Financial Statements – II

CBSE · Class 11 · Accountancy — exam notes

This chapter shows how to convert raw trial-balance figures into a true Trading Account, Profit & Loss Account and Balance Sheet by passing year-end adjustments. Every adjustment follows the accrual and matching principles and always has a DUAL effect — one in the Trading/P&L Account and one in the Balance Sheet — so that profit is honest and the Balance Sheet balances.

Key terms & definitions

Adjustment
A year-end correction that records an item not yet (or wrongly) reflected in the trial balance, so that income and expenses fall in the period they truly belong to.

Closing Stock
The value of goods left unsold at the end of the accounting year, found by physical stock-take and valued at cost or net realisable value, whichever is lower.

Outstanding Expense
An expense whose benefit has been received in the current year but which is still unpaid at year-end; it is a current liability.

Prepaid (Unexpired) Expense
An expense paid in advance whose benefit relates to the next year; the unexpired part is a current asset.

Accrued (Outstanding) Income
Income earned during the current year but not yet received in cash; it is a current asset.

Income Received in Advance (Unearned Income)
Income received in cash this year for a service to be rendered next year; it is a current liability.

Depreciation
The systematic allocation of the cost of a fixed asset over its useful life; it is a non-cash expense charged to the P&L Account that reduces the asset's book value.

Bad Debts
Debts that are definitely irrecoverable and written off as a loss against debtors.

Provision for Doubtful Debts
An estimated charge (usually a percentage of debtors) created in anticipation of future bad debts, in line with the principle of prudence/conservatism.

Provision for Discount on Debtors
An estimated reserve for cash discount likely to be allowed to debtors who pay promptly; calculated on good debtors AFTER deducting further bad debts and the provision for doubtful debts.

Manager's Commission
A reward paid to the manager as a percentage of profit; an expense of the firm and, if unpaid, a current liability.

Goods Withdrawn for Personal Use (Drawings in Goods)
Stock taken by the proprietor for private use; deducted from purchases and added to drawings, so the business is not charged for the owner's consumption.

Why adjustments are needed

- A trial balance only lists items already in the ledger; it ignores expenses incurred but unpaid, income earned but unreceived, unsold stock, fall in asset values and likely losses.
- Adjustments apply the accrual principle (record revenue when earned and expense when incurred, not when cash moves) and the matching principle (match the period's expenses to its revenues).
- GOLDEN RULE: an item that appears INSIDE the trial balance is recorded only ONCE in the final accounts; an item appearing only in the ADJUSTMENTS (below the trial balance) is recorded in TWO places — once in Trading/P&L and once in the Balance Sheet.

Closing Stock

- Effect 1 (Trading A/c): shown on the CREDIT side of the Trading Account; this arithmetically reduces the cost of goods sold and raises gross profit.
- Effect 2 (Balance Sheet): shown on the ASSETS side as a current asset.
- Closing stock is NEVER placed on the debit side of the Trading Account; opening stock (already in the trial balance) sits on the debit side.
- Exception: if closing stock already appears INSIDE the trial balance, it is shown only in the Balance Sheet (purchases would have been recorded net of it).

Outstanding Expenses

- Effect 1 (P&L / Trading A/c): ADD the outstanding amount to the relevant expense before charging it.
- Effect 2 (Balance Sheet): show as a CURRENT LIABILITY ('Outstanding ___').
- Wages outstanding are added in the Trading Account (direct), salaries/rent outstanding in the P&L Account (indirect).

Prepaid (Unexpired) Expenses

- Effect 1 (P&L / Trading A/c): SUBTRACT the prepaid (unexpired) portion from the expense.
- Effect 2 (Balance Sheet): show the prepaid amount as a CURRENT ASSET.
- Quick test: benefit already consumed = expense of this year; benefit still to come = asset carried forward.

Accrued (Outstanding) Income

- Effect 1 (P&L A/c): ADD the accrued amount to the relevant income on the credit side.
- Effect 2 (Balance Sheet): show as a CURRENT ASSET ('Accrued ___' / income receivable).

Income Received in Advance (Unearned Income)

- Effect 1 (P&L A/c): SUBTRACT the advance portion from the income on the credit side.
- Effect 2 (Balance Sheet): show as a CURRENT LIABILITY ('___ Received in Advance').

Depreciation

- Effect 1 (P&L A/c): charge depreciation as an indirect expense on the debit side.
- Effect 2 (Balance Sheet): DEDUCT depreciation from the asset's value on the assets side, showing the reduced (written-down) book value.
- Under the Straight-Line Method (NCERT Class 11): Annual Depreciation = (Cost – Residual/Scrap Value) ÷ Useful Life; charge for part of a year if the asset was bought mid-year.
- If an asset is purchased during the year and appears as an additional adjustment, calculate depreciation only for the months it was in use.

