

UNIT-III

Trading, Profit and Loss Account and Balance Sheet

A business needs to prepare a trading and profit and loss account first before moving on to the balance sheet. Trading and profit and loss accounts are useful in identifying the gross profit and net profits that a business earns. The motive of preparing trading and profit and loss account is to determine the revenue earned or the losses incurred during the accounting period.

The trading and profit and loss account are two different accounts that are formed within the general ledger. The two parts of the account are:

1. Trading Account
2. Profit and Loss Account

Trading account is the first part of this account, and it is used to determine the gross profit that is earned by the business while the profit and loss account is the second part of the account which is used to determine the net profit of the business.

1. Trading Account

Trading account is used to determine the gross profit or gross loss of a business which results from trading activities. Trading activities are mostly related to the buying and selling activities involved in a business. Trading account is useful for businesses that are dealing in the trading business. This account helps them to easily determine the overall gross profit or gross loss of the business. The amount thus determined is an indicator of the efficiency of the business in buying and selling.

The formulae for calculating gross profit is as follows:

$$\text{Gross profit} = \text{Net sales} - \text{Cost of goods sold}$$

Where

$$\text{Net sales} = \text{Gross sales of the business minus sales returns, discounts and allowances.}$$

The trading account considers only the direct expenses and direct revenues while calculating gross profit. This account is mainly prepared to understand the profit earned by the business on the purchase of goods.

Items that are seen in the debit side includes purchases, opening stock and direct expenses while credit side includes closing stock and sales.

Preparing Trading Account

Trading account is prepared by closing all the temporary purchases and revenue accounts and making adjustments in the inventory accounts by the use of a closing journal entry

For the following question, prepare a trading account

Particulars	Amount	Particulars	Amount
Sales	2,05,000		
Sales returns	15,000		
Purchases	49,000		
Purchases returns	3000		
Opening inventory	8000		
Closing inventory	30,000		
Trading Account	1,500		

The format of trading account after passing the closing entry is as follows:

Dr.		Cr.	
ended			Trading Account for the year
Sales returns	15,000	Sales	205,000
Purchases	49,000	Purchase returns	3,000
Beginning inventory	8,000	Ending inventory	9,000
Balance c/d	145,000		
Total	217,000	Total	217,000

Balance b/d	145,000
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In this example, all accounts are closed and transferred to the trading account. The credit entry of 1,45,000 is the gross profit for the period.

2. Profit and Loss Account

Profit and loss account shows the net profit and net loss of the business for the accounting period. This account is prepared in order to determine the net profit or net loss that occurs during an accounting period for a business concern.

Profit and loss account get initiated by entering the gross loss on the debit side or gross profit on the credit side. This value is obtained from the balance which is carried down from the Trading account.

A business will incur many other expenses in addition to the direct expenses. These expenses are deducted from the profit or are added to gross loss and the resulting value thus obtained will be net profit or net loss.

The examples of expenses that can be included in a Profit and Loss Account are:

1. Sales Tax
2. Maintenance
3. Depreciation
4. Administrative Expense
5. Selling and Distribution Expense
6. Provisions
7. Freight and carriage on sales
8. Wages and Salaries

These appear in the debit side of Profit and Loss Account while Commission received, Discount received, profit obtained on sale of assets appears on the credit side.

Net profit can be determined by deducting business expenses from the gross profit and adding other incomes obtained

Net profit = Gross profit – Expenses + Other income

Trading and Profit and Loss Account Format

Trading and Profit and Loss Account format is represented separately as follows:

Format for Trading Account

Trading account for the year ended.....

To opening stock	xxx	By Sales	xxxx	
To purchases	xxxx	Less returns	xx	
Less returns	xxx		-----	xxxxx
	-----	By closing stock		xxx
To Direct expenses:	xxxxx	By gross loss (if loss)		xxx
Carriage inward	xxx			
Freight	xxx			
Octroi	xxx			
Dock dues	xxx			
Excise duty	xxx			
Royalty	xxx			
Motive power	xx			
Coal, gas, water	xxx			
Factory expenses	xxx			
To Gross Profit (if profit)	xxx			
	xxxxx			xxxxx

Format for Profit and Loss Account

Profit & Loss Account			
(For the year ended...)			
Dr.	Particulars	Amount	Cr.
			Amount
	To Gross loss b/d	Xxx	By Gross Profit b/d
	To Salaries	Xxx	By Discount Received
	To Office rent, rates and taxes	Xxx	By Commission Received
	To Printing & stationery	Xxx	By Bank Interest
	To Telephone expenses	Xxx	By Rent received
	To Postage & telegram	Xxx	By Dividend on shares
	To Discount Allowed	Xxx	By Interest earned on debentures
	To Insurance	Xxx	By Profit on sale of asset
	To Audit Fees	Xxx	By Net loss
	To Electricity charges	Xxx	
	To Repairs & renewals	Xxx	
	To Depreciation	Xxx	
	To Advertisement	Xxx	
	To Carriage Outwards	Xxx	
	To Bad Debts	Xxx	
	To Provision for Bad debts	Xxx	
	To Selling commission	Xxx	
	To Bank Charges	Xxx	
	To Interest on loans	Xxx	
	To Loss on sale of asset	Xxx	
	To Net Profit	Xxx	
		<u>xxx</u>	
			<u>xxx</u>

Difference between Trading and Profit and Loss Account

The following points of difference exist between the Trading and Profit and Loss Account

Parameters	Trading Account	Profit and Loss Account
Meaning	Trading account used to find the gross profit/loss of the business for an accounting period	Profit and loss account or Income statement is used to find the net profit/loss of the business for an accounting period
Timing	Trading Account is prepared first and then profit and loss account is prepared.	Profit/Loss Account is prepared after the trading account is prepared.
Purpose	For knowing the gross profit or gross loss	For knowing the net profit or net loss of

	of a business	a business
Stage	It is the first stage in the creation of the final account.	it is the second stage in the creation of the final account.
Dependency	It is not dependent on trial balance	It is dependent on trading account
Transfer of Balance	The balance in the form of Gross loss or Gross Profit of the trading account will be transferred to the Profit and Loss Account	The balance in the form of Net loss or Net Profit of the profit and loss account will be transferred to the Balance Sheet