Financial Statements – I

CBSE · Class 11 · Accountancy — exam notes

This chapter shows how a sole trader converts a finished trial balance into the three statements that summarise a year's working: the Trading Account (which finds gross profit), the Profit & Loss Account (which finds net profit), and the Balance Sheet (which lists what the business owns and owes on the last day of the year). Here the trial balance is taken at face value, so no year-end adjustments are made — that complexity is left for Financial Statements – II.

Key terms & definitions

Financial Statements
The end-of-year reports a business prepares to show its profitability and its financial position — chiefly the Trading and Profit & Loss Account (an income statement) and the Balance Sheet (a position statement).

Trading Account
A nominal account prepared first that matches the cost of goods sold against sales to arrive at gross profit (or gross loss). It records opening stock, purchases and direct expenses on the debit side and sales and closing stock on the credit side.

Gross Profit
The profit earned purely from buying and selling goods, i.e. Net Sales minus Cost of Goods Sold, before any indirect/running expenses are deducted. A gross loss arises if cost of goods sold exceeds net sales.

Profit & Loss Account
A nominal account prepared after the Trading Account. It begins with gross profit, deducts all indirect expenses and losses, adds all non-trading incomes, and arrives at net profit (or net loss) for the period.

Net Profit
The final profit left for the owner after every business expense — direct and indirect — has been met and every gain added. It is transferred to the Capital Account, increasing the owner's capital.

Operating Profit
The profit from the normal, regular operations of the business: Gross Profit minus operating (day-to-day running) expenses, ignoring non-operating incomes and non-operating expenses. Also equal to Net Profit + non-operating expenses – non-operating incomes.

Direct Expenses
Expenses incurred to purchase goods and bring them to a saleable condition or location — e.g. carriage/freight inwards, wages, dock and clearing charges, factory power and fuel, import duty. They are shown in the Trading Account.

Indirect Expenses
Expenses incurred to run, manage, sell and finance the business rather than to acquire goods — e.g. office salaries, rent, electricity, advertising, carriage outwards, bad debts, interest on loan. They are shown in the Profit & Loss Account.

Cost of Goods Sold (COGS)
The cost of the goods actually sold during the year = Opening Stock + Net Purchases + Direct Expenses – Closing Stock. Gross Profit = Net Sales – COGS.

Balance Sheet
A statement (not an account) listing all assets, liabilities and capital of the business on a particular date to reveal its financial position. It is based on the equation Assets = Liabilities + Capital and both sides must agree.

Marshalling
The orderly arrangement of assets and liabilities in the Balance Sheet, either in order of liquidity (most liquid first) or in order of permanence (most permanent first).

Capital vs Revenue items
Capital expenditure (e.g. buying machinery) and capital receipts (e.g. owner's capital, a loan) affect the Balance Sheet; revenue expenditure (e.g. rent, wages) and revenue receipts (e.g. sales, commission earned) affect the Trading and P&L Account.

Meaning, objectives and need of financial statements

- Financial statements are the end products of the accounting process; after journalising, posting and balancing, all balances finally rest in these statements.
- They have two parts: an income statement (Trading and P&L Account) that measures profit earned over a period, and a position statement (Balance Sheet) that shows the financial position on a date.
- Objectives: to ascertain the profit or loss of the year, to show the true financial position (assets, liabilities, capital), to help judge solvency and liquidity, and to provide information to the owner, lenders, tax authorities (Income Tax, GST) and prospective buyers.
- For a sole proprietor these statements are the basis for filing the income-tax return and for supporting a bank-loan application.

Capital and revenue — expenditure and receipts

- Capital expenditure: spending that gives a long-term benefit or adds a non-current asset/earning capacity — e.g. purchase of machinery, building, furniture, or major improvement to a fixed asset. It is shown in the Balance Sheet (asset side).
- Revenue expenditure: spending whose benefit is used up within the year — e.g. rent, wages, salaries, repairs, carriage. It is shown in the Trading or P&L Account.
- Capital receipt: an amount received that is not earned in the ordinary course of business and creates a liability or reduces an asset — e.g. additional capital introduced, a loan taken, sale proceeds of a fixed asset. It is shown in the Balance Sheet.
- Revenue receipt: an amount earned in the normal course of business — e.g. sale of goods, commission or interest received. It is shown in the Trading or P&L Account.
- Why it matters: wrongly treating a capital item as revenue (or vice-versa) distorts both profit and the Balance Sheet. Example — treating machinery purchase as an expense understates profit and omits an asset.

