FINANCIAL ACCOUNTING (Lecture-9)

Learning Objective

- After studying this chapter, you should be able to:
  - Explain what are Assets and Liabilities: and
  - Draw up simple Balance Sheet from given information in trial balance.

Assets are economic resources that are owned by a business and are expected to benefit future operations. In most cases, the benefit to future operations comes in the form of positive future cash flows. The positive future cash flows may come directly as the asset is converted into cash (collection of a receivable) or indirectly as the asset is use din operating the business to create other assets that result in positive future cash flows (building & land used to manufacture a product for sale). Assets may have definite physical form such as building, machinery or stock. On the other hand, some assets exist not in physical or tangible form, but in the form of valuable legal claims or right; examples are accounts receivables, investment in govt. bonds, and patent rights.

Liabilities are debts. The person or organization to which the debt is owed is called creditors. All businesses have liabilities; even the most successful companies purchase stocks, supplies, and services on credit. The liabilities arising from such purchases are called accounts payable**.**

Classification of Assets

- **Fixed Assets** – Are the assets of permanent nature that a business acquires, such as plant, machinery, building, furniture, vehicles etc.

- **Long Term Assets** –These are the assets of the business that are receivable after twelve months of the balance sheet date. For example, if business has invested for two years in any saving scheme or has purchased saving certificates for more than one year, it is a long-term asset.

- **Current Assets** – Are the receivables that are expected to be received within one year of the balance sheet date. Debtors, closing stock & all accrued incomes are the examples of Current Assets because these are expected to be received within one accounting period from the balance sheet date.
- **The year in which long-term asset is expected to be received; long-term asset is transferred to current assets in that year.**

Classification of Liabilities

- **Capital** – is the funds invested by the owners of the business. Business has a liability to return these funds to the owner.

  We know that for the purpose of accounting business is treated separately form its owners. This is known as Separate Entity Concept i.e. Business is a separate entity. Therefore, if the owner gives something (can be in form of Cash or Some other Asset) to the business then the business not only has to return the amount to the owner but it also has to give some return on that money. That is why we treat Capital (Owners Funds) as a Liability.

- **Profit and Loss Account** – The net balance of the profit and loss account i.e. either profit or loss also belongs to the owners.

  While explaining capital we said that the business has to give return to the owners. Now if the business is managed successfully then this return would be a Favorable figure (Profit). This return will therefore be added to the Owners investment.

- On the other hand if the business is managed un-successfully then this return would be an un-favorable figure (Loss). It will therefore be deducted from the Owner's Investment.

- **Long Term Liabilities** – These are the liabilities that will become payable after a period of more than one year of the balance sheet date. For example, if business has taken a loan from bank or any third person and it is payable after three years, it is along term liability of the business.

- **Current Liabilities** – These are the obligations of the business that are payable within twelve months of the balance sheet date. Creditors all accrued expenses are the example current liabilities of the business because business is expected to pay these back within one accounting period.
- **The year in which long term liability is to be paid, long term liability is transferred to current liability in that year**

BALANCE SHEET

- It is a position statement that shows the standing of the organization in Monetary Terms at a Specific Time.
- Unlike Profit and Loss that shows the performance of the entity over a period of time the Balance Sheet shows the Financial State of Affairs of the entity at a given date.
- Balance sheet is the summarized analysis in a 'T' form of all assets and liabilities of the entity, with liabilities listed on left hand side and assets on right hand side.
- Asset is any owned physical object (tangible asset) or a right (intangible asset) having economic value to the owner.
- Liability is an obligation of the business to deliver goods or provide a benefit in future.

FINANCIAL ACCOUNTING (Lecture-9)

SOLVED EXAMPLES

ILLUSTRATION # 1

The following is the trial balance extracted from the books of Naeem & Sons as on 30/06/2002. Prepare a profit & loss account & balance sheet for the year ended June 30, 2002.

	Dr.	Cr.
Sales		**100,000**
Purchases	**45,000**	
purchase return		**3,000**
Salaries	**12,000**	
Rent	**5,000**	
Debtors	**25,000**	
Creditors		**16,000**
Capital		**368,000**
Plant & machinery	**400,000**	
Grand Total	**487,000**	**487,000**

SOLUTION

Naeem & Sons
Profit & Loss Account for the year ended June 30, 2002.

	Rs.		Rs.
		Sales	100,000
cost of goods sold:			
Purchases	45,000	Purchase return	3,000
Gross Profit	58,000		
	103,000		103,000
Salaries	12,000	Gross Profit	58,000
Rent	5,000		
Net Profit	41,000		
Total	58,000		58,000

- This is a presentation of profit & loss account in 'T' account form. Now same illustration is presented in statement form.

