UNIT 4 PREPARATION AND ANALYSIS OF FINAL ACCOUNTS

Structure

4.0 INTRODUCTION

As you may know that a business is started either for profit or welfare motive. Whenever, any stakeholder wants to associate with the business firm as a supplier, financer, manager, investor needs information to know the financial strength and profitability for planning, controlling and organizing activities of the business. No decision can be taken without the consideration of the past activities as the future is, normally associated with the past. So, therefore accounting is a systematic record of the bunnies transactions, events leading to a presentation of a complete financial picture for a specific period,normally annually. Hence, Accounting is mainly concerned with the preparation of three statements known as Income Statement/Profit & Loss Account, Balance –sheet and Cash Flow Statement. Generally, accounting involves the following steps namely:

- collecting data,
- recording,
- classifying,
- summarising,
- analysing and
- Reporting information

Besides the abovementioned steps, the reporting of information is directly correlated with business activities and its subsequent operational effects besides the financial outcomes in monetary aspects. This accounting information is sought by many stakeholders internally and externally both. It means accounting is a business language that communicates financial and economic information about the business to the needy parties. To meet the objectives, every business firm used to prepare financial statements every year, which are sometimes called formal records of financial activities of a business. For a business firm, the relevant financial information presented in a structured manner and in an easy-to-understand form, is called financial statement.

The profit and loss account are sometimes known as the Income Statement, and the balance sheet known as financial statements. A trading account is included in the profit and loss account, and if the business manufactures any goods or articles, a manufacturing account is also included. All of these accounts are created only when the trial balance has been completed. These statements prove helpful for the various stakeholders in knowing the overall profit or loss position during the period and the financial position at the end of the period. Thus, the overall objectives of preparing the accounts are ascertaining of profit or loss, highlighting the financial position. Therefore, it is necessary to know about the meaning, objectives, and process of preparation of final accounts.

4.1 OBJECTIVES

After studying this unit, you would be able to:

- Recognize the significance of accounting information.
- Identify the different users of accounting information and their information needs.
- Realise the objectives behind creation of Trading and Profit and Loss Account.
- Determine the variances in Trading Account and Profit and Loss Account, Gross Profitability and Nett Profits.
- Understand the concepts of balance sheet.
- Relate and use the various principles of asset valuation.
- Understand the tole of depreciation in ascertaining firm’s profitability.
- Apply different Adjustment entries for determining the firm’s financial situation.
- Prepare the “Trading and Profit & Loss Account” and “Balance-Sheet” from a given information and with the adjustments.
- Understand about the need of forensic accounting.

4.2 NEED OF ACCOUNTING INFORMATION

Accounting plays a vital role in running a business because it helps you in tracking income and expenditures, statutory compliance, and provide significant information to investors, management, and government which can be used in making business decisions. There are two categories of people who are interested in a business. - i.e., Internal and External.
(a) Internal Users are those who manage and operate the business, including top, medium, and lower-level management.
(b) External Users - Investors, creditors, banks, customers, government agencies, and everyone else who isn't an internal user.

The necessary information is supplied to the external users through the following statements -

(i) Information about profit or loss of the business through the preparing of Profit & Loss Account/ Income Statement
(ii) Information about financial position through the preparing of Balance-sheet

Information about Profit or Loss of the Business
The profit and loss account, commonly known as the Income Statement, that shows how much money was made or lost over the year. This statement shows gross profit from the trade account as well as net profit from the profit and loss account –

Gross Profit = Net Sales (Sales-Sales Return) - Cost of Sales

This information is very useful as it helps in deciding the following questions:

A. Whether cost of Sales is reasonable or not?
B. Whether it can be reduced or not?
C. Whether selling price can be increased or not?

The accounting information obtained from the trading account assists us in answering the preceding queries.

In contrast, the Net Profit earned after deducting all factory, administrative, financial, and selling and distribution expenses. As a result, the Profit & Loss account/Income Statement provides information about net profit earned or net loss incurred. This also aids in answering the following questions:

A. Is it reasonable to spend this much money?
B. Is it possible to save costs or not?

Net profit is used as a basis for taxation and distribution as a profit/dividend among the owners/partners/shareholders of the business firm.

Information about Financial Position of the Business
The Balance Sheet, and the Position Statement both are same, and it provides information about the financial health of the company. This statement provides additional information about the business assets, such as current assets, fixed assets, cash and bank balances. These assets are the sum of the business's liabilities, which may be taken from the proprietor or borrowed from outsiders. This statement can help you answer the following questions:

A. Whether the funds invested are safe and sound. It means the return on the investment is reasonably good along with the safety of the invested amount i.e., capital.
B. Whether return on total assets is adequate or not?
C. It helps the investors, the creditors to arrive at a correct decision regarding investment, lending of funds etc.
D. It helps in restoring confidence among the employees about their provident fund being properly deposited with the cost as per requirements.

As a result, you can see how accounting can play an essential part in displaying the business-running outcomes (profit/loss) as well as its financial status (solvency or insolvency).

4.3 TRADING ACCOUNT

Trading account is the first step in the process of preparing final accounts. It helps in finding out the gross profit or gross loss during an accounting year. It is normally prepared by a merchandising concern which purchases and sells the goods during a particular period. The trading account shows the result of buying and selling goods.

Gross Profit = Net Sales Revenue - Cost of Goods Sold Gross Loss = (Net Sales Revenue - Cost of Goods Sold)

where:

Net Sales Revenue = Cash Sales + Credit Sales - Sales Returns

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

Net Purchase = Cash Purchases + Credit Purchases - Purchases Returns.

We have already observed initially that our 'Trading Account' is generally prepared in 'T' form, wherein the 'carried in' goods stock, procurement and inwards along with the directly made expenditure being depicted at debit side while the sales and closing stock featured at the credit side of the trading account.

