Financial Accounting
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Lecture – 56
5.6 Tutorial–Preparation of Trading Account

Welcome to another tutorial video. In this video we are going to learn to prepare the profit and loss account: in fact, the first section of the profit and loss account, which is called Trading Account as well. I am introducing you to this terminology for the first time.

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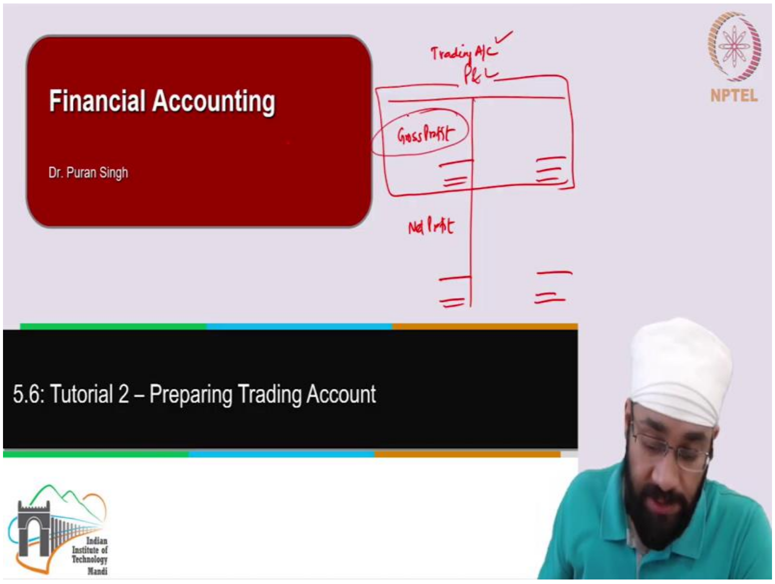

Please understand that in the profit and loss account, we first figure out the gross profit and then we figure out net profit. There are two sections to the profit and loss account: there it looks like this. This first section is called trading account and the second section is called profit and loss account. Together, in practice, the whole account is called a profit and loss account. But actually, it is divided into two sections: the trading account which gives you gross profit and, the profit and loss account which gives you net profit.

In the final statement which is shown as income statement, you do not see this distinction; you only see sales minus all the expenses. From a presentation point of view, when you disclose the statements to the public, you do not do this categorization. The reason for doing this categorization is internal. We need to convert the data in the financial statement into information. And we have already started categorizing the data so that we can come to that information. With that purpose, in this video, we are going to look at the first section in more detail. We have, of course, prepared the whole final accounts in the previous video as well, but we are going to specifically look at the nitty-gritties, the details, the dynamics, in figuring out the gross profit for a company. So, let us get started.

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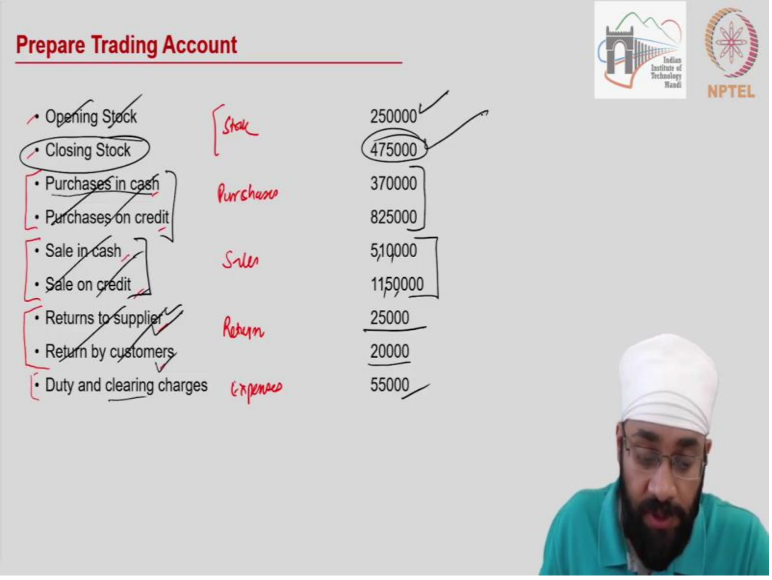

On the screen you see a list of items. There is opening stock, closing stock, two types of purchases given to you, cash and credit. Then you have sales given to you, cash and credit. Then there are returns to the supplier and return from your customers to you and there are duty and clearing charges. Basically, you have purchase, sales, returns of both purchase and sale and then there is stock information and some expenses. It seems all the items on the screen are related to the trading account, the first section where we calculate the gross profit. Now, I want to talk about some dynamics. In the first section, we have discussed the cost of the goods sold. I am going to invoke the matching principle of accounting that says you have to match the expenses of the current year to the revenues of the current year to figure out your profit. The way these items in a trading account are related is as follows.