Naeem & sons		
Profit & Loss Account for the year ended June 30, 2002		
Particulars	**Amount Rs.**	**Amount Rs.**
Income / Sales / Revenue		**100,000**
Less: Cost of Goods Sold		
Purchases	45,000	
Less: Purchase Return	(3,000)	**(42,000)**
Gross Profit		**58,000**
Less: Administrative expenses		
Salaries	(12,000)	
Rent	(5,000)	(17,000)
Net Profit		**41,000**

This is not a correct way to present profit & loss account in statement form. In actual practice only main heads of expenses are presented in profit & loss account along with foot note number. Detail of that head of expense is given in the note. Correct presentation of profit & loss account is hereunder:

Naeem & sons		
Profit & Loss Account for the year ended June 30, 2002		
Particulars	**Amount Rs.**	**Amount Rs.**
Income / Sales / Revenue		**100,000**
Less: Cost of Goods Sold (See Note # 1)		**(42,000)**
Gross Profit		**58,000**
Less: Administrative expenses (See Note # 2)		**(17,000)**
Net Profit		**41,000**

<u>Note # 1</u>
<u>Cost of goods sold</u>

Purchases	**45,000**
Less: Purchase Return	**(3,000)**
Net Purchases	**42,000**

Note # 2

<u>Administrative expenses</u>

Salaries	12,000
Rent	5,000
Total Administrative expenses	17,000

It is advised that Profit & loss account should be prepared in above mentioned format.

BALANCE SHEET

Naeem & Sons			
Balance Sheet As At June 30, 2002			
Liabilities		**Assets**	
Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
Capital **Profit and Loss Account**	**368,000** **41,000**	**Fixed Assets** Plant & Machinery	 400,000
	409,000		
Current Liabilities Creditors	 16,000	**Current Assets** Debtors	 25,000
Total	**425,000**	**Total**	**425,000**

Balance sheet in statement form is presented hereunder:

Naeem & Sons		
Balance Sheet As At June 30, 2002		
Particulars	**Amount Rs.**	**Amount Rs.**
<u>**Assets**</u> **Fixed Assets** Plant & machinery **Current Assets** Debtors		 400,000 25,000
Total		**425,000**
<u>**Liabilities**</u> **Capital** **Profit**	 **368,000** **41,000**	 **409,000**
Current Liabilities Creditods		 25,000
Total	**425,000**	**425,000**

Illustration # 2

The following trial balance has been extracted from the books of Saeed & co. on 30-06-2002. From this, prepare an income statement and balance sheet for the year ended 30-06-2002.

	Dr.	Cr.
Sales		200,000
Purchases	180,000	
purchase return		2,500
Office salaries	3,500	
Furniture & Fixture	16,000	
Office Equipment	11,000	
Rent	5,000	
Accounts Payable(creditors)		28,000
Sales Salaries	3,000	
Freight & custom duty on purchases	6000	
Repair of office equipment	2,000	
Accounts Receivable(debtors)	52,000	
Freight on sales	1,000	
Capital		41,500
Cash in hand	37,000	
Loan from bank(for three years)		50,000
Bank charges	500	
Interest on loan	5,000	
Grand Total	322,000	322,000

SOLUTION

Saeed & Co.

Profit & Loss Account for the year ended June 30, 2002.

	Rs.		Rs.
		Sales	200,000
Purchases	180,000	Purchase return	2,500
Freight, custom duty on purchases	6,000		
Gross Profit	16,500		
	202,500		202,500
Salaries	3,500	Gross Profit	16,500
Rent	5,000		
Repair of office equipment	2,000		
Sales salaries	3,000		
Freight on sales	1,000		
Interest on loan	5,000		
Bank charges	500		
		Net loss	3,500
Total	20,000		20,000

Profit & loss account in statement form:

Naeem & sons		
Profit & Loss Account for the year ended June 30, 2002		
Particulars	**Amount Rs.**	**Amount Rs.**
Income / Sales / Revenue		**200,000**
Less: Cost of Goods Sold (See Note # 1)		**(183,500)**
Gross Profit		**16,500**
Less: Administrative expenses (See Note # 2)		**(10,500)**
Less: Selling expenses (See Note # 3)		**(4,000)**
Less: Financial Expenses (See Note # 4)		**(5,500)**
Net Profit/(Loss)		**(3,500)**

NOTE # 1
COST OF GOODS SOLD

Purchases	180,000
Less: purchase return	(2,500)
Add: Freight, custom duty on purchases	(6,000)
TOTAL	**183,500**

NOTE # 2
Administrative expensees

Salaries	3,500
Rent	5,000
Repair of office equipment	2,000
TOTAL	**10,500**

NOTE # 3
Selling expenses

Sales salaries	3,000
Freight on sales	1,000
TOTAL	**4,000**

NOTE # 4
Financial expenses

Interest on loan	5,000
Bank charges	500
TOTAL	**5,500**

BALANCE SHEET

Saeed & co.			
Balance Sheet As At June 30, 2002			
Liabilities		**Assets**	
Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
Capital **Profit and Loss Account**	**41,500** **(3,500**	**Fixed Assets**)Furniture & Fixture	 16,000
	38,000		
Long Term Liabilities Loan from bank **Current Liabilities** Creditors	 50,000 28,000	**Current Assets** Debtors Office equipment Cash	 52,000 11,000 37,000
Total	**116,000**	**Total**	**116,000**

Balance sheet in statement form

Saeed & Co.		
Balance Sheet As At June 30, 2002		
Particulars	**Amount Rs.**	**Amount Rs.**
<u>**Assets**</u> **Fixed Assets** Furniture & Fixture **Current Assets** Debtors Office Equipment Cash		 16,000 52,000 11,000 37,000
Total		**116,000**
<u>**Liabilities**</u> **Capital** **Profit/(Loss)**	 **41,500** **(3,500)**	 **38,,000**
Long Term Liabilities Loan from bank **Current Liabilities** Creditors		 50,000 28,000
Total		**116,000**