

**Financial Accounting**  
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**Lecture – 59**  
**5.9 Practice Problem**

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**Practice Problem**

	Dr.	Cr.	
Share Capital		90000 ✓	BS-L
✓ Land and Building	31480	- BS-A-NCA	
✓ Plant and machinery	14270	- BS-A-NCA	
✓ Furniture	1250	- BS-A-NCA	
✓ Carriage inwards	4370	- P&L → Trading A/C	
✓ Wages	21470	- P&L → Trading A/C	
✓ Salaries	4670	- P&L → P&L	
✓ Bad debts provision		2470 → BS-CL	
✓ Sales		91230 ✓ P&L	
✓ Sale return	1760	- P&L	
✓ Bank Charges	140	- P&L	
✓ Coal, gas and water	720	- P&L	
✓ Rates and taxes	840	- P&L	
✓ Discount		120 P&L-Cr	
✓ Purchase	42160		
✓ Purchase return		8460	

It is time for a practice problem. On the screen I have a trial balance which has balances of accounts, debit and credit, and it runs into two pages.

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**Practice Problem**

	Dr.	Cr.	
✓ Bills receivables	1270	- BS-CA	
✓ Trade expenses	1950	- P&L-IE	
✓ Debtors	37800	- BS-CA	
✓ Creditors		12170 BS-CL	
✓ Opening stock	26420	P&L - Trading	
✓ Interest		500 P&L - Unearned	
✓ Fire insurance	490	- P&L-Exp	
✓ Cash	13000		
✓ Bank	890	BS-CA	
<b>Total</b>	<b>204950</b>	<b>204950</b>	

  

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graph TD
    BS --- L
    BS --- A
    BS --- CA
    L --- E
    L --- NCL
    L --- CL
    A --- NCA
    A --- CA
    IS --- E
    IS --- IE
    I --- OI
    I --- NOI
  
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There are few new items which you have not seen, new account balances which you have not seen before.

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Particulars	Dr. Amount	Particulars	Cr. Amount
Opening stock	26,400	Sales	91,230
Purchases	42,160	Returns	17,600
Returns	8,460		89,470
Carriage inwards	4,157		
Wages	21,473		
Coal, gas & water	720		
Gross Profit c/d (Balancing fig)	2,790		89,470
	89,470		
		Gross Profit Hd	2,790
Salaries	4,670	Discount received	120
Bank charges	140	Interest Income	500
Rates & Taxes	840	Net loss c/d (Balancing fig)	46,800
Trade Expenses	19,500		
Fire Insurance	490		
	80,900		80,900

Using this trial balance, we are going to prepare both trading and profit and loss account and the balance sheet.

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### Balance Sheet

Liabilities	Amount	Assets	Amount
Equity		Non Current Assets	
Share Capital	90,000	Land & Building	31,480
Reserve Surplus	(4,080)	Plant & Machinery	14,270
		Furniture	1,250
Non Current Liabilities	—		
Current Liabilities		Current Assets	
Provision for doubtful debts	2,470	Bills Receivable	1,270
Creditors	12,190	Solvent	27,800
		Cash	15,000
		Bank	890
	99,960		99,960

We are going to follow the same process. The learning objective of this practice problem is to use a large number of items and post them to both these statements at one go and also learn

some of the new items, get habituated to some of the new account balances that are here in this practice problem.

Let us get started. I go to the balance sheet here and write the names and the headings which are required. I will take another color here, this one. On the assets side we have noncurrent assets and current assets. On the liability side you have equity, noncurrent liabilities, and current liabilities: standard format of liabilities.

Now, we will look at the trial balance. Look at a number and take it to its respective place. Share capital 90,000, we know this goes to the balance sheet on liabilities side. Next up you have land and building which is an asset. So, this will go to the balance sheet on the asset side 31,480– noncurrent assets. Plant & machinery is 14,270, again this will go to the balance sheet asset side under noncurrent assets. Furniture is 1,250. Again, this is an asset and a non current asset in nature, 1,250 furniture.