Components of Trading Account

4.3.1 Opening/Closing Stock

It is the carried stock in hand which we bring into the account for beginning a new accounting/ financial year. This is inclusive of the wide variety or types like the raw material, in process goods and finished goods and are shown in the debit side of the (TB) Trial Balance report. Another issue to the accountant is the valuation of the said stock whether it is done on cost price or the prevalent market prices. So generally, the lower valuations are preferred. At the end of the said financial year this becomes the closing stock while the same entry is accepted for the opening stock for the next accounting period. The closing stock gets captured on the credit side of the Tr. a/c.

4.3.2 Net Purchases

Business requires continuous purchase and sales of various products and services. Purchase of raw material and selling of finished goods remains key purchase areas. It may be noted that goods or material are factored here as assets and the stock which is not for the sale purposes is not considered here under this classification. So, for better understanding Net purchase amount is calculated by deducting purchase returns (or Return Outward) from the gross purchases (on cash & credit both)

4.3.3 Direct Expenses

These are the cumulative including the amounts spent towards the expenses made to bring the goods at the production site till they are consumed to become a saleable product. This may include the transportation expenses etc. towards this purpose. Their various types would be covered now one by one for ease of understanding.

i. **Wages** paid towards labour working for production shall be debited in the trading a/c. it may be noted that the firm should not have a separate manufacturing account maintained.

ii. **Carriage/freight inwards** as said earlier, expenses under this head or similar nature (whether paid or outstanding), spent on transportation of raw stock to the production site or warehouse are to debited to trading a/c.

iii. **Octroi:** a form of municipal tax paid when the goods enter from a municipal check-post. This amount paid is captured as a direct expense in the trading a/c.

iv. **Custom duty:** applicable when the goods arrive from another country and this amount is paid towards importing them and the usage of such stock is to be used for selling, gets debited to trading a/c. However, it may also be noted that if this duty gets paid at the time of exporting, it gets captured in the selling expense head and duly depicted in the P & L a/c.

v. **Factory rent, insurance, lighting & power, and heating:** these all expenses spent in the direction of converting the raw material to finished product are to be debited to trading a/c.

4.3.4 Net Sales

Irrespective of the nature of sales transaction, whether it is on cash or credit, the sales returns require to be deducted from the gross sales to arrive at the Net sales figure. It is also to be understood here that this sales head pertains to the sales transactions of the finished goods and not arising out of sale of any asset of the company. Also, the goods sold but not sent to the customer/ supply chain partner or received at the customer/ supply chain partner premise are to be recorded in the closing stock and not in the sales head. However, with the change of ownership, the necessary entries be passed, accordingly.

Format (Proforma) of the Trading Account:

Trading Account

(For the year Ended..)

Dr. Cr.

Particulars	Amount	Particulars	Amount
To Opening Stock Raw Material ---------- Work In Progress ---------- Finished Goods ----------- To Purchase Purchase ----------- Purchase Return ---------- To Direct Expenses To Gross Profit (Transfer to profit and loss A/C)		By Net Sales Sales -------------- Sales Returns------------- By Closing Stock Raw Material Work In Progress---------- Finished Goods -----------	

Example 1

Of the accounting data of Shiva Agencies, create a Trading a/c for the FY ending 31-03-2021

Particulars	***Amount (Rs.)***
Opening stock	1,30,000
Purchases	9,00,000
Sales	14,40,000

Returns Inwards	10,000
Returns Outwards	30,000
Carriage Inwards	24,000
Wages	96,000
Fuel & Power	64,000
Closing stock	1,60,000

Answer 1

Trading a/c of Shiva Agencies
for the FY ending 31-03-2021

Dr. Cr.

Particular	Amount Rs	Particular	Amount Rs
To Opening Stock To Purchases 9,00,000 Less : Returns 10,000 To Carriage To Wages To Fuel & Power To Gross Profit transferred to P & L A/c	1,30,000 8,90,000 24,000 96,000 64,000 **3,66,000**	By Sales 14,40,000 Less : Returns 30,000 By closing Stock	 14,10,000 1,60,000
	15,70,000		15.70.000

☞ **Check your Progress – 1**

(i) Create a Trading a/c from the given accounting data:

Opening Stock	40,000	Power	6,000
Purchases	1,80,000	Octroi	11,000
Carriage Inward	4,000	Freight	8,000
Wages	42,000	Sales	3,20,000
Return Outwards	7,000	Sales Return	10,000

Closing Stock Rs. 60,000.

(ii) How are Purchases different from Net Purchases?

(iii) How are Net Sales different from Sales?

(iv) List any five items which are in the nature of direct expenses.

(v) From the following information, calculate the gross profit —
ales - Rs 25,00,000; Purchases Rs 12,00,000, Closing Stock - Rs 3,00,000, Wages -2,50,000 and Opening Stock - 5,50,000

4.4 PROFIT AND LOSS ACCOUNT (P & L A/C)

Profit & Loss account /Income Statement presents the operational results of a business firm for a particular period. This account shows the summary of changes in the owner's capital/equity/claim resulting from the operations of a firm in the given period of time. In this account revenues of a particular period are matched with the expenses of the same period. The excess of revenues over the expenditures is termed as a 'net profit' and excess of expenditures over the revenues is termed as 'net loss'.

