Financial Accounting
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Lecture – 55
5.5 Tutorial - Preparation of Final Accounts

This is a tutorial. In this video we are going to learn to prepare the Final Accounts which are balance sheet and income statement, using the trial balance from the previous videos.

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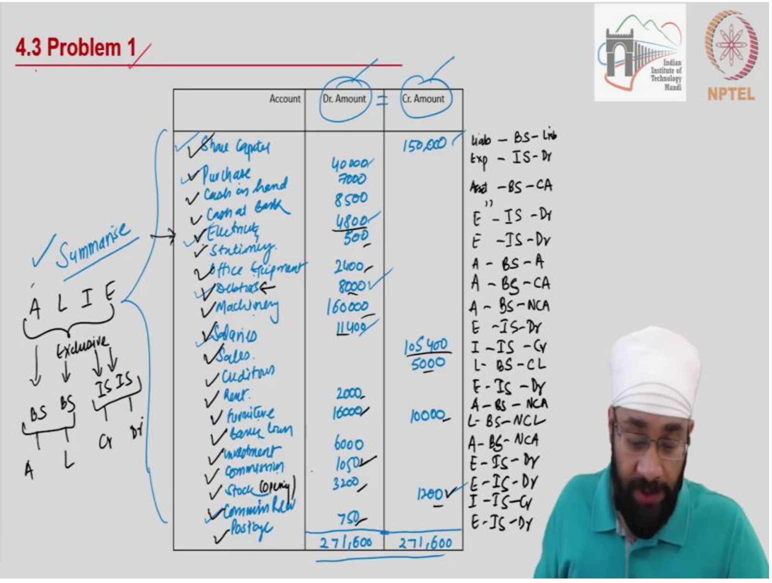

So, in 4.3 we had this problem 1, where we prepared our trial balance. I am going to use this trial balance to prepare a profit and loss account and balance sheet. Let me pick another colour. So, what I am going to do here is look at each of the items in the trial balance and then mark it as asset, liability, income, and expense, and then post it to the correct place in the income statement or the balance sheet. Let us start with share capital. Share capital is a liability and it is going to be posted in the balance sheet.

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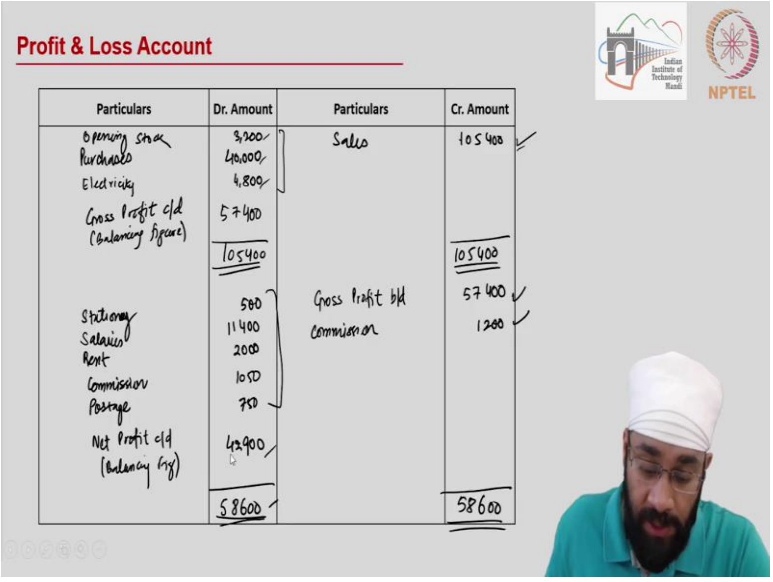