Trading Account — purpose and contents

- Purpose: to calculate gross profit or gross loss, i.e. the result of the trading (buying-and-selling) activity alone.
- Debit (left) side items: Opening Stock, Purchases less Purchase Returns (Returns Outward), and all Direct Expenses such as carriage inwards, freight inwards, wages, dock charges, clearing charges, import duty, factory rent, fuel/power.
- Credit (right) side items: Sales less Sales Returns (Returns Inward), and Closing Stock.
- Closing stock appears on the credit side because those goods were purchased but not sold; it must be removed from the cost of goods consumed.
- Balancing figure: if the credit side is larger, the excess is Gross Profit c/d (carried to P&L); if the debit side is larger, the excess is Gross Loss c/d.
- Formula link: Gross Profit = Net Sales – Cost of Goods Sold, where COGS = Opening Stock + Net Purchases + Direct Expenses – Closing Stock.

Profit & Loss Account — purpose and contents

- Purpose: to calculate net profit or net loss after charging all indirect expenses and crediting all other incomes.
- It starts with Gross Profit brought down (b/d) on the credit side (or Gross Loss b/d on the debit side).
- Debit (left) side — indirect expenses and losses: office and administrative expenses (salaries, office rent, printing, stationery, postage, legal charges, insurance), selling and distribution expenses (advertising, carriage outwards, packing, commission to salesmen, bad debts), and financial expenses (interest on loan, bank charges, discount allowed), plus depreciation and any abnormal losses (note: depreciation and similar adjustments are studied in detail in Financial Statements – II).
- Credit (right) side — gains and incomes: discount received, commission received, interest received, rent received, and any other non-trading income.
- Balancing figure: excess of credit over debit is Net Profit (transferred to Capital, increasing it); excess of debit over credit is Net Loss (deducted from Capital).

Operating profit and net profit (the three levels of profit)

- Gross Profit: result of trading only (from the Trading Account).
- Operating Profit: profit from the main/regular operations = Gross Profit – Operating Expenses (office, administrative, selling and distribution expenses). It deliberately ignores non-operating items.
- Non-operating expenses are those unrelated to main operations — e.g. interest on loan, loss on sale of a fixed asset, loss by fire. Non-operating incomes are gains unrelated to main operations — e.g. interest/dividend received, rent received, profit on sale of a fixed asset.
- Net Profit = Operating Profit + Non-operating Incomes – Non-operating Expenses. Equivalently, Operating Profit = Net Profit + Non-operating Expenses – Non-operating Incomes.
- Why distinguish them: operating profit shows how well the core business performs without being flattered or dragged down by one-off or unrelated items.

Direct vs indirect expenses — the decision rule

- The single test: was the expense incurred to buy goods or bring them to a saleable state/location? If yes, it is a direct expense (Trading Account); if it is to run, sell, manage or finance the business, it is indirect (P&L Account).
- Watch the carriage trap: carriage/freight INWARDS (on goods bought) is direct → Trading Account; carriage/freight OUTWARDS (on goods sold/delivered to customers) is indirect → P&L Account.
- Wages (paid to workers handling goods) → Trading Account; Salaries (paid to office/management staff) → P&L Account. The combined item 'Wages and Salaries' goes to the Trading Account, while 'Salaries and Wages' goes to the P&L Account (the first word decides).
- Note on the effect: shifting an expense between the Trading and P&L Account (e.g. wrongly putting a direct expense in P&L) changes the gross profit but leaves the net profit unchanged, because the total of all expenses is the same. Net profit only changes if the item is wrongly omitted or double-counted. Examiners test this directly, so classify carefully.

Balance Sheet — meaning, need and characteristics

- It is a statement, not an account; therefore it has 'Liabilities' and 'Assets' headings rather than debit/credit, and it is prepared 'as at' a particular date (not 'for the year ended').
- Need: to show the financial position, to reveal the nature and value of assets and the amount owed to outsiders and to the owner, and to help assess solvency.
- It is built on the accounting equation: Assets = Liabilities + Capital; the two sides must always be equal because every figure has already passed through double-entry.
- In the Indian (NCERT) horizontal/T-format, Capital and Liabilities are on the LEFT and Assets on the RIGHT.
- Closing capital shown here = Opening Capital + Net Profit (or – Net Loss) + Additional Capital – Drawings.