Recording entries in a Profit and Loss Account:

The profit & Loss account is prepared in two sections – Trading account and Profit & Loss account. The trading account shows the gross profit or loss made by a firm on selling and purchasing of goods. This account does not include the other operating expenses incurred by a firm during the course of operating of a firm. These items related to the operating expenses are appeared in the second section of the account i.e. 'profit & loss account'. Likewise, a firm may have other incomes from different sources e.g income received from rent, interest, dividend, commission etc are also shown in the credit side of the profit & loss account. The net result of such incomes and expenses is the net profit or net loss and this result of profit & loss account is transferred to capital account of the owner in the balance-sheet. The format of preparing the Profit & Loss account is given in the next paragraph -

Enlisted entities be debited in the P&L a/c:

1. Administrative Expense (Office Salaries & premise rentals, electricity, Printing, stationery, postage, Insurance and communication expenses, Director's Fees, etc.
2. Sales and Distribution Expenses including Salesmen's salary, Commission, travelling expenses, Advertising, Packing expenses, Royalty, etc.
3. Financial Expenses (Interest on loan/Capital, Cash Discount, Bad Debts, Bank Charges, etc.)
4. Asset Depreciation.
5. Other Expenses/ Losses incurred towards Loss on Sales of Fixed Assets, Loss by Fire, by Theft, by Accident, etc.
6. Taxes including Sales Taxes, Income Taxes etc.

The following items are credited in the Profit and Loss Account (reported gains and receipts) such as:

Dividend, Cash Discount, Interest, Rent, Selling Fixed Assets, Apprentice Premium etc.

It may be noted that any expense of household and personal nature paid by the company to the owner(s) don't factor in the P & L a/c statement. It may be recorded as drawing s of personal nature by the owner(s) and be subtracted from the Capital Head of the Balance Sheet statement for the corresponding financial year.

The Following is the Proforma of Trading and Profit & Loss Account:

Profit and Loss Account for the year ended…

Particulars	Amount	Particular	Amount
To Gross loss b\d **(In case of gross loss)** To office rent, rates, and taxes To salaries To Telephone charges To Insurance To Audit fees To Legal charges To Electricity charges To Maintenance expenses To Repairs and renewals		**By Gross profit b/d** **(In case of gross loss)** By Discount received By Commission receive By Bank interest By Rent received By Bad debts recovered By Profit on sale of machinery By Profit on sale of investments	

To Depreciation To Salaries To Advertisement To Carriage outward To Bad debts To Provision for bad debts To Loss on sale of machinery To Loss on sale of investments To Loss by fire **To Net Profit** **(Transfer to capital a/c)**		**By Net Loss** **(Transferred to Capital A/c)**	

Note: 1. Either gross profit or gross loss as opening balance will be reflected.

2. Similarly, the ending balance will also reflect either net profit or net loss.

Example 2

M/s Forever Ltd. reports below-mentioned data Tin their financial statements. Based on it, make a Trading a/c and P & L a/c the FY 31 March 2022.

	Debit (I R)	Credit (II R)
Drawings	35,000	
Building	60,000	
Debtors and Creditors	50,000	80,000
Returns	3,500	2,900
Purchases and Sales	3,00,000	4,65,000
Discount	7,100	5,100
Life Insurance	3,000	
Cash	30,000	
Stock (Opening)	12,000	
Bad Debts	5,000	
Reserves for Bad Debts	-	17,000
Carriage Inwards	6,200	
Wages	27,700	
Machinery	8,00,000	
Furniture	60,000	
Salaries	35,000	
Bank Commission	2,000	
Bills Receivable/Payable	60,000	40,000
Trade Expenses/Capital	13,500	9,00,000

Additional Information: Stock on 31st March 2022 was valued at **INR** 50,000/-

Answer

Trading and P& L Account of M/s Forever Ltd.
for the Year Ending on 31st March 2022

Dr. **Cr.**

Particulars		**Rs.**	**Particulars**		Rs.
To Opening Stock		12,000	By Sales	4,65,000	
To Purchases	3,00,000		Less: Return	3,500	
Less: Return	2.900				4,61,500
		2,97,100			
To Wages		27,700			

To Carriage Inward To Gross Profit	6,200 1,68,500	By Closing Stock	50,000
	5,11,500		5,11,500
To Discount Paid To Life Insurance To Salaries To Bank Commission To Trade Expenses To Bad Debts To Net Profit	7,100 3,000 35,000 2,000 13,500 5,000 1,25,000	By Gross Profit By Discount Received By Reserve for Bad Debts	1,68,500 5,100 17,000
	1,90,600		1,90,600

Note: Balance Sheet of this Example is presented later under heading **"Balance Sheet"**

☞ Check Your Progress – 2

Trading. A/c.	P&L a/c.
Aimed at determining gross profit (GP) or loss for a business entity.	It is made to disclose net profit/loss.
It pertains to the sales and cost of goods sold, including direct expenses.	It pertains to the indirect expenses like ones of administrative & financial nature. They are adjusted with gross profit and other arising revenues.
Its result in gross profit/loss being transferred to the P & L a/c.	It results in the net profit/loss being transferred to the capital account**.**

1. Elaborate your understanding by differentiating between the following:
   - i. Gross Profit and Net Profit
   - ii. Trading Account and P & L a/c.

2. List any FIVE items each either debited or credited in the P & L a/c statement.

3. Make a Trading and P & L a/c for the year ended 2022 based on information provided below:

Particulars	**Dr. (Rs.)**	**Cr. (Rs.)**
Capital		1,00,000
Building	15,000	
Drawing	18,000	
Furniture	7,500	
Motor Car	25,000	
Interest Paid for Loan	900	
Loan from XYZ 'et 12%		15,000
Purchases and Sales	75,000	1,00,000
Opening Stock	25,000	
Establishment Ex.	15,000	

Wages	2,000	
Insurance	1,000	
Commission		7,500
Debtors and Creditors	28,100	10,000
Bank Balance	20,000	

Additional Information: Closing Stock is Rs. 32,000.

4.5 BALANCE SHEET

After preparing the 'Profit & Loss account which provides the information related to the operational performance in terms of net profit or net loss of the firm for a particular period, now a firm wants to know the financial position of the firm as on a particular date so therefore, every business firm also prepare another financial statement known as a 'Balance-sheet' presents the details of all assets and liabilities. Therefore, a balance-sheet is a list of balances in the assets and liabilities accounts. This list shown the position of assets owned and liabilities owed by a firm at a particular point of time.