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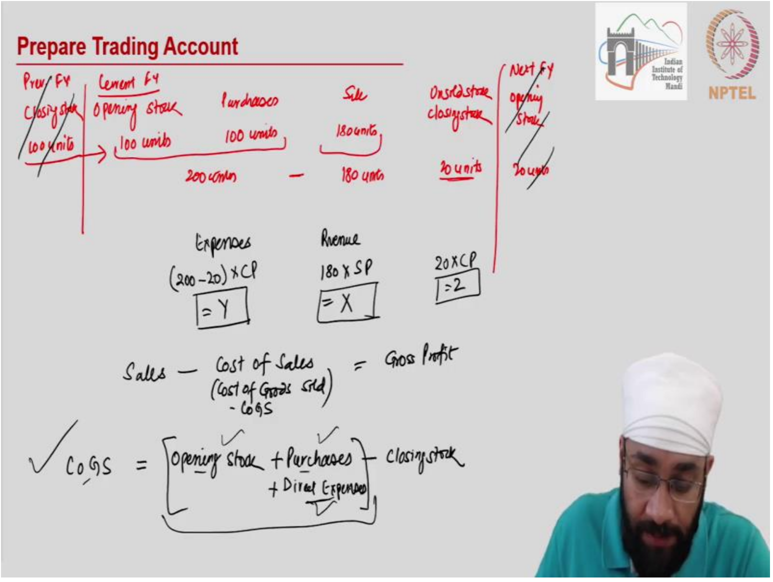

You start with an opening stock; the opening stock is the closing stock of the previous financial year. The reason we use it here is because when we had an unsold stock in the last financial year, we said we will sell this in the following year. Now, in this year if we have sold this then the cost of this stock has to be shown as an expense. Let me clarify how this works. Let us say you started this financial year with existing units of stock i.e., opening stock of 100 units. And then you make some purchases during this year, say, 100 more units you purchased. So, the total units available to be sold is now 200 units. And then comes the time to sell. During the financial year you have sold 180 units. So, out of the 200 units; 180 units have been sold and you are left with unsold stock, the unsold stock is 20 units. This unsold stock is called closing stock. And this is the current financial year. Let us say you go to the next financial year. Then these 20 units become the opening stock here. Likewise, if this is the current financial year then there was a previous financial year. In that financial year the closing stock was 100 units, which is now being used in this year as the opening stock. So, just understand that timeline. Right now we do not need to worry about the closing stock and the previous year and the next year, we are dealing with this year. In this year what is the sales amount that we have? And what is the amount which should be shown as the expenses?

The revenue of this year is equal to 180 multiplied by the unit selling price and that will come out to be some number. These units I am just assuming. The total sale given to us is 5,10,000 plus 11,50,000 so, that is the total sale. Whatever is the total sale that number comes here. Let us say there is a number equal to X, you have this revenue. And now you have to show expenses in order to figure out the profit. So, what are the expenses you should show? The expenses should be shown not for 200 units, but only for 180 units. Only 180 units multiplied by the unit cost price will give you expenses equal to Y. So, this is something that you need to understand: the remaining 20 units will go down. So, 20 units into the cost price, this is going to become your Z, which is the unsold stock during the year. Following the same principle, we prepare the trading account. So, in the trading account we take sales, or the revenue, minus the cost of sales, or goods sold minus the cost of goods sold. Cost of sales is also written as cost of goods sold, actually it is more popular that way or you can write COGS in short that is another popular abbreviation. When you do this, you have gross profit. Gross profit made during the year.

Cost of goods sold = Opening Stock + Purchases – Closing Stock

Thus, cost of sales, or cost of goods sold includes opening stock that we had in the beginning of the year, and purchases that we made during the year and excludes the closing stock; unsold stock. This is the cost of the goods, which have been sold during the year alright.

So, you can arrive at the number of units which are actually sold during the year by using this formula or if you have the amounts, then you input the amounts. One addition to this is that along with the opening stock and purchases we also add the value of the direct expenses; value of the direct expenses is added to opening stock and purchases and then closing stock is taken out. The assumption is that the direct expenses directly contribute to the cost of the goods. Therefore, when you are calculating the cost of the goods, which have been sold, please include these direct expenses when you are figuring out the cost of the goods sold. So, this is the cost of the goods calculation. Now using this principle, using this understanding, we are going to prepare the trading account.