Carriage inward. Now, the direction of the goods is inwards which means this company is purchasing the goods from a vendor. When you are purchasing the goods from a vendor, you are paying transportation on it as well. So, this is related to purchase of raw materials and will go to the trading account, the first section in the income statement. So, this will go to profit and loss account, but this will go to the trading account within this account. Profit and loss account has two sections; the first section is trading account; second section is profit and loss account, by the same name. So, the carriage inward is 4,370. I am going to write it somewhere here, because we typically start with opening stock and purchases. So, carriage inwards is going to be written here, amount is 4,370. Then you have wages 21,470. We are going to assume that the wages are being paid to the factory workers, daily wagers. So, this will also go to trading account: 21,470, these are wages. We are going to assume that salaries are being paid to the sales staff. So, it will go to the profit and loss account, second section, somewhere here 4670, salaries.

Then you have bad debt provision, this is something new. A provision, I have discussed before. Provision is the amount taken out of the reserves and surpluses and you fix that amount to be used in case of certain liabilities. Bad debt provision means it is possible, in the future, that some customers may not turn up or not pay up, or they go insolvent and you are not able to recover the money. In that case, this loss will be made good using this amount, so that is the provision you are creating.

Similarly, you could create provision for tax liability that could rise up in future. Unforeseen other kinds of liabilities as well, so that is how the provisions are created. Therefore, this is essentially part of the profit and to be used towards a current liability or any other liability. So, this will go to the balance sheet. And under the balance sheet this goes to the current liability section, because typically the provision is supposed to be used in the near future, you expect that thing to happen. So, bad debt provision 2,470 is going to go to current liabilities. Actually, under the current liabilities head you have current liabilities and provisions: two subheads. So, provision for bad debts is shown here: 2470 is the amount. There you go.

Then you have sales. Sales are 91,230. The reason I write it here is because I saw the next line which is sales return. So, I have to make the adjustment. 1,760 is the sales return which has to be taken out in order to figure out the net sales during the year. The returns cannot be considered as sales. This amount comes out to be 89,470. Bank charges are the money paid for an annual maintenance charge or debit card fee or something like that. So, your bank auto deducts it from your bank account. Bank charges 140, we are going to consider this as an indirect expense. Then you have coal, gas, and water. This is, of course, related to the manufacturing of the goods. So, 720 is going to go down as the direct expense 720 – coal, gas, and water, direct expense. And I have not written things here. Let me just quickly do that this goes to profit and loss account. Sales return goes to profit and loss account and coal and gas also goes to profit and loss account.

Then you have rates and taxes. These are local taxes which, say, the municipality, collects from you. There can be different categorizations, different types of taxes depending on what kind of business, what geography, what state you are in. Simply, these are administrative expenses or expenses to be paid to the government establishments. So, 840 goes to the profit and loss account in the second section, rates and taxes, 840.

Then you have a discount and the discount is written in the credit column. So, this will go to profit and loss account, but will go to the credit side. Why? Because this is not the discount that we are giving to our customers; this is a discount that we are receiving. It has been shown on the credit side, as a credit balance, means it is an income or gain. So, clearly this is a gain. You paid your vendor and the vendor allowed you some discount. So, 120 is going to be a non-operating income or a gain. Discount received is 120, this goes to profit and loss account. This is done.

Purchase and I see purchase return as well. I will accordingly be careful while writing 42,160 purchases. Let me write here purchase 42,160, and I have returns. So, I am going to deduct the returns amount to show the net purchases 8,460. The amount comes out to be 33,700. Then you have the next page where we have bills receivable or the bills to be received from your customers. So, balance sheet, current asset, bills receivable are 1,270.

Then you have trade expenses and trade expenses go to profit and loss account. As these are in general trade we consider these as indirect expenses and go to the second section. The amount is 1,950 trade expenses. Sometimes people confuse it by saying we are preparing a trading account, the first section is called trading account, so trade expenses should go there. But it is necessarily a sales or administrative expense which should be considered as an indirect expense rather.

Then you have debtors 37,800. Debtors are shown under current assets. Creditors are current liabilities. Again, let me write it here: balance sheet current assets, balance sheet current liabilities. 12,170 is creditors. Then you have opening stock 26,420. I knew that these items exist. So, I left space. Again this is the convention: you want to look at these items clearly in a specific order. So, the opening stock is 26,420 and it goes to the profit and loss account in the trading account, the first section.

Interest is 500. Again, you have a credit balance which means this is an income. So, profit and loss and you show this as a non-operating income. Other than sales, all incomes are non-operating in nature. 500 should be shown here as the non-operating income. So, this is interest income.