As the Balance sheet is for the specific period, any next transaction by the firm changes the statement and thus requiring another one being generated. This can be understood with the following exhibit:
Mr. PV Pillai intends to buy a car costing INR 8,00,000. Since he didn't have that much money, he required to borrow some from a bank. The bank offered to finance him with a loan of INR 5,00,000/- if Mr. Pillai brings in three lakh rupees.
On broadly accepting the offer, Mr. Pillai goes to the bank to taking their loan proposal forward. The bank manager required to verify my loan repaying capability for which he sought replies from Mr. Pillai on his two queries?

i. The cumulative value of assets he owns.
ii. The cumulative value of assets he owes and to whom?

This can be understood that the bank would like to ascertain 'Mr. Pillai's worth.
He gave the below mentioned replies:

Claims Against Things of Value		Things of Value Owned by Mr. Pillai	
	INR		**INR**
Personal loan from friend	2,00,000	Balance with bank	3,50,000
		Fixed deposits	2,50,000
		Other personal Belongings	4,00,000
	2,00,000		10,00,000

Claims Against Things of Value		Things of Value Owned by Mr. Pillai	
	INR		**INR**
Personal loan from friend	2,00,000	Balance with bank	3,50,000
		Fixed deposits	2,50,000
		Other personal Belongings	4,00,000
	2,00,000		10,00,000

The above information of Mr. Pillai would indicate that he owns INR 10,00,000 worth things of value of which INR 3,50,000 are available in liquid form with the bank.

Another INR 2.5 lakh investment is in a locked form (FD). Rest of four lakh is in the form of immovable asset (house/ building/ property etc.). Besides these assets, Mr. Pillai requires repaying one lakh to his friend. This means he already carries a liability of one lakh rupees on his things of value amounting to INR 10 lakhs.
For ease of understanding it may be narrated that Mr. Pillai's worth of INR ten lakh Rs. 10,00,000, one lakh comes as a claim on his worth, so Mr. Pillai's **Net Worth** arrives to be INR nine Lakhs.

Now, we may tabulate his situation as follows:

Financial Position I

Amount owned by Mr. Pillai		**Things of Value Owned by Mr. Pillai**	
	Rs.	**Rs.**	
Personal loan from friend	1,00,000	Balance with bank	3,50,000
Own claim or net worth	9,00,000	Fixed deposits	2,50,000
		Other personal Belongings	4,00,000
	10,00,000		10,00,000

Under the above scenario, bank would be comfortable for loan grant of INR five lakh. To enable Mr. Pillai to own the car, it will cost INR 8,00,000. At the time Mr. Pillai drives the car to his house, his situation can be captured as:

Financial Position II

Claims Against Things of Value		**Things of Value Owned by Mr. Pillai**	
	Rs.		**Rs.**
Personal loan from friend	1,00,000	Balance with bank	50,000
Mortgage loan from bank	5,00,000	Fixed deposits	2,50,000
Own claim or net worth	9,00,000	Car	4,00,000
		Other personal Belongings	8,00,000
	15,00,000		15,00,000

It is very much visible that Mr. Pillai's worth has substantially been increased post purchasing the car i.e., from earlier 10 Lakh to at present, 15 lakhs. It may also be observed that there is an equal and substantial surge in claims or outstanding on his reported worth i.e., mortgage loan from the bank, though his net worth remains as it is.

4.6 CONSTRUCTING A BALANCE SHEET

With having a sound understanding about the need for and importance of annual financial statements, we would focus on various aspects of the Balance sheet. We know that the financial transactions require to be captured in the annual statements and that the stakeholders are interested in having updated information about the performance and the financial position of the firm. It is not possible to make a new balance sheet every time transaction after transaction, as this statement is typically made on culmination of a particular period which generally is a financial year (F.Y) for the company. This F.Y is also known as an accounting period or fiscal year also.

Many firms use the period for making a balance sheet as one calendar year as an ongoing practice but there is no logical reason behind this.

The making of a Balance sheet' is a structured and systematic representation or reporting of financial data of the assets and liabilities in a company. This statement, made at the end of a year, as discussed previously, showcases the annual position of a firm's assets and subsequent claims on those assets, thereby making our balance sheet as an important annual financial statement depicting annual numbers of the firm's assets, liabilities, and capital accounts.

We Indians, prefer the English convention, as per the below format for liquidity, i.e., ease of encashing on the assets. Based on this ease of liquidity the faster liquid-able assets are put initially and the others are put on the same continued basis, in the said annual Proforma. On the same lines, Liabilities are depicted with the current liabilities standing first in line to be followed by the fixed or long-term Liabilities while, the owner(s) capital is placed at last.

Liabilities	**NTR**	**Assets**	**INR**
Current Liabilities		**Fixed Assets**	
Creditors Bills		Furniture and Fixtures	
Payable		Plant Machinery	
Bank Overdraft		Land	
Outstanding Expenses		Goodwill	
Income Received in Advance		**Current Assets**	
		Cash in Hand	
		Cash at Bank	
Fixed Liabilities		Stock-in-Trade	
Loan Mortgage		Debtors	
Capital		Bills Receivable	
		Prepaid Expenses	

Firm's assets may also be presented in the balance sheet on the basis of **permanence**, with more stable, enduring or long lasting assets ranked first while the short lived ones follow as per their lives.

Balance Sheet of M/s...
As on DD/ MM/ YYYY

Liabilities	**INR**	**Assets**	**INR**
Capital		Goodwill	
Mortgage		Patents and Trade Marks	
Bank Overdraft		Furniture and Fittings	
Outstanding Expenses		Plant and Machinery	
Income Received in Advance		Unexpired Expenses	
Creditors		Stock-in-Trade	
Bills Payable		Sundry Debtors	
Loan		Investments	
		Bills Receivable	
		Cash in Bank	
		Cash in Hand	

Let's see the practical implications of our learnings to business. The entity principle says to consider 'business' distinct from owner(s) and the same is given in the following example of a Balance sheet extracted from a P & L a/c.