Bad Debts (further / additional)

- Bad debts already shown INSIDE the trial balance are simply taken to the debit of the P&L Account (no Balance Sheet effect on their own).
- FURTHER bad debts given in adjustments: Effect 1 — add to bad debts in the P&L Account (debit); Effect 2 — DEDUCT from sundry debtors in the Balance Sheet.
- Order of working on debtors: first deduct further bad debts from debtors, THEN compute the provision on the reduced figure.

Provision for Doubtful Debts

- Step 1: Good debtors = Sundry Debtors – Further Bad Debts.
- Step 2: New Provision = required % × good debtors.
- P&L charge = Further Bad Debts + Bad Debts already in trial balance + New (closing) Provision – Old (opening) Provision already in trial balance (this net amount is debited to the P&L Account).
- If the old provision exceeds the year's bad debts plus the new provision, the EXCESS is a gain — credited to the P&L Account.
- Balance Sheet: deduct the NEW provision from debtors (after deducting further bad debts) to show net realisable debtors.

Provision for Discount on Debtors

- Created only on GOOD debtors expected to pay (because discount is allowed only to those who actually pay).
- Base for the calculation = Debtors – Further Bad Debts – New Provision for Doubtful Debts; then apply the discount %.
- Effect 1 (P&L A/c): debit the new provision for discount (adjusted for any old provision, like doubtful debts).
- Effect 2 (Balance Sheet): deduct it from debtors after the provision for doubtful debts has been deducted.

Goods Withdrawn / Distributed (non-sale uses of stock)

- Goods taken by the proprietor for personal use: DEDUCT from purchases (Trading A/c) and ADD to drawings (deducted from capital in the Balance Sheet).
- Goods given as free samples / advertisement: DEDUCT from purchases and DEBIT advertisement (P&L expense).
- Goods distributed as charity: DEDUCT from purchases and DEBIT charity/donation (P&L expense).
- Goods lost by fire/theft (abnormal loss): DEDUCT the cost from purchases or credit the Trading A/c; the loss net of any insurance claim is debited to the P&L A/c, and any admitted insurance claim is a current asset in the Balance Sheet.

Interest on Capital and Interest on Drawings

- Interest on Capital: Effect 1 — debit the P&L Account (an expense/charge of the business); Effect 2 — ADD to capital in the Balance Sheet.
- Interest on Drawings: Effect 1 — credit the P&L Account (a gain to the business); Effect 2 — ADD to drawings (i.e. deduct from capital) in the Balance Sheet.
- These are notional entries for a sole proprietor — they redistribute the proprietor's own funds, so both legs touch the capital account in the Balance Sheet.

Manager's Commission

- Effect 1 (P&L A/c): debit as an expense after all other expenses and incomes are accounted for (it is computed on profit).
- Effect 2 (Balance Sheet): if unpaid at year-end, show 'Commission Payable / Outstanding Commission' as a current liability.
- Commission ON profit BEFORE charging commission = Net Profit (before commission) × Rate ÷ 100.
- Commission ON profit AFTER charging commission = Net Profit (before commission) × Rate ÷ (100 + Rate).

The dual-effect checklist

- For every adjustment ask two questions: (1) What is the Trading/P&L effect? (2) What is the Balance Sheet effect?
- Answer both, every time. An adjustment recorded in only one statement will leave the Balance Sheet out of balance.
- Memory aid for liabilities/assets: outstanding expense & income-in-advance = liabilities; prepaid expense & accrued income = assets.

Formulas & formats

- Closing Stock → (1) Credit side of Trading A/c; (2) Asset (current) in Balance Sheet.
- Outstanding Expense → (1) Add to expense in P&L (or Trading for wages); (2) Current liability in Balance Sheet.
- Prepaid Expense → (1) Subtract from expense in P&L; (2) Current asset in Balance Sheet.
- Accrued Income → (1) Add to income (credit) in P&L; (2) Current asset in Balance Sheet.
- Income Received in Advance → (1) Subtract from income (credit) in P&L; (2) Current liability in Balance Sheet.
- Depreciation → (1) Debit (expense) in P&L; (2) Deduct from the asset in Balance Sheet. SLM: (Cost − Residual Value) ÷ Useful Life.
- Further Bad Debts → (1) Add to bad debts (debit) in P&L; (2) Deduct from debtors in Balance Sheet.
- Provision for Doubtful Debts → P&L debit = Bad Debts + Further Bad Debts + New Provision − Old Provision; Balance Sheet = deduct new provision from (Debtors − further bad debts).
- New Provision for Doubtful Debts = % × (Sundry Debtors − Further Bad Debts).
- Provision for Discount on Debtors = % × (Debtors − Further Bad Debts − New Provision for Doubtful Debts); (1) debit P&L; (2) deduct from debtors in Balance Sheet.
- Goods withdrawn for personal use → (1) Deduct from Purchases (Trading A/c); (2) Add to Drawings (deduct from Capital in Balance Sheet).
- Goods as free samples/charity → (1) Deduct from Purchases; (2) Debit Advertisement/Charity in P&L.
- Abnormal loss of stock → (1) Reduce purchases / credit Trading A/c with cost; (2) Loss (net of claim) debited to P&L, insurance claim admitted = current asset.
- Interest on Capital → (1) Debit P&L; (2) Add to Capital in Balance Sheet.
- Interest on Drawings → (1) Credit P&L; (2) Add to Drawings / deduct from Capital in Balance Sheet.
- Manager's Commission before charging = Profit (before commission) × Rate ÷ 100.
- Manager's Commission after charging = Profit (before commission) × Rate ÷ (100 + Rate); if unpaid, current liability.