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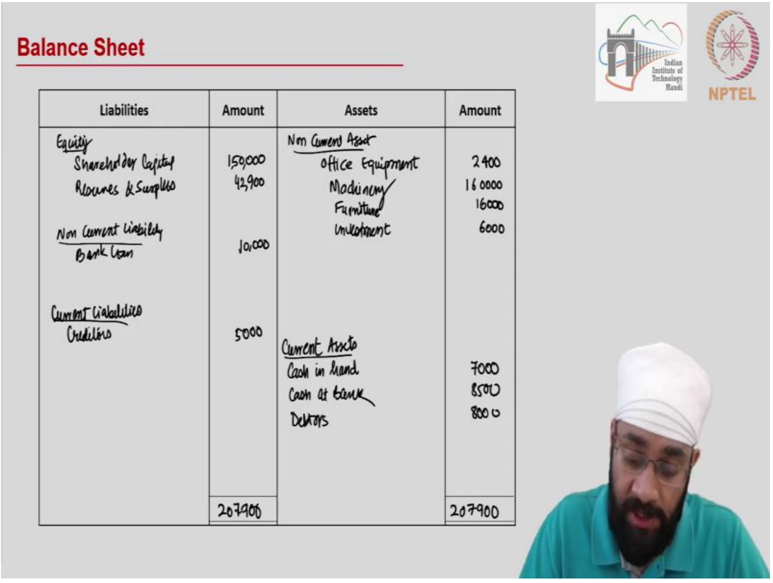

I have the format of the profit and loss account and the balance sheet with me. On the balance sheet, I am going to go to the liability side. You have equity capital here. Under equity you have shareholders' capital and the amount is 1,50,000. The first item is done: the share capital has been posted to its respective place in the final accounts. Next up is purchases. Purchase, as we know, is an expense and it has to be shown in the income statement. Again, within the income statement, we can say it will be shown on the debit side just as shareholders' capital is a liability and it is shown in the liabilities side. So, purchases are going to go to the profit and loss accounts.

So, I am just going to write down purchases here and the amount is 40,000. Next step you have cash in hand which is an asset. This will go to the balance sheet under the current assets subhead, amount is 7,000. I am going to write cash in hand and the amount is 7000. Next is cash at bank: same treatment for 8,500, done. Next is electricity. So, electricity here is 4,800 which is an expense. This will go to the income statement on the debit side and one more decision that we have to take is whether we are going to treat electricity as the factory electricity i.e., relating to manufacturing or an indirect expense relating to sales. Let us assume, and we are making an assumption, it is not clarified in this question, because we picked it up from the trial balance discussions. So, we are going to treat this as a direct expense: 4,800 electricity. I am going to write it down as a direct expense, electricity 4,800. Then you have stationery 500, this is an expense income statement debit side and let me write stationery 500 somewhere here. Then you have office equipment 2400, this is an asset that goes to the balance sheet on the asset side, under the noncurrent assets. Let me write noncurrent assets and you have office equipment; the amount is 2400. Next step you have debtors 8,000. The debtors are assets in the balance sheet under the current assets head. Let me write it here, debtors 8,000 and we should also write the heading: current assets. Next is machinery 160,000. This is an asset in the balance sheet balance sheet, under the noncurrent asset: 160,000, this is machinery. Next item is salaries 11,400. This will go to the income statement, on the debit side as salary is an expense. Now, we are assuming that these expenses are indirect expenses. Of course, in business you will have clarity on which are the expenses you are doing at the factory level, manufacturing level, and what are the sales related expenses. Accordingly, you will categorize that. But if you do not have this information, we are just making assumptions and moving forward. So, salary, stationery are being treated as an indirect expense. Then you have sales 105,400. Sales is an income and goes to the income statement on the credit side: 105400, this is sales. Next step is creditors 5000; creditors are a liability in the balance sheet under the current liabilities. So, 5000 creditors and the head is current liabilities, then we have rent 2000, this is an expense in the income statement on the debit side 2000: rent 2000. Next step is furniture 16000; this is an asset in the balance sheet under the noncurrent assets: 16000 furniture under the noncurrent assets. Then you have a bank loan 10000. This is a liability under the balance sheet, noncurrent liability. This is a long-term liability. So, the bank loan is 10000, let me write it here.

Bank loan is a noncurrent liability. Next step is investment 6,000; this is an asset in the balance sheet, noncurrent asset in the balance sheet. This is the investment made by the company in some other investment avenues. Commission 1050, this is an expense. Since, this is on the debit side in the income statement. All expenses have debit balances. So, if the amount is written on the debit side, we know this is an expense, commission is 1050. Then you have stock: this is the stock in the beginning. This is the opening stock: 3,200, which is going to be sold during the year. This is equivalent to the purchase, the stock you purchased and you are going to sell it this year, this is the stock left in the last year. So, in this year you are using the stock to sell the goods. So, this becomes an expense for you. So, we are going to treat this as an expense in the income statement on the debit side 3,200. Let me write, opening stock 3,200. Then you have commission received 1200, this is income. In the income statement, on the credit side commission received. Now, commission was earlier given on the debit side. Now, it is given on the credit side. So, all incomes have credit balances, that is how it is being shown on the credit side and you should deduce this is an income commission received 1200 and you write it here. Commission received 1200 and finally, you have postage 750, this is an expense that goes to the income statement debit side: 750 postage.