Balance Sheet of Flora Plastics Ltd. as on 31st March 2022

Liabilities	INR	Assets	INR
Capital 9,00,000		Building	60,000
+ Net profit 1,25,000		Machinery	8,00,000
- Drawings 35,000	9,90,000	Furniture	60,000
Bills Payable	40,000	Debtors	50,000
Creditors	80,000	Stock	50,000
		Cash	30,000
		Bills Receivable	60,000
	11,10,000		11,10,000

Accounting Concepts to Evaluate a Balance Sheet

Of the various accounting rules, concepts and postulates studied would serve to be an enabler in making a Balance Sheet. The **Dual Aspect Principle** stands much important in this direction as it treats each accounting transaction having dual effects so placed both at the debit & credit columns. This makes it stand equated to the concept of **Equality of Assets to Liabilities and Owner's Equity**.

It is important to note that all such captured transactions stand recorded in the book of accounts as **Monetary Units** regardless of the time & quality parameters. In the above illustrative example, cash, merchandise inventory and shop premises contribute to the **Monetary Quantities**.

All the recorded transactions in the balance sheet present the financial position of the firm and not for the firm's owner. The formation of balance sheet also follows the Going concern principle. Thus, cumulative asset value is written off over a period by depreciation method. The asset valuation is on the **Historical Cost** basis.

☞ Check Your Progress – 3

Fill in the blanks:

i) The balance sheet is created for the following annual accounting period:
Ans: ____

ii) The balance sheet, which is prepared at the end of a financial year, shows the following balances:
Ans: ____

iii) The assets on a balance sheet are grouped together as:
Ans. ____

iv) On the balance sheet, claims against assets are listed as:
a) ____________________ liabilities b) ________________ liabilities
c) ____________________equity.

4.7 CLASSIFICATION OF BALANCE SHEET'S ITEMS

We understand now that the structure of the balance sheet has three distinct features been recorded individually i.e., assets, liabilities, and capital. Also, assets & liabilities get depicted in sub-groups to be recorded in the order of their **liquidity/Permanence**. Liabilities and capital are listed above the assets.

Current Assets

Happens to be the belongings, convertible to cash in a year or within the **operating cycle**. The operating cycle is time-duration required for transforming raw-material to a finished product and adding the further selling time plus time taken for recovering money from debtors/ retail or supply chain partners.

Cash

It comprises of the Government controlled currency (legal tender), bank cheques for trading purposes. It is a current asset when required by a firm for its daily business operations. Firms keep it in their reserves and further provision with banks to get money 'on call' from their current accounts.

Account Receivables

These are the sums owed to the firm by **Debtors,** so also called as "unpaid customer accounts" and "trade receivables". When the debtor(s) fails to repay the amount, those amounts get classified as non-collectable amounts or payment defaults or **Bad Debts**. Though one can't predict which and how much the amounts will turn 'Bad' still based on past trends, the accountant estimates and provisions for them.

Inventory

The term has large scale ramifications as it carries differential understanding with different business operations. Say for a trading entity, it is the quantitative value of the merchandise carried for customer selling as a routine practice. While productions companies take inventory as stock/ raw material for producing goods. The under-production goods, stocks in stores and finished good stock etc. all get captured under this head.

Pre-paid Expenses

It comprises of some expenses typically paid as 'advance' like rent, advance tax, subscriptions, insurance etc. They are categorised under the head of 'current assets' since they are paid in advance (pre-payments).

Fixed Assets

are tangible assets of the business which have comparatively longer life. They continue to hold importance for a firm not only once but year on year till they last or are not sold off. Current assets are easily liquefiable to cash. They amount to 'value addition' by aiding to the production and trade processes. These fixed assets have a period for which they are economically used.

It's widely seen examples are land, building, plant, machinery and motor vehicles. Except land, all others get depreciated over the time periods, so land is recorded separately

Intangible and Other Fictitious Assets

are the ones which carry value but have no physical attributes. They are intangible and example being **Goodwill. "**Goodwill is defined as ability of a firm to earn profits in excess of normal return". It has been witnessed that valuation of intangible assets depletes with time and this expiration cost is called A**mortization**, like depreciation.

Current Liabilities

Liabilities are Outsiders' claims against the company are referred to as liabilities. They are the sums owing by the company to people who have lent money or offered goods or services on credit to the company. These liabilities are categorised as current liabilities if they are due within an accounting period or the business's operating cycle.

Accounts Payable

Also known as 'sundry creditors' comprise of unsecured debts owed by business. They may not have formal endorsement or promise to pay.

Accrued Liabilities
are the expenses/obligations of last year being paid in next year for e.g., Wages and rent.

Provisions or Anticipated Liabilities
Comprise of known liabilities but undefined amount, like income tax payable. Accountants use the trending method to forecast such liabilities.

Contingent Liabilities
Before going ahead in this, you should first understand the distinguishing feature of contingent liabilities from estimated liabilities. The latter have uncertain amounts while the former doesn't happen to be liabilities, presently. But become one after a defined event.

Long Term Liabilities
are generally of more than a year and encompass typically all outsider's liabilities not included in the **Current Liabilities** and **Provisions**. For example, debentures, bonds, and bank borrowings.

Capital
We already are aware that **Assets = Liabilities + Owners' Equity**.

Reserves and Surplus or Retained Earnings
Every business effort for shareholder's profitability distributed as dividends. Such profits may be chosen to be retained to business by the management.

