is prepared for a particular date to show the information of the accounting equation. The accounting equation is as follows,

Capital + Liabilities = Assets

Therefore the Balance Sheet shows the assets, capital and liabilities to a certain date of an organisation. It is the financial position of the organisation. It is therefore a statement but not an account. The balance sheet prepared as above provides the information to the interested parties to make their economic decisions of the organisation.

The net profit or loss calculated through the Trading and Profit and Loss account is transferred to the capital account at the Balance Sheet.

- If it is a net profit it is added to the capital
- If it is a net loss it is deducted from the capital

Let us prepare a Balance Sheet from the items given in the following example.

Example : Tharaka's Business accounting year ends at 31/12/20xx. Following balances are as at the above date.

Motor vehicles	450,000
Land	425,000
Buildings	300,000
Debtors	35,000
Closing stocks	28,000
Investments 10%	50,000
Creditors	58,000
Bank over draft	10,000
Capital as at 01/01/20xx	650,000
Furniture and Equipment	30,000
Prepaid insurance premium	5,000
Bank Loan 15%	200,000
Mortgage Loan	150,000
Investment income receivables	3,000
Rent received in advance	4,000
Cash balance	32,000
Net profit	192,000

Drawings	16,000
Building –Provision for depreciation	15,000
Motor Vehicle - Provision for depreciation	90,000
Furniture and Equipment- Provision for depreciation	3,000
Accrued electricity	2,000

Based on above information the Balance Sheet of Tharaka's Business as at 31/12/20xx is as follows.

Tharaka's Business
Balance Sheet as at 31/12/20xx

	Rs.	Rs.		Cost Rs.	Accumu. Depreci. Rs.	Net Amount Rs.
Capital			Non Current Assets			
Balance as at 01/01/20xx.	650,000		Land	425,000		425,000
Add – Net Profit	192,000		Building	300,000	15,000	285,000
	842,000		Motor vehicles	450,000	90,000	360,000
Less - Drawings	16,000	826,000	Furniture and equ.	30,000	3,000	27,000
				1,205,000	108,000	1,097,000
Non Current Liabilities						
Bank Loan 15%	200,000		Investments 10%			50,000
Mortgage loan	150,000	350,000				
Current Liabilities			Current Assets			
Creditors	58,000		Closing stock		28,000	
Rent received in ad. acc.	4,000		Debtors		35,000	
Accrued Electricity	2,000		Pre paid insurance		5,000	
Bank over draft	10,000	74,000	Inve. income to be rece.		3,000	
			Cash in hand		32,000	103,000
		1,250,000				1,250,000

Activity 03

The book keeper of Anoma's business organization has forwarded the following balances as at 31/12/20xx

Capital	250,000
Net profit	126,000
Buildings	400,000
Building - Provision for depreciation	60,000
Drawings	6,000
Mortgage loan	80,000
Ending stocks	18,000
Investment 10%	80,000
Creditors	27,000
Debtors	25,000
Investment income to be received	8,000
Building rent received in advance	5,000
Cash balance	29,000
Accrued electricity	3,000
Bank O/D	15,000
Machinery	140,000
Machinery - Provision for depreciation	42,000
Furniture	22,000
Bank loan 15%	120,000

Based on the above information prepare the Balance sheet as at 31/12/20xx

When the Balance sheet is prepared correctly the total of capital and the liabilities in the organisation are equal to its total assets.

We have discussed the preparation of Trading account, Profit and Loss account and the Balance Sheet separately. When financial statements are prepared for a particular financial year the accounts are as follows,

- ❋ Trading, Profit and Loss account
- ❋ Balance Sheet

When preparing the above financial statements the balances in the trial balance have to be adjusted with the adjustments. The following example includes adjustments.

Example : ⊙ The accounting period ends on 31/12/20xx for Pivithuru Traders. The trial balance as at that date is as follows.

Description	Debit Rs.	Credit Rs.
Closing stocks as at 01/01/20xx	2,000	
Purchases	195,000	
Sales		368,000
Furniture and Equipment	60,000	
Furniture and E. – Provision for depreciation (01/01/20xx)		18,000
Carriage inwards	1,500	
Bank loan 12%		50,000
Loan interest paid	4,000	
Debtors	42,000	
Creditors		41,000
Sales returned	8,000	
Salaries –Salesman	25,000	
Rates and Insurance	12,000	
Capital		250,000
Discount allowed	4,500	
Discount received		9,000
Cash Balance	182,000	
Land and Building	200,000	
	736,000	736,000

Additional information are as follows.

i. Stocks as at 31/12/20xx Rs.14,000

ii. Furniture and equipment is depreciated at 10% on straight line basis.

iii. Prepaid salaries for salesman Rs.1,000

iv. Pivithuru has taken Rs.4,000 worth of goods for his personal use, but it is not recorded.

v. The loan interest is accrued.

vi. Carriage inwards has to be paid Rs. 2,000.