Important questions & model answers

1 mark **State the two effects of an outstanding expense in the final accounts.**

- It is added to the related expense in the Trading/Profit & Loss Account (raising the expense).
- It is shown as a current liability on the liabilities side of the Balance Sheet.

3 marks **Closing stock is not shown in the trial balance but appears in the final accounts. Explain why and give its treatment.**

- Opening stock is already in the trial balance (it is last year's closing stock), but this year's closing stock is known only after a physical stock-take at year-end, so it is given as an adjustment.
- Effect 1: it is recorded on the credit side of the Trading Account, which reduces the cost of goods sold and increases gross profit.
- Effect 2: it is shown on the assets side of the Balance Sheet as a current asset.
- It is valued at cost price or net realisable value, whichever is lower (prudence).

3 marks **Distinguish between a prepaid expense and an outstanding expense, with the treatment of each.**

- Outstanding expense: benefit received this year but not yet paid — it is an expense due. Prepaid expense: paid this year but benefit relates to next year — it is paid in advance.
- Outstanding expense is ADDED to the expense in the P&L Account and shown as a current liability.
- Prepaid expense is SUBTRACTED from the expense in the P&L Account and shown as a current asset.
- Test: if the benefit is already consumed it is an expense; if the benefit is still to come it is an asset/liability carried to the next year.

3 marks **A delivery van was bought for ₹1,50,000 with an estimated scrap value of ₹15,000 and a useful life of 5 years. Compute annual depreciation under SLM and state its two effects.**

- Annual Depreciation = (Cost – Residual Value) ÷ Useful Life = (₹1,50,000 – ₹15,000) ÷ 5 = ₹27,000.
- Effect 1: ₹27,000 is debited to the Profit & Loss Account as an expense.
- Effect 2: ₹27,000 is deducted from the van's value on the assets side of the Balance Sheet, showing a written-down value of ₹1,23,000.
- Residual value is deducted first because that portion of the cost is expected to be recovered on sale and is never 'used up'.

4 marks **Sundry Debtors are ₹2,00,000. Further bad debts ₹5,000; create a provision for doubtful debts at 5%. Show the P&L charge and the Balance Sheet presentation.**

- Good debtors = ₹2,00,000 – ₹5,000 (further bad debts) = ₹1,95,000.
- New provision = 5% × ₹1,95,000 = ₹9,750.
- P&L Account (debit side) = Further Bad Debts ₹5,000 + New Provision ₹9,750 = ₹14,750 (assuming no old provision).
- Balance Sheet (assets): Debtors ₹2,00,000 – Further Bad Debts ₹5,000 = ₹1,95,000 – New Provision ₹9,750 = Net Debtors ₹1,90,250.

4 marks **Trial balance shows Debtors ₹1,00,000; Bad Debts ₹2,000; Provision for Doubtful Debts (old) ₹4,000. Adjustment: write off further bad debts ₹3,000 and keep a provision of 5% on debtors. Calculate the amount charged to the P&L Account.**

- Good debtors = ₹1,00,000 – ₹3,000 = ₹97,000; New provision = 5% × ₹97,000 = ₹4,850.
- Total provision required side = Bad Debts ₹2,000 + Further Bad Debts ₹3,000 + New Provision ₹4,850 = ₹9,850.
- Less: Old Provision ₹4,000.
- Amount debited to P&L Account = ₹9,850 – ₹4,000 = ₹5,850.
- Balance Sheet: Debtors ₹97,000 – New Provision ₹4,850 = ₹92,150 (net).

4 marks **Net profit before commission is ₹2,10,000. The manager is entitled to 5% commission. Calculate the commission if it is (a) on profit before charging commission, and (b) on profit after charging commission.**

- (a) Before charging: Commission = ₹2,10,000 × 5 ÷ 100 = ₹10,500.
- (b) After charging: Commission = ₹2,10,000 × 5 ÷ (100 + 5) = ₹2,10,000 × 5 ÷ 105 = ₹10,000.
- Check for (b): profit left = ₹2,10,000 – ₹10,000 = ₹2,00,000; 5% of ₹2,00,000 = ₹10,000 — confirms the figure.
- In both cases the commission is debited to the P&L Account; if unpaid it is a current liability.