☞ Check Your Progress- 4

Fill in the blanks:

A. Generally, items on the balance sheet are listed in the order of their respective importance. Write the order.
B. Balance sheet might be provided in________ or __________ format.
C. The principle of __________ is used to value inventories in the balance sheet.
D. Accounts receivables are also referred to as______________________
E. Expired cost with respect to a fixed asset is referred to as_____________ expense.
F. Expiration of cost of intangible assets is referred to as _______________
G. Bill Payable are referred to as _____________
H. We judge an item as a current asset if it is converted into cash during an ________
I. Liquidity refers to nearness of an item to ____________
J. Items classified as current assets are usually listed in the order of their relative _______
K. The basis of valuation as applied to temporary investment is ____
L. Asset losses expected out of non-collection of receivables are called _____________
M. Formal written/documented debts refer to_____________
N. Items commonly referred to as inventory include (a)______ (b)_____and (c)_______
O. Fixed Assets are valued on the basis of _____________
P. Balance Sheet is a statement of ____________
Q. ___________ represents the Owner's Claim against the Assets of a business.

R. ___________ represents Claims of Outsiders against the business.
S. ___________ increase Owner’s Equity.
T. Amounts owed by a business on account of purchase of inventory are usually called __________ or __________.
U. Amounts receivable by a firm against credit sales are usually called ___________
V. As a general rule all assets are valued at their _____________ to the business.
W. The dual aspect principle ensures an important equality reflected by the Balance Sheet ___________
X. All valuations specially those of fixed assets in a balance sheet are based on an important assumption about the entity as a _______________
Y. Owner’s Capital could be understood as comprising of two parts (a) _________ and (b) ___________.
Z. Operating Cycle is the duration of ________________

4.8 ADJUSTMENT ENTRIES

The account subject encompasses direct correlation with the various accounting concepts/conventions/principles. We also understand that the Final a/cs get treated on accrual basis, so the expenses require to be regularly deducted. Such expenses get paid when due for the period in the ongoing financial year or the provisioned other accounting year(s). We should ‘add’ the currently earned revenue items, but not received yet. All the above-mentioned provisions and corrections in the final A/cs are better known as Adjustments. These adjustments incorporated with the help of adjusting entries confirm a judicious matching of costs and revenues towards ensuring a correct P & L statement for a particular period.
Further now, we would try to understand the effect of the said adjustments on the underlying final account.

4.8.1 Closing Stock

Is also understood as the value of the unsold stock of the firm. The valuation parameter stands important here as on what basis the stock valuation happens i.e. cost price of the firm or the market price. The lower values are accepted.

4.8.2 Depreciation

Fixed assets periodically reduce their value thus factored as depreciation. As the accounting entry Depreciation account is debited while individual asset account is credited.

4.8.3 Bad Debts

Amounts to loss arising from unpaid debts. From debtors or it may even be said as irrecoverable. They are treated by transferring them to the debit side of P&L a/c.

4.8.4 Provision for Bad and Doubtful Debts

As understood from Bad debts, they require to be ‘written off’ from the accounting records. Thus, based on past trends or management’s insights, a provision towards doubtful debts is made. This is done to make the balance sheet capture and reflect the true essence of business.

4.8.5 Outstanding Expenses (Liabilities)

Business involves paying for the expenses and accountants capture such payments made in their records. Failure to capture an expense is understood as an Understatement.

4.8.6 Expenses (Assets)

Expenses may be done as advances and are known as prepaid expenses. While making annual financial statements a part or full, payment not made or remains unconsumed becomes asset.

4.8.7 Accrued Income (Assets)

is an amount earned but not actually received during that accounting period or by the time of final accounts being made?

4.8.8 Income Received in Advance (Liability)

Can be defined as “income received but not earned during the accounting period”. It can be said that it is the corresponding amount for which the goods or services are to be offered in coming times.

4.9 FORENSIC ACCOUNTING

Forensic accounting is often described as a specialized field of accountancy, which investigates fraud and analyzes financial information to be used in legal proceedings. It is an amalgam of numerous varied disciplines. Its roots extend not only to accounting and auditing, but also to law, criminology, psychology, sociology, economics and finance. Accounting records, financial statements, and other associated financial documents are investigated in forensic accounting. The investigation's findings are mostly used for legal support and conflict resolution.
It used in tax frauds, securities fraud, business valuation and economic damages calculations. It also covers bankruptcies, reorganisations, insolvencies, money laundering and post acquisitions disputes.
The financial statements of the company, management accounts, and other related documents, data, and information relating to the investigated subject matter are usually the focus of the investigation and verification.

Definitions

Dictionary of accounting terms -
"Forensic accounting is a science (i.e., a department of systemized knowledge) dealing with the applications of accounting facts gathered through auditing methods and procedure to resolve legal problems."
Websters Dictionary -
Forensic accounting means, "Belonging to, used in for suitable to court, of judicature or to public discussions, debate and ultimately disputes resolutions, it is also defined as an accounting analysis that is suitable to the court which will form the basis for discussion, debate and ultimately dispute resolution."
As a result, forensic accounting delivers a court-acceptable accounting analysis that will serve as the foundation for debate, discussion, and, ultimately, conflict settlement.

Scope of Forensic Accounting
The following are the scope of the use of forensic accounting -
- Banks Frauds

- Securities and Exchange Board of India (SEBI)
- Insolvency cases
- Serious Fraud Investigation Office
- Economic Offenses Wings

Difference between Forensic Accounting and Audit:

There are some parallels and contrasts between forensic accounting and auditing. A financial audit statement, for example, is designed to allow auditors to conduct an impartial evaluation and then provide an opinion. On the financial statements, the auditor will only provide reasonable assurance. Forensic accounting, on the other hand, looks into the financial statements and calculates the potential loss. They are not going to provide an opinion.
Until recently, it was believed that the 'conventional' accounting and auditing function are sufficient for detecting fraud. It was believed that it is the duty of the internal and external auditors that while doing their routine procedure of audit, they would report all kinds of irregularities they detect. But we also know that the financial auditing does not go beyond checking the books of the organization for the conformity to GAAP (Generally Accepted Accounting Principles), auditing standards and accounting policies. Financial auditing is limited to the unearthing of material deviations, exceptions, oddities, errors and variances from the acceptable and applicable standards of accounting & auditing practices. But the fraud is something which is deep rooted in the accounting systems of organization and therefore, the necessity for forensic accounting. The whole idea is to probe deeply into the financial transactions & business situations, so as to rule out any possible fraudulent activity. The general accounting is limited to maintaining of books by keeping the adequate record of all the material financial transactions of the organization, duly supported by the vouchers, so that the results are communicated to the stakeholders through various reports. Forensic accounting goes beyond the books. It's looking beyond the numbers. Forensic accountant is categorically required to visit the past transactions and report about any kind of anomalies. They need to play a 'proactive' risk-reduction role. The 'explanatory' analysis i.e., cause & effect of phenomena of fraud is the basis of Forensic accounting.