Classification of assets and liabilities, grouping and marshalling

- Assets: Fixed (non-current) assets are held for long-term use — land, building, plant and machinery, furniture, and intangibles like goodwill and patents; Current assets are convertible into cash within a year — closing stock, debtors, bills receivable, bank balance, cash, prepaid expenses (when present).
- Liabilities: Long-term (non-current) liabilities are repayable after a year — long-term loans, mortgage; Current liabilities are payable within a year — creditors, bills payable, bank overdraft, outstanding expenses (when present). Capital is the owner's claim, shown separately.
- Grouping: putting items of a similar nature under one head (e.g. all sundry debtors together).
- Marshalling: arranging the groups in a definite sequence. Order of liquidity lists the most easily realisable items first (Cash, Bank, Debtors, Stock... then Fixed Assets). Order of permanence is the reverse — the most permanent items first (Goodwill, Land/Building... then liquid assets). Liabilities are arranged on a matching principle.
- A sole proprietor may choose either order, but the same basis must be used consistently for both assets and liabilities.

Difference between Trading & P&L Account and the Balance Sheet

- Nature: the Trading and P&L Account is a nominal account; the Balance Sheet is a statement.
- Purpose: the Trading and P&L Account ascertains profit/loss for a period; the Balance Sheet shows financial position on a date.
- Period vs point: the income statement covers a span ('for the year ended 31 March'); the Balance Sheet is at a single instant ('as at 31 March').
- Content: the income statement contains nominal accounts (expenses, losses, incomes, gains); the Balance Sheet contains real and personal accounts (assets, liabilities, capital).
- Sequence: Trading Account → P&L Account → Balance Sheet; gross profit flows from the first to the second, and net profit flows from the second into capital on the third.

Formulas & formats

- Cost of Goods Sold (COGS) = Opening Stock + Net Purchases + Direct Expenses − Closing Stock (Net Purchases = Purchases − Purchase Returns).
- Gross Profit = Net Sales − Cost of Goods Sold (Net Sales = Sales − Sales Returns); if negative, it is Gross Loss.
- Net Profit = Gross Profit + Other (non-trading) Incomes − Indirect Expenses; if negative, it is Net Loss.
- Operating Profit = Gross Profit − Operating Expenses = Net Profit + Non-operating Expenses − Non-operating Incomes.
- Closing Capital = Opening Capital + Additional Capital + Net Profit − Drawings (subtract Net Profit if it is a loss).
- Accounting equation / Balance Sheet check: Assets = Liabilities + Capital.
- TRADING ACCOUNT (for the year ended 31 March 20X2) — T-format. Dr (left): To Opening Stock; To Purchases (less Returns Outward); To Direct Expenses (Carriage/Freight Inwards, Wages, Dock/Clearing charges, Import Duty, Factory Power/Fuel); To Gross Profit c/d. Cr (right): By Sales (less Returns Inward); By Closing Stock. Both totals equal.
- PROFIT & LOSS ACCOUNT (for the year ended 31 March 20X2) — T-format. Dr (left): To Gross Loss b/d (if any); To Indirect Expenses — Office/Admin (Salaries, Rent, Printing & Stationery, Postage, Insurance, Legal), Selling & Distribution (Advertising, Carriage Outwards, Commission, Bad Debts), Financial (Interest on Loan, Bank Charges, Discount Allowed); To Net Profit (transferred to Capital). Cr (right): By Gross Profit b/d; By Incomes/Gains (Discount Received, Commission Received, Interest Received, Rent Received). Both totals equal.
- BALANCE SHEET (as at 31 March 20X2) — Indian T-format. LEFT (Capital & Liabilities): Capital + Net Profit − Drawings (= closing capital); Long-term Liabilities (Loans, Mortgage); Current Liabilities (Creditors, Bills Payable, Bank Overdraft). RIGHT (Assets): Fixed Assets (Goodwill, Land & Building, Plant & Machinery, Furniture); Current Assets (Closing Stock, Debtors, Bills Receivable, Bank, Cash). LEFT total = RIGHT total.