You have now posted all the items from the trial balance. Each and every item has been brought to the profit and loss account or to the balance sheet. One thing to notice is that, from the trial balance, each item goes to one specific statement on one specific side. All the items in the trial balance fall under either assets, liabilities, income, or expenses and these four categories are mutually exclusive. Mutually exclusive meaning a given item like debtors will either be an asset or a liability or an income or an expense, it cannot be income and expense both or income and asset both. So, these are mutually exclusive categories and whenever you have an asset, it goes to the balance sheet, whenever you have a liability, it goes to the balance sheet. Any income or expenses go to the income statement.

Therefore, any account balance from the trial balance is either going to go to the balance sheet or go to the income statement. Again, all assets are shown on the asset side, all liabilities on the liability side. So, one of the two sides, incomes are shown on the credit side, expenses are shown on the debit side.

Just as a rule of thumb, you should note that whenever you are preparing final accounts each item goes to only one place. That takes care of the other issues involved in the double entry system as well.

Next thing to do is to figure out what the profit earned during the year is. I am going to sum this side up 105,400 and we have a balancing figure here, which is called gross profit. This gross profit carried down is the balancing figure, which means that you had sales of 105,400 and now you have a bunch of expenses here. The cost of the stock which was with you from the last year plus you purchased more stock, all of this has been sold during the year and there are expenses on electricity. So, after you deduct the total of this from 105,400 you have a profit of 57,400. This is the gross profit, this is the margin that you have. The margin is equal to sales minus the cost of the goods which are being sold. The cost of the goods is equal to 40,000 plus 48,000 plus 3,200. Now, this gross profit is brought forward: gross profit brought down 57,400. What it means is that now you have the gross margin after taking care of the cost of the goods which are being sold, you have an additional 57,400 with you; out of this money you can spend on whatever expenses you want to do like administrative expense, sales expenses, finance ah, cost etc. Then you will have your net profit. Here you have gross profit, but you also made some commission. So, 58,600 is the total money that you have and this includes the gross margin plus the commission that you make. Now you have to figure out the net profit during the year. So, just sum up, and you fill out the total of this side and take it out of 58600: this gives you a balancing figure which is called net profit or net profit carried down.

This is a balancing figure. So, when you do the calculations, the number comes out to be 42,900, this is the balancing figure. This net profit is now taken to the balance sheet. If you remember from the very initial videos where we discussed the relationship between asset, liability, incomes, and expenses: we said that the profit is fed back into the shareholders' funds. The shareholders, the investors, of the business have the right over this net profit; they can decide to reinvest it as well. So, this money is going to be transferred to the shareholders' funds, the reserves and surpluses of the shareholder. Let me now go to the balance sheet and in the balance sheet I am going to write reserves and surplus. In the textbooks you will see that this amount is added to the share capital and the share capital is increased, that is one way of doing it.

But in the case of company form of business you will see that, there is a separate head called reserve and surpluses; that is where this amount is shown. So, there you go: this was one missing piece in the balance sheet. In the balance sheet we need to have this amount of profit or loss during the year. The balance sheet preparation depends upon the income statement preparation. Therefore, we start with income statement and then we go to the balance sheet.

Now all you have to do is to come up with the total. My format is in place equity, noncurrent and current everything is fine. The total of the balance sheet comes out to be 207,900 on both sides. So, the balance sheet is equal, the assets are equal to liabilities, the accounting equation holds as well.

In this video, just to summarize, we looked at a trial balance. The trial balance was prepared during the discussions on trial balance in the previous videos. This was one of the practice problems. Using those numbers, we prepared an income statement and we prepared a balance sheet. Key learnings are that from the trial balance each account balance goes to one of the two statements and one of the two sides. The profit from the income statement has two parts. There is a gross profit. There is a net profit. The net profit is carried to the balance sheet and put in the reserves and surpluses. We follow the format which is prescribed to prepare the balance sheet in terms of having noncurrent and current nature of items and we are done with that. So, that is how you prepare the balance sheet and income statement using a trial balance. I will see you in the next video.