☞ Check Your Progress – 5

1. Indicate against each statement whether the following statement is true or false-
   A. Wages should be credited to the Trading account
   B. Freight outward should be debited to the trading account
   C. Prepaid expenses are a part of current assets.
   D. Provision for doubtful debts is a liability
   E. Closing stock, when appearing in the trail balance, should be taken directly to the balance sheet.

2. Mention any three uses of Forensic Accounting.

4.10 SUMMARY

Accounting is the medium of recording the business transactions made in the business that is why, accounting is termed as the language of the business. All the persons interested in the business such as investors, banks, suppliers, government, employees and others get the necessary financial information through accounting because it is properly analysed and summarised to the extent that can be understood by all concerned. So, therefore, it is necessary for a business firm to prepare the financial statements every year. Financial Statements are also known final accounts. Final Accounts means P & L a/c statement and balance sheet. P & L a/c statement also contains one more account which is known as 'Trading Account' and if the business is manufacturing any item or article, then one more account is also prepared that is known as 'Manufacturing Account'. Profit and Loss account which is also known as the Income Statement is an important statement for every business firm which discloses the result of the operations of the firm for a given period which is normally 12 months. It shows the profitability and earning capacity of the firm. The balance-sheet of a firm, on the other hand, presents the financial conditions as on a specific date. It is like a screen picture of the financial position that reveals financial health in terms of assets and liabilities on a particular date. However, on its own, it doesn't disclose operational details of the business. Though, comparing a pair of balance sheets gives the business professional about the comparative changes in the business position. This makes way for another set of well appreciated statements from the commercial world i.e., the Funds Flow Statement and Cash Flow Statement. These two statements would be taken up in the next unit 1.2.

4.11 KEY WORDS

Asset: comprises of everything which is tangible or intangible and also carries a monetary value for a business entity; including what it owns.

Contingent Liability: it is a form of liability which may arise for a business entity in the coming times or future. It doesn't gets entered in the book of accounts by the time it occurs. For ex. A legal matter may arise for this business entity. It may however be provisioned for a certain amount be paid for.

Cost of Goods Sold - It is the direct cost of goods sold. It is arrived as follows -

Opening Stock + Purchases + Carriage Inward + Wages - Closing Stock

Current Assets: comprises of various assets of a business entity kept for the purpose of encashing them within the operating cycle or within a year whichever is longer. Such assets include cash, receivables, inventory and pre-payments (advances).

Current Liabilities: include claims/dues arising out of the firm's creation of assets, which it has to pay for (from cash and current assets) within one year or within the operating cycle, whichever is longer. Account payable, tax or other claims payable, accrued expenses form the various types of current liabilities.

Fixed Asset: based on the time parameter it is for a longer life-period of more than a year and is tangible in nature. It may encompass assets like land, building, plant, machinery, motor vehicles, furniture and fixtures.

Forensic Accounting - Forensic Accounting is the use of accounting skills to analyse the financial data for use in legal proceedings.

Gain - It is used for profit other than regular profit such as capital gain.

Gross Profit - It is the amount (difference) between sales - cost of sales.

Intangible Assets: They don't have any physical attribute(s) and are long term in nature. It comprises of assets like goodwill, patents, franchises, formation expenses and copyrights.

Liability: it is the amount which requires to be paid by the individual or the firm (debtor) to the other entity called creditor. A balance sheet of that firm comprises of all cumulative claims from the creditors raised by pledging firm's assets. Here, the firm's assets doesn't comprise of the owners' assets.

Net Profit - The amount of gross profit left after allowing for all expenses. If expenses are more than Gross Profit then the net result would be net loss.

Owner's Equity: pertains to the firm owner's investments to the business towards the firm's continuity. The firm owes this owner's amounts and is liable to pay it back

4.12 SELF ASSESSMENT QUESTIONS/EXERCISES

1. Discuss the utility of accounting information.
2. What do you understand by trading account? How far it is different with the Profit & Loss account?
3. What adjustments are required to close the books of account? Explain in details.
4. Discuss the various items which are shown in profit & loss account.
5. What are the Financial Statements? What purpose do they serve?
6. Discuss the various items which are shown in the Balance-Sheet.
7. Why are adjustment entries required to be made at the time of preparing Final Accounts? Give illustrative examples of any Five such adjustment entries.
8. Differentiate between -
   (a) Prepaid Expenses and Outstanding Expenses
   (b) Outstanding Income and Accrued Income
   (c) Interest on Capital and Interest on Drawings
9. Discuss the concept of 'Forensic Accounting' and its applications in different areas.
10. How the forensic accounting is different with the audit.

