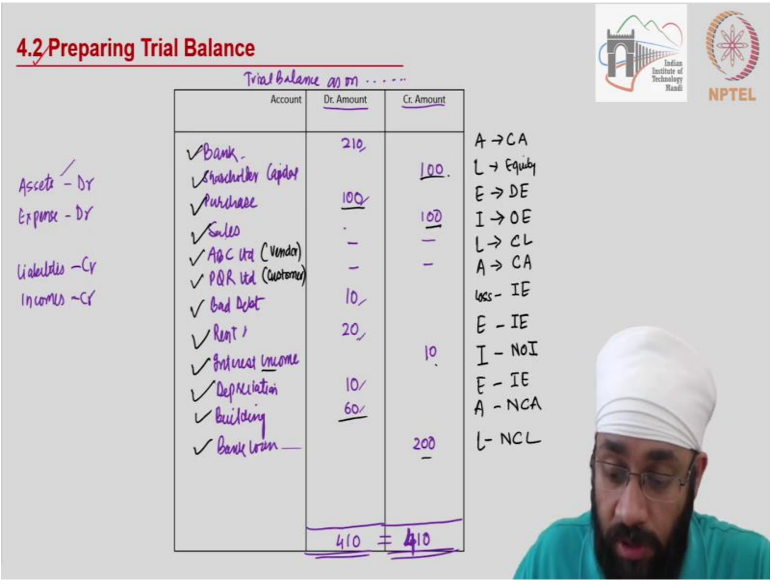
**Financial Accounting**
**Dr. Puran Singh**
**School of Humanities and Social Sciences**
**Indian Institute of Technology, Mandi**

# Lecture – 54
## 5.4 Preparation of Financial Accounts

Alright, the time has come to demystify the preparation of final accounts. How is the balance sheet and income statement prepared, how is profit and loss account and the balance sheet prepared.

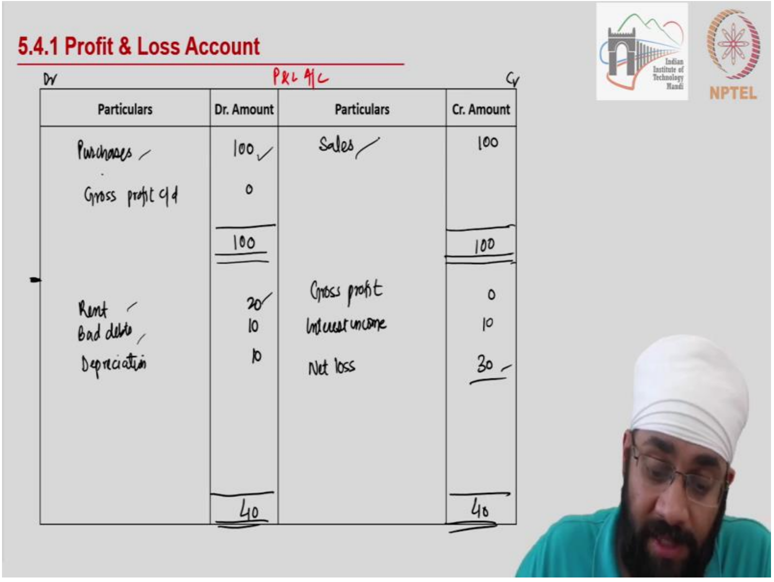
(Refer Slide Time: 00:34)




In this video, I am going to look at the trial balance that was prepared in lecture 4.2. You can go back to that video if you like. We prepared our trial balance. Now, this trial balance was prepared based upon the 14 transactions that we used for writing the journal entries, and then we used the same 14 transactions to do the ledger posting, and we prepared the trial balance.