Important questions & model answers

1 mark **State any two objectives of preparing financial statements.**

- To ascertain the net profit or net loss of the business for the accounting year.
- To ascertain the financial position (assets, liabilities and capital) of the business on the last day of the year. (Any one more accepted: to provide information to owners, lenders and tax authorities.)

1 mark **Carriage inwards is debited to the Trading Account but carriage outwards is debited to the Profit & Loss Account. Why?**

- Carriage inwards is a direct expense — it is the freight paid to bring purchased goods into the business, so it is part of the cost of goods and goes to the Trading Account.
- Carriage outwards is an indirect (selling) expense — it is the freight paid to deliver goods to customers after sale, so it is charged to the Profit & Loss Account.

3 marks **Distinguish between gross profit and net profit.**

- Gross profit is found in the Trading Account; net profit is found in the Profit & Loss Account.
- Gross profit = Net Sales – Cost of Goods Sold, i.e. it considers only direct trading items; net profit additionally deducts all indirect expenses and adds all other incomes.
- Gross profit ignores running costs such as rent and salaries; net profit is the final figure after meeting every expense.
- A business can earn gross profit yet end with a net loss if its indirect expenses are very large.

3 marks **Differentiate between capital expenditure and revenue expenditure, with one example each, and state where each is shown.**

- Capital expenditure gives a benefit lasting more than one year or creates/improves a fixed asset; revenue expenditure gives a benefit consumed within the year.
- Example of capital expenditure: purchase of machinery; example of revenue expenditure: payment of rent or wages.
- Capital expenditure is shown on the asset side of the Balance Sheet; revenue expenditure is shown in the Trading or Profit & Loss Account.
- Treating a capital item as revenue understates profit and omits an asset, distorting both statements.

4 marks **What is meant by marshalling of a Balance Sheet? Explain the two orders in which it can be done.**

- Marshalling is the orderly arrangement of assets and liabilities in the Balance Sheet in a definite sequence.
- Order of liquidity: assets are listed with the most easily convertible into cash first (Cash, Bank, Debtors, Stock, then Fixed Assets); liabilities are listed with those payable soonest first.
- Order of permanence: the reverse — the most permanent/fixed items are listed first (Goodwill, Land & Building, Plant, then current assets); liabilities follow the matching order with capital/long-term first.
- The same basis must be applied consistently to both sides, and a sole proprietor may adopt either order.

4 marks **Distinguish between operating profit and net profit, and give the formula linking them.**

- Operating profit is the profit from the regular/main operations of the business; net profit is the final profit after all items, operating and non-operating.
- Operating profit = Gross Profit – Operating (office, administrative, selling and distribution) expenses; it ignores non-operating incomes and expenses.
- Non-operating items include interest on loan, loss by fire (expenses) and interest or rent received, profit on sale of an asset (incomes).
- Linking formula: Net Profit = Operating Profit + Non-operating Incomes – Non-operating Expenses; therefore Operating Profit = Net Profit + Non-operating Expenses – Non-operating Incomes.

6 marks **From the following balances of Raj Enterprises for the year ended 31 March 2024, prepare the Trading Account, Profit & Loss Account and Balance Sheet: Opening Stock ₹15,000; Purchases ₹1,20,000; Sales ₹2,00,000; Carriage Inwards ₹5,000; Wages ₹8,000; Salaries ₹12,000; Rent ₹10,000; Electricity ₹4,000; Closing Stock ₹20,000; Furniture ₹49,000; Debtors ₹30,000; Cash ₹25,000; Creditors ₹18,000; Capital ₹60,000.**

- TRADING A/C (for the year ended 31 Mar 2024): Dr — To Opening Stock 15,000; To Purchases 1,20,000; To Carriage Inwards 5,000; To Wages 8,000; To Gross Profit c/d 72,000; total 2,20,000. Cr — By Sales 2,00,000; By Closing Stock 20,000; total 2,20,000.
- Working: COGS = 15,000 + 1,20,000 + 5,000 + 8,000 – 20,000 = 1,28,000; Gross Profit = 2,00,000 – 1,28,000 = 72,000.
- PROFIT & LOSS A/C (for the year ended 31 Mar 2024): Dr — To Salaries 12,000; To Rent 10,000; To Electricity 4,000; To Net Profit 46,000; total 72,000. Cr — By Gross Profit b/d 72,000; total 72,000. Net Profit = 72,000 – 26,000 = 46,000.
- Closing Capital = 60,000 + 46,000 = 1,06,000 (no drawings given).
- BALANCE SHEET (as at 31 Mar 2024): LEFT — Capital 1,06,000; Creditors 18,000; total 1,24,000. RIGHT — Furniture 49,000; Closing Stock 20,000; Debtors 30,000; Cash 25,000; total 1,24,000. Both sides agree at ₹1,24,000.