11. Anshul Enterprises is a trading firm. There was no stock of goods at the beginning of 2021. During the year 2021, it purchased 3,00,000 units of goods in which it trades of Rs 60,00,000. It incurred Rs 600,000 towards freight inwards and Rs 1,20,000 towards wages to make the goods ready for sale. At the end of the year, 15,000 units were in stock. The closing stock and of 15,000 units should be valued at Rs ………
12. From the following information supplied by Mr. Neeraj Aggarwal, prepare a Balance Sheet of Mr. Neeraj Aggarwal as on 31st March 2022

	Rs.
Capital	50,000
Land	15,000
B/R	25,000
Sundry Creditors	30,000
Plant and Machinery	58,000
Investments	5,000
Cash in hand	1,000
Cash at Bank	1,000
Stock at the end	10,000
Bank Overdraft	8,000
Bank Loan	20,000
Net Profit	10,000
Drawings	3,000

13. Below tabulated information was derived from the TB report of M/s. Seeta Enterprises. Draft a Trading as well as P & L a/c for the annual period ending Mar' 2022.

Particular	Amount Rs	Particular	Amount Rs.
Machinery	4,00,000	Capital	9,00,000
Cash at Bank	1,00,000	Sales	16,00,000
Cash in Hand	50,000	Sundry Creditors	4,50,000
Wages	1,00,000	Interest Received	30,000
Purchases	8,00,000		
Stock on 1st April 2017	6,00,000		
Sundry Debtors	4,40,000		
Bills Receivable	2,90,000		
Rent	45,000		
Commission	25,000		
General Expenses	80,000		
Commission	50,000		
	29,80,000		29,80,000

Additional Information:

(i) Outstanding commission were ` 45,000.

(ii) Depreciation on Machinery at 10%.

(iii) Outstanding wages were ` 5,000.

(iv) Rent prepaid ` 10,000.

(v) Interest on capital 5% per annum.

(vi) Stock on 31st March 2022 ` 8,00,000.

Prepare Trading and P&L A/c for annual period ending March 2022 and Balance Sheet so that period itself.

14) For the annual year ending Mar'22, the Trial balance report for M/s Rakesh & Co. were generated. You are required to make annual final account statement for the same period. This requires incorporating following modified entries.

1. Depreciation: 5% of plant and machinery and 10% of fixtures and fittings.
2. Reserve for bad debts 2.5% on Sundry Debtors
3. Insurance unexpired on 31st March 2022 Rs. 70
4. Outstanding wages Rs. 800 and Salaries Rs. 350.

Trial Balance

	Rs
Machinery	55,000
Fixtures	1,720
Factory Fuel	542
Salaries	3,745
Lighting (Factory)	392
Travelling Expenses	925
Carriage outward	960
Bank Balance	2,245
Bills Receivable	47,800
Net Purchases	66,710
Wages	9,915
Rent and Taxes	1,915
Office Expenses	2,778
Carriage Inward	897
Discount allowed	422
Drawings	6820
Stock 1 April 2021	21,725
Manufacturing Expenses	2,680
Sales Return	7,422
Insurance	570

Closing Stock	16,580
Rent Outstanding	150
`Capital	93,230
Sales	1,26,177
Sundry Creditors	22,680
Purchase Return	3,172
Bills Payable	6,422

4.13 SOLUTIONS / ANSWERS

☞ Check Your Progress – 1

i) Gross Profit Rs. 86,000

ii) Net purchase= Purchase- Purchase Returns

iii) Net sales= Sale- Sale Returns
iv) Carriage Inward, Power, Freight, Octroi, Wages
v) Gross Profit Rs 8,00,000

☞ Check Your Progress – 2

1.
(i)**Gross Profit** - It is the amount (difference) between sales - cost of sales.
Net Profit - The amount of gross profit left after allowing for all expenses.
(ii) **Trading Account -** The trading account shows the result of buying and selling goods.
P & L a/c.- This account shows the summary of changes in the owner's capital/equity/claim resulting from the operations of a firm in the given period of time.

2. **Debited in the P & L accounts** are - Salaries, Rent paid, Advertisement, Depreciation, Stationery, Miscellaneios Expenses.
Credited in P & L accounts are – Income received from dividend, interest, commission, sale of fixed assets, transfer fee, interest on drawings etc.

3. G.P Rs. 30,000 and N.P Rs. 10,600

☞ Check Your Progress – 3

i) (a) accounting period (b) calendar year (c) financial year

ii) (a) Total asset (b) Total liability (c) Owners Equity

iii) (a) current asset (b) fixed assets (c) tangible assets

iv) (a) Current Liabilities (b) long-term liabilities (c) shareholders' funds.

☞ Check Your Progress – 4

A. Liquidity
B. (a) T account form (b) Report form
C. Is time taken by a unit to convert goods into sales and to collect money from debtors?
D. Lower of cost or market price

E. Sundry debtors
F. Depreciation
G. Amortization
H. Accounts payable
I. Accounting year
J. Cash
K. Liquidity
L. 'Lower of cost or market price'.
M. Bad debts.
N. Bills receivable.
O. Raw material (ii) Work-in-Process (iii) Finished goods.
P. Historical cost- Depreciation.
Q. Assets, Liabilities, and capital
R. Owners' equity
S. Liabilities
T. Profits
U. Sundry creditors
V. Sundry debtor
W. Original cost
X. Contributed capital and retained earnings
Y. Assets = Liabilities + Owner's Equity
Z. Going concern.

☞ Check Your Progress – 5

1.
A. Wages should be credited to the Trading account False
B. Freight outward should be debited to the trading account False
C. Prepaid expenses are a part of current assets. True
D. Provision for doubtful debts is a liability False [It is a reduction of an assets]
E. Closing stock, when appearing in the trail balance, should be taken directly to the balance sheet. True

2. Use of Forensic Accounting - 1 Bank Frauds, 2 - SEBI for Insider trading, Shell Companies, 3. Bank frauds; 4. Insolvency cases

Answer to Self Assessment Questions/Exercises

11. Rs 3,36,000
12. Balance Sheet total -Rs.1,15,000
13. Balance Sheet total -Rs. 20,50,000. Net Profit Rs. 6,50,000, Gross Profit Rs. 8,95,000

14. Balance Sheet total Rs. 1,19,366. Net Profit Rs. 2,554, Gross Profit Rs. 18,266.

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