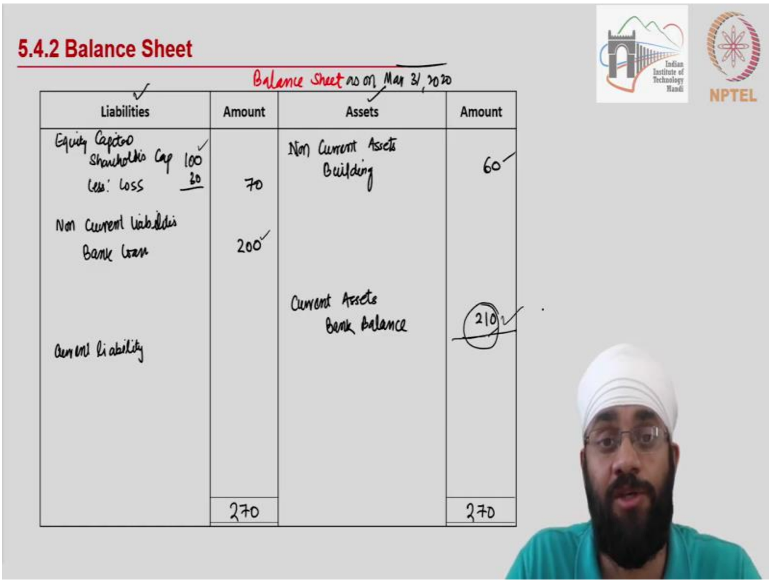
Now, we are using the same trial balance to prepare the balance sheet and profit and loss account. So, we have debit balances and credit balances here. All we are going to do is pick these and place these into the two statements: income statement and balance sheet.

(Refer Slide Time: 01:19)




I also have in the slide deck with me a profit and loss account format. And, on the next slide, I have the format of the balance sheet.

(Refer Slide Time: 01:27)




And, I also know that both these accounts follow a proper sequence as well. So, I am going to mention that here as well. On the asset side, we have to first write the non-current assets. This is going to be followed by current assets. This is how it is supposed to be presented. On the liability side, we are going to have the shareholder capital or we call it equity capital. And then, you have non-current liabilities, and current liabilities. So, this format has to be followed whenever you are preparing a balance sheet of any company.

As far as the income statement or the profit and loss account is concerned, you have a credit side and a debit side and there are no specific subheads which are given. They are given in the statement format, but for the purpose of the account form of profit and loss account, we are going to be following the two sections. Let us say, we segregate it here, we will write all the direct expenses here and indirect expenses here.

So, let us get started. The first thing to do is to identify from this trial balance which of these items are incomes, expenses, assets, or liabilities. The incomes and expenses are going to be taken to the profit and loss account, and assets and liabilities are going to be taken to the balance sheet. Bank account is an asset, so I will just write asset. And also, within the assets it is a current asset, so I have identified the two categories. So, a bank account has to be taken to the current assets: 210 is the amount. Under the current assets I will write bank and I will write 210. So, this is the bank balance at the end of the year, when we are preparing this statement. Next item is shareholder capital, which is 100. This is a liability item and this goes under the equity: shareholder equity or shareholder capital. I am going to write here shareholders capital and this is 200. Next step, you have purchase 100. Purchase is an expense and is also a direct expense. So, 100 is going to be written here, purchases 100 during the year, this is an expense. Then you have sales: sales is an income and also an operating income. 100 to be written in the income statement, in the profit and loss account, here on the credit side at the top. Then, you have ABC and PQR, there is no balance in these accounts. But, if there was balance in these accounts, we know that ABC is the vendor, and PQR is the customer. So, if you had any balance, then the vendor balance would represent a liability. So it is going to be a liability and a current liability. On the other hand, the customer's account is going to be an asset and a current asset. Thus, if there were any balances in these accounts we will post them in these respective places. Then you have bad debts which are a loss. So, this loss is going to be shown under the indirect expenses. Bad debts 10 is going to be shown here. I will write somewhere here. So, bad debts are 10. Next is rent, rent is an expense and this is an indirect expense. Although, one might come back and argue saying, we do not know if this rent is for the factory space or for sales office space, but let us assume regular trading business here. If you do not have clarity you can put rent in the indirect expenses, but in practical life you would know where this money is being spent. So, rent 20, done. Next is interest income, 10. This goes into incomes and this is also a non-operating income. Any income other than sales is non-operating income, unless otherwise you are into that business as well: you are into multiple businesses. So, interest income is 10, it is going to be written here, interest income in the second half of the profit and loss account, the amount was 10. Then is depreciation, 10. Depreciation has been regarded as an expense and as an indirect expense; as an indirect expense. So, depreciation will be shown here. Then, you have building, building is an asset and it is a non-current asset as well. So, 60 goes to the balance sheet under building, 60. Also, note that even under non-current assets you can have the categorization of tangible and intangible assets. There is more granularity involved as well. But for now, this is sufficient. Then, you have a bank loan of 200. This is a liability and a non-current liability, 200 bank loan. So, in the balance sheet, I am going to write a bank loan, 200. There you go we have posted the items to the different places where they need to go. I think one mistake that we made is shareholders capital was 100, and we have written it as 200, so let us make it 100 here.