6 marks **From the following, prepare adjustments and find net profit. Trial balance (31 March 2024): Opening Stock ₹40,000; Purchases ₹2,10,000; Sales ₹4,50,000; Rent Paid ₹24,000; Salaries Paid ₹60,000. Adjustments: Closing stock ₹55,000; Outstanding rent ₹2,000; Prepaid salary ₹5,000.**

- Trading A/c: COGS = Opening Stock ₹40,000 + Purchases ₹2,10,000 – Closing Stock ₹55,000 = ₹1,95,000.
- Gross Profit = Sales ₹4,50,000 – COGS ₹1,95,000 = ₹2,55,000.
- Rent expense = ₹24,000 + Outstanding ₹2,000 = ₹26,000.
- Salary expense = ₹60,000 – Prepaid ₹5,000 = ₹55,000.
- Net Profit = Gross Profit ₹2,55,000 – Rent ₹26,000 – Salary ₹55,000 = ₹1,74,000.
- Balance Sheet: Outstanding Rent ₹2,000 = current liability; Prepaid Salary ₹5,000 and Closing Stock ₹55,000 = current assets.

4 marks **Explain the treatment of goods withdrawn by the proprietor for personal use and goods distributed as free samples.**

- Goods for personal use: DEDUCT the cost from Purchases in the Trading Account (the business is not charged for the owner's consumption) and ADD it to Drawings, which is deducted from Capital in the Balance Sheet.
- Free samples / advertisement: DEDUCT the cost from Purchases in the Trading Account and DEBIT it to Advertisement Expense in the P&L Account (it is a selling cost).
- Both keep purchases (and hence gross profit) correct by removing stock that was never sold.
- Journal idea — personal use: Drawings A/c Dr, To Purchases A/c; free samples: Advertisement A/c Dr, To Purchases A/c.

3 marks **Why is a provision for discount on debtors calculated AFTER the provision for doubtful debts, and on what amount?**

- Cash discount is allowed only to debtors who actually pay; doubtful debtors are not expected to pay, so no discount will be given to them.
- Therefore the provision for discount is computed only on the GOOD, paying debtors.
- Base = Debtors – Further Bad Debts – New Provision for Doubtful Debts; the discount % is then applied to this figure.
- It is debited to the P&L Account and deducted from debtors in the Balance Sheet after the provision for doubtful debts.

Exam tips

- First scan whether each item is INSIDE the trial balance (record once) or in the ADJUSTMENTS (record twice). This single check prevents most errors.
- Work debtors strictly in order: Debtors – Further Bad Debts → New Provision for Doubtful Debts → Provision for Discount. Never apply the percentage to the gross debtor figure.
- Wages outstanding go to the Trading Account (direct expense); salaries/rent/interest outstanding go to the P&L Account (indirect).
- Closing stock on the CREDIT side of the Trading Account only — writing it on the debit side is a classic mark-loser.
- For manager's commission, underline whether it is 'before' or 'after' charging commission; use ÷100 vs ÷(100+rate) accordingly.
- Show provisions and depreciation as DEDUCTIONS within the Balance Sheet (e.g. Debtors xxx less Provision xxx), not as separate liabilities.
- Label liabilities precisely: 'Outstanding Salary', 'Salary Received in Advance', etc. — vague labels lose presentation marks.
- Always state BOTH effects of an adjustment; examiners award marks for the Balance Sheet leg even if the P&L leg is wrong.

Quick revision

- Adjustments exist to honour the accrual and matching principles — right item, right period.
- Inside trial balance = recorded once; in adjustments = recorded twice (P&L + Balance Sheet).
- Closing stock → credit Trading A/c + current asset.
- Outstanding expense → add to expense + current liability; Prepaid → subtract from expense + current asset.
- Accrued income → add to income + current asset; Income in advance → subtract from income + current liability.
- Depreciation → debit P&L + deduct from asset; SLM = (Cost – Scrap) ÷ Life.
- Provision for doubtful debts: % on (Debtors – further bad debts); P&L = bad debts + further bad debts + new provision – old provision.
- Provision for discount on debtors: % on (Debtors – further bad debts – new doubtful-debt provision).
- Goods withdrawn → deduct from purchases + add to drawings; free samples/charity → deduct from purchases + debit relevant expense.
- Interest on capital → debit P&L + add to capital; Interest on drawings → credit P&L + add to drawings.
- Manager's commission: ×rate/100 (before) or ×rate/(100+rate) (after); unpaid = current liability.
- Final self-check: for every adjustment, did I record a P&L effect AND a Balance Sheet effect?