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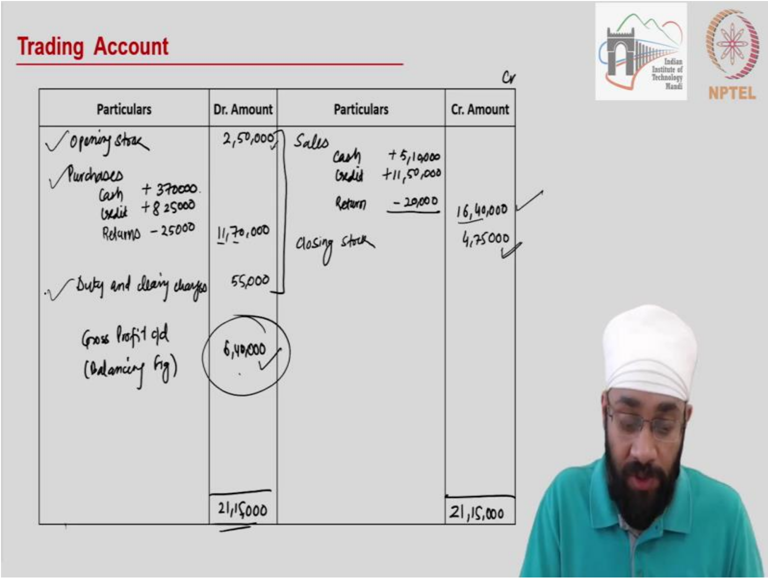

In the trading account we have to show income on the credit side, i.e., sales and then we have to show opening stock, which becomes an expense here, and then we are going to show purchases and then we are going to show any direct expenses. I will go back to the numbers, pick the amounts and post them in the right places: opening stock is 2,50,000, for purchases we have two different numbers: cash purchase and credit purchase. Now, according to accrual principle, it does not matter whether you have paid cash for an item. If you have purchased an item and your supplier has delivered that item to you, then you are liable to pay and you can then record the cost of these items, which have been delivered to you as an expense in the business. So, we will just sum these two things and write total purchases that come out to be: 3,70,000 cash and credit purchases 8,25,000. So, under purchases let me write cash and credit only for internal information; you do not disclose this in the final statements as such, but this is an internal preparation. The amount was 3,70,000 and you have credit purchases 8,25,000. This amount comes out to be 11,95,000: that is the total purchases done during the year. Now, 2,50,000 plus 11,95,000 is the total cost of goods, which are available with you to be sold, you may have sold less also. You will need to make an adjustment for that and how do we do that? We will see. Then you have sales in cash and in credit again, we are just going to show all the sales, because credit sale means we have delivered the goods which means that we have a right to the income: the income is accrued, has become due, you have earned the right on that income. Let me write cash and credit sales so, cash sale is 5,10,000 and the credit sale is 11,50,000. The total sale comes out to be 16,60,000. So, 5,10,000; 11,50,000 done: cash, credit both are done.

Next up you have returns, we did not adjust for return. So, you purchased some items, but you then returned some items to the vendor. Similarly, your customers also returned some items to you. So, we have to make an adjustment for that as well. So, how we are going to do that is as follows. I am just going to write here returns. Returns are supposed to be deducted, because you did not pay for those, you are not liable to pay for the goods which have been returned. Similarly, your customer is not going to be liable for the returns that he does to you: you cannot show that as an income. Purchase return, the return to supplier, is 25,000 and return by customer is 20,000. So, 25,000 and 20,000 these are the returns, and we have to deduct these. So, what I am going to do is make a correction and remove this line. We do not need this and I will deduct 25,000 from 11,95,000 which gives me 11,70,000 and then I am going to erase this. And I will deduct 20,000 from 16,60,000 so, I have 16,40,000 and then I am going to deduct this. So, all we did was write these three amounts. So, you have cash purchases plus credit purchases minus the returns, which gives you the net purchases during the year. Similarly, you have cash sales, add to it credit sales and minus the returns that customers have done: it gives you net income during the year; net sales during the year; net income is a specific word it is a term reserved for something else we will discuss later. Now we are done with these two and we have adjusted for all these items. We have also taken care of opening stock. Let me now take care of the duty and clearing charges: these are the direct expenses 55,000. So, 55,000 duty and clearing charges. Direct expenses have been shown here. Now, one last item which is remaining is the closing stock. The closing stock represents the money, the value, the cost of the goods which have not been sold. So, what was the amount of goods that were available? You had 2,50,000 plus 11,70,000. Thus, 2,50,000 and 11,70,000 is the value, is the cost that you paid, the expenses that you paid to purchase or earlier purchased these goods. However, 4,75,000 worth of goods are unsold here, and you should deduct that. So, I believe what you should do is add both these and say minus 475000. However, the convention is not to deduct that on the debit side. In order to have the same effect of deducting 4,75,000 because this is unsold, we can write closing stock on the opposite side; closing stock and the amount 4,75,000. Writing it on the opposite side means you are deducting it from the debit side. It is going to mean the same thing, when we calculate the gross profit.