Trading, Profit and Loss account and Balance Sheet are as follows.

Pivithuru Traders

Trading, Profit and Loss account For the year ended 31/12/20xx

	Rs.	Rs.		Rs.	Rs.
Stocks as at 01/01/20xx		2,000	Sales		368,000
Purchases	195,000		Less: Sales returns		8,000
Less: Drawings goods	4,000				360,000
	191,000				
Carriage inwards	35,00	194,500			
Cost of goods to be sold		196,500			
Less : Stocks as at 31/12/20xx		14,000			
Cost of sales		182,500			
Gross Profit		177,500			
		360,000			360,000
Organization and Administration expenses			Gross Profit B/F		177,500
			Discount received		9,000
Rates and Insurance	12,000				
Furniture and Equipment dep.	6,000				
		18,000			
Selling and distribution expen					
Salesmen salaries	24,000				
Discounts given	4,500				
		28,500			
Financial and other expenses					
Bank loan interest	6,000	6,000			
		52,500			
Net profit transferred to capital account		134,000			
		186,500			186,500

Pivithuru Traders
Balance Sheet as at 31/12/20xx

			Non Current Assets	Cost Rs.	Accumu. Deprecia Rs.	Net Amount Rs.
Capital (01/01/20xx.)	250,000		Land & Building	200,000		200,000
Add – Net Profit	134,000		Furniture and Equip	60,000	24,000	36,000
	384,000					
Less - Drawings	4,000			260,000	24,000	236,000
		380,000	Current Assets			
Non Current Liabilities						
Bank Loan 12 %		50,000				
Current Liabilities			Closing stock		14,000	
			Pre paid salaries		1,000	
Creditors	41,000					
Accrued bank loan interest	2,000		Debtors		42,000	
Accrued carrige inwards	2,000		Cash in hand		182,000	
		45,000				239,000
		475,000				475,000

Activity 04

In Sahan's business the accounting period ends on 31/12/20xx. The trial balance as at that date is as follows.

Description	Debit	Credit
Ending stocks as at 31/12/20xx	3,000	
Distribution vehicle at cost	600,000	
Purchases	340,000	
Sales		725,000
Investment 10%	50,000	
Advertising expenses	12,000	
Insurance premium	6,000	
Motor vehicle – provision for depreciation 01/01/20xx		90,000
Carriage inwards	2,000	
Debtors	45,000	
Creditors		82,000
Bank loan 15%		120,000
Cash in hand and bank	259,000	
Capital		300,000
	1317,000	1317,000

Information not yet adjusted as at 31/12/20xx is,

i. Ending stocks as at 31/12/20xx Rs.12,000

ii. Investment income is accrued for the year

iii. Depreciate motor vehicles 5% at cost

iv. Prepaid advertisement expenses Rs. 2,000

v. Write off Rs. 3,000 as bad debts from the debtors

vi. Bank loan has been taken on 01/04/20xx. Interest has not yet been paid

You are required to prepare :

i. The profit and loss account for the year ended 31/12/20xx

ii. The balance sheet as at 31/12/20xx.

Activity - 05

Sandun is a businessman. In his organization the trial balance as at 31/12/20xx after calculating gross profit is as follows.

Description	Debit Rs.	Credit Rs.
Gross profit		240,000
Ending stocks as at 12/31/20xx	25,000	
Debtors	42,000	
Creditors		38,000
Administrative salaries	18,000	
Salaries of salesmen	32,000	
Investment 10%	120,000	
Bank loan 15%		200,000
Rates and Insurance	16,000	
Discounts allowed	4,000	
Discounts received		7,000
Bad debts	3,000	
Distribution Motor vehicle	450,000	
Buildings	400,000	

Provision for depreciation (01/01/20xx)		
Motor vehicle		45,000
Building		40,000
Capital		600,000
Cash in hand and bank	45,000	
Bank loan interest	15,000	
	1,170,000	1,170,000

Additional information is as follows.

i. Investment has been acquired on 01/04/20xx. Investment income is accrued for the period.

ii. Accrued expenses as at 31/12/20xx

Administration salaries	6,000
Rates	1,000

iii. Prepaid salesmen salaries is 2,000

iv. A bad debt of 2,000 is to be deducted from debtors.

v. The non-current assets are depreciated on straight line basis. The percentages are,

Motor vehicles	10%
Building	5%

You are required to prepare,

i. Journal entries for the adjustments

ii. The Profit and Loss account for the year ended 31/12/20xx

iii. Balance Sheet as at 31/12/20xx