Fire insurance is a debit. You are paying this premium 490 and we treat this as an indirect expense. Fire insurance premium 490. You have cash balance and you have bank balance, both these items go to the balance sheet under current assets, and fire insurance is an expense – indirect expense. Cash and bank balance needs to be posted 13,890: this is cash and this is bank balance. There you go.

We have posted every item from this trial balance to either the profit and loss account, or the balance sheet. Again, we should remember that from the trial balance, every account balance will go to only one place to only one of the two statements. Either it will go to the balance sheet or to the income statement. In the balance sheet, it will either go to liabilities or to the assets side while in the income statement it will go to either expenses or income. Again, within income

it could go to the first section where you show operating incomes or it goes to the other section non-operating income. Similarly, if it is an expense, it could go to the first section as a direct expense, or to the second section as an indirect expense. Under liabilities, it could go to the equity or to noncurrent liability or to current liability. Likewise, under assets, it could go to noncurrent assets or to current assets. Only one of these sections is where every item from the trial balance is going to be posted. All we have to do now is to figure out the profits, and then bring that to the balance sheet. The total on the credit side is 89,470. This is the amount earned during the year, this is the top line, 89,470. And you have to sum this up and say what is the total expenses, total cost of the goods that have been sold, in order to arrive at the balancing figure which is gross profit carried down during the year. This is a balancing figure. I, of course, have done the calculations here. And the gross profit comes out to be 27,90. This is the balancing figure. The top line was 89,470. And out of that you have the cost of the stock line, cost of the goods which have been sold. And this cost includes the cost of stock which you already had and the cost of the stock that you purchased. And then in bringing the stock you paid for transportation, you paid workers to convert the stock into the finished goods, and for coal, gas, and water. So, all of that comprises the cost of the product. You deduct that from the sale and then you have the gross profit, gross margin earned during the year.

Then you bring the gross profit, gross margin brought down 2,790. And suddenly it seems that you do not have sufficient income to pay off these expenses. So, we are going to first total the expenses side because clearly there is an item with 4,000 rupees and on the other hand you have less than 4,000. So, the total expenses that you have done are 8,090. However, you did not have 8,000, you did not earn 8090 in this year; you only earned 2,790 plus 120 plus 600. So, you earned less than what you spent. Clearly there is a net loss: instead of net income during the year, net profit during the year, you have a loss that you are making. You are spending more than you earned during this year. So, 8,090, and the net loss comes out to be 4,680 this is the balancing figure. You earned less and you spent more this year. Now, do not confuse this by saying how you can spend more than what you earn. This is one financial year, you have money from previous financial years accumulated, you can pay out of that as well. Just be clear about that. When we talk about cash account, that is when we say you cannot spend more cash than what you actually have: that is a different scenario entirely.

Now, let us take this number, net loss 4,680, and transfer this to the balance sheet. So, this will go to reserve and surplus 4,680, and I am going to put brackets around it which indicates that

this is the negative number. So, typically what would happen in a business is that you will already have some balance in the reserve and surplus from the previous year. And then you will reduce that balance by this amount. However, this is a standalone example, a practice problem. Here you just show it as negative, but if you had, let us say, 50,000 in the reserve and surpluses. Now, the amount that you will show here will be 43,320, whatever the amount this comes out to be. Let me get rid of this, it means nothing. You have everything you need to prepare the balance sheet. All you need to do is sum this up. You have no amounts on the noncurrent liability side. When I total these two sides, I am going to do 90,000 minus 4,680 plus 2,479 plus 12,170. So, the total comes out to be 99,960. And same on both the sides: all assets are equal to all liabilities, all debits have equal credits.

So, in this practice problem we learnt a few new things. We had a loss, for example, how do we adjust for the loss made during the year. We also had a new item called provision for bad debts. And then we looked at a bunch of items which we posted to the balance sheet and income statement. You also had incomes here. You had a credit balance in the discount account which was also new. All in all, we looked at a bigger range of transactions or the accounts. And we posted them into the final accounts to prepare the balance sheet and income statement.

I hope by now you have a firm grasp over how the balance sheet, income statement are prepared internally, for the purpose of data creation. Of course, this data will be converted into more presentable format and then presented to the public, then published to the public: there are guidelines which are followed, the templates which have to be followed, the sequence which has to be followed. But internally this is how we prepare the balance sheet income statement.

And then you will also learn, as we move forward, how these numbers are used in the analysis to convert this data into information, so that decision making can be done. All of that will come up very soon in the course as well. I will see you in the next video.