3 marks **Why is the Balance Sheet called a statement and not an account, and why must its two sides always be equal?**

- It is called a statement because it merely lists the closing balances of assets, liabilities and capital on a date — it is not part of the double-entry ledger and so carries the headings 'Assets' and 'Liabilities' instead of debit and credit.
- It is prepared 'as at' a date, recording a position at a point in time rather than transactions over a period.
- Its two sides are always equal because it is based on the accounting equation Assets = Liabilities + Capital, and every figure has already been balanced through double-entry, so total assets must equal total claims against them.

4 marks **Compute gross profit and net profit: Sales ₹4,00,000; Sales Returns ₹10,000; Opening Stock ₹40,000; Purchases ₹2,60,000; Purchase Returns ₹8,000; Carriage Inwards ₹12,000; Closing Stock ₹54,000; Office Salaries ₹30,000; Rent ₹18,000; Commission Received ₹6,000.**

- Net Sales = 4,00,000 – 10,000 = 3,90,000; Net Purchases = 2,60,000 – 8,000 = 2,52,000.
- COGS = Opening Stock 40,000 + Net Purchases 2,52,000 + Carriage Inwards 12,000 – Closing Stock 54,000 = 2,50,000.
- Gross Profit = Net Sales 3,90,000 – COGS 2,50,000 = ₹1,40,000.
- Net Profit = Gross Profit 1,40,000 – (Salaries 30,000 + Rent 18,000) + Commission Received 6,000 = ₹98,000.

Exam tips

- Always prepare the statements in order — Trading Account, then P&L Account, then Balance Sheet — and carry gross profit and net profit forward correctly; a wrong carry-down loses marks in all three.
- Use net figures: deduct Returns Outward from Purchases and Returns Inward from Sales before entering them.
- Closing stock is given outside the trial balance in these (no-adjustment) sums — show it once on the credit side of the Trading Account and once on the asset side of the Balance Sheet.
- Sort every expense with one question — 'was it to acquire/prepare goods?' If yes it is direct (Trading A/c); if not, indirect (P&L A/c). Beware carriage inwards vs outwards and wages vs salaries.
- Head each statement precisely: 'for the year ended 31 March 20X2' for the Trading and P&L Account, but 'as at 31 March 20X2' for the Balance Sheet.
- Show your COGS and gross/net profit workings clearly — examiners award step marks even if the final total has a slip.
- If the Balance Sheet does not tally, re-check that closing capital includes net profit and excludes drawings, and that closing stock is on the asset side.

Quick revision

- Three statements: Trading A/c (gross profit) → P&L A/c (net profit) → Balance Sheet (position).
- COGS = Opening Stock + Net Purchases + Direct Expenses – Closing Stock; Gross Profit = Net Sales – COGS.
- Net Profit = Gross Profit – Indirect Expenses + Other Incomes; it is added to capital.
- Three profit levels: Gross Profit (trading) → Operating Profit (Gross Profit – operating expenses) → Net Profit (after non-operating items).
- Direct expenses (Trading A/c): carriage/freight inwards, wages, factory power, import duty. Indirect (P&L A/c): salaries, office rent, advertising, carriage outwards, bad debts, interest.
- Balance Sheet equation: Assets = Liabilities + Capital; in Indian T-format, Capital & Liabilities on LEFT, Assets on RIGHT.
- Assets split into Fixed and Current; liabilities into Long-term and Current; marshalling = order of liquidity or order of permanence.
- Capital items → Balance Sheet; revenue items → Trading/P&L Account.
- Closing Capital = Opening Capital + Additional Capital + Net Profit – Drawings.
- No adjustments here (closing stock is the only extra) — outstanding/prepaid expenses, depreciation and bad-debt provisions belong to Financial Statements – II.