This is the convention because internally you do want to know what is the stock left? What was the actual sale? What are the cash sales? Credit sales? and so on. Therefore, you are generating that data field wise. When we go to analysis, then you know these details specifically. So, let me remove this specific item from here and we are done. What we have now is the trading account, the first section of the profit and loss account with more nitty-gritties, with more details. Now, we just need to figure out the gross profit or gross loss during the year.

The total on this side becomes 21,15,000. Let me close this 21,15,000 from this total. We are going to deduct the total of this and we figure out the gross profit. So, the gross profit carried down during the year is a balancing figure and the amount comes out to be 6,40,000 after you deduct the total of the debit side from the total of the credit side. Now, this is the gross profit which you will take to the next section in the profit and loss account and pay selling expenses, administrative expenses and other remaining expenses.

What we did in this example in this tutorial was that we looked at a lot of detailed data relating to purchase of stock, sale of stock, returns, and closing stock. And then we learnt this concept of cost of the goods sold and this is the formula for that and this formula is taking effect in the trading account; opening stock and purchases and direct expenses are being added so, here opening stock purchases and direct expenses are being added. And then you are deducting from that the closing stock by writing it on the opposite side. When you do that, you can figure out your cost of goods sold and the cost of goods sold when deducted from sales gives you the gross profit.

Using this data if you have to figure out your cost of goods sold, now what you could do is you could say opening stock is 2,50,000 so: let me, maybe, do it on the next slide.

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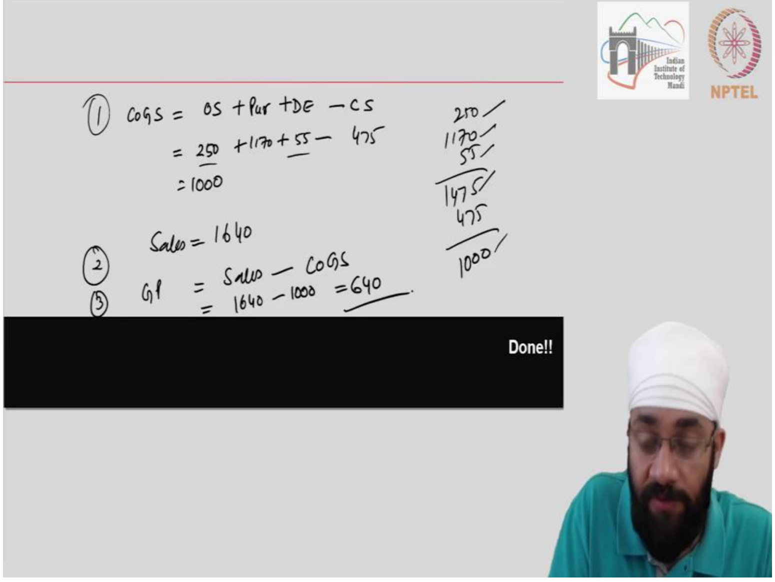

So, the cost of goods sold is equal to opening stock plus purchases plus direct expenses minus the closing stock. So, opening stock is equal to 2,50,000 plus the purchases are 11,70,000, direct expenses are 55,000 minus the closing stock which is 4,75,000. When you do this calculation, you can figure out the cost of the goods sold.

I will just do this quickly. So, you have 250 plus 1170 and 55 this comes out to be 7 and you have 4 you have to deduct 475 so, you left with 1000. So, this is your cost of goods sold, I hope the calculations are correct 250, 1170, 55 so, this gives you 5 10 7 4 1 minus 475 sounds about right. And then you deducted out of the sales that you have. Sales are 1640. So, the cost of goods sold has been figured out. The sales during the year are 1640 and now to figure out the gross profit which is equal to sales minus the cost of goods sold is equal to 1640 minus 1000, which gives you 6,40,000 which is what is being shown here as the gross profit.

So, the net effect is the same as showing the closing stock on the opposite side. You can deduct it on the debit side, but the convention is to show it on the opposite side. So, that you have this equation in front of what is the closing stock and opening stock, because you have to take this closing stock to the next year as opening stock therefore, we are showing it separately. Let us close this video here and I will see you in another tutorial.