Now all we need to do is to calculate the profit here. So, we have 100 as the total on this side, so we close this, using the convention of closing an account and you have 100 total. So, the gross profit, the gross profit carried down is nil, you do not make any profit you are selling it at the same cost. Then, you bring forward the gross profit which is 0. And, it seems like you have more expenses than the income, so there is a loss, so which is alright. Let us do the total here, you have 40 and 40 here. This means there is a 30 loss, so this is a net loss during the year. So, 30 rupees is the loss. If there is any profit that contributes to shareholders capital. Since there is a loss here, it should reduce the capital of the shareholders. So, what I am going to do is I am going to bring this capital here. So, capital was 100 and we are going to take out the loss during the year which is 30, so this becomes 70.

What we have done is that as there was no profit, the profit cannot be contributing to the capital of the shareholder. There is a loss, the capital has to be reduced and that is what we did. Capital has been reduced here. The total of the liability side is 270 and the total of the asset side is 270. The accounting equation says assets are equal to liabilities. So, assets are actually equal to liability.

We just took 14 typical transactions, representative transactions, and we have gone from the very first book journal, to ledger, to trial balance, and now, we have prepared a balance sheet and income statement. We have seen that the accounting equation holds, the double entry system holds, trial balances total was equal, and the total of the liabilities is also equal to the asset side. There you go, that is a quick show of the process of the accounting cycle. If you remember the first transaction, which was the shareholders bringing in money to the business, that amount has been populated here. The loan has been populated here, the building is here, bank balance is here. However, if you look behind this, this 210, this 210 can be mapped back to the ledger posting where a lot of transactions were involved about 5 to 10 transactions were involved, after which you reached at this amount of 210.

So, the final numbers after you do the accounting cycle process are shown on the balance sheet. The balance sheet is a statement and as said, the statement is true as on a date. So, the balance sheet is prepared as on the last day of any financial year, so let us say 31st March 2020. On this date, the bank balances 210, and if you want to know what happened to the bank balance, during the year, you can go back to the bank account that we prepared and you can know more details.

All of the journal, ledger, and trial balance is the backend to this front end. The front end is the balance sheet. This is what is shown to the public. The income statement here and the balance sheet. Also, in the profit and loss account what is shown is total purchases are 100. However, we know that 50 purchases were cash, 50 were on credit, but none of that is shown here. Again, this is a front end. This is what the stakeholders are going to view. If somebody needs more information, if you are the management, member of the management team in the organization and you need to view how these purchases were made during the year or what was monthly rent and so on, you could go to the ledger of rent account, bad debts account, depreciation account, purchase account or sales account and look at their details.

So, that is what I wanted to discuss in this video. Now, you know the whole process of the accounting cycle, and how it produces this outcome which is called final accounts. I will see you in the next video.