Unit 3

Module 1

Financial and Corporate Accounting

Definition

Accounting is the art of recording, classifying, summarizing in a significant manner and in terms of money transactions and events which are a part at least of financial character and interpreting the results there off.

Accounting Concepts

Accounting concepts are the basic rules, assumptions, and conditions that define the parameters and constraints within which accounting operates. In other words, accounting concepts are generally accepted accounting principles, which form the fundamental basis of consistently preparing the universal form of financial statements.

1 – Entity Concept

The entity concept is a concept that explains to you that your business is different from yours. It tells you that the business owner and the owner are two separate entities. The statute recognizes the entity as an artificial person. The entity must prepare its own set of financial statements and record its business transactions accordingly.

2 – Money Measurement Concept

Money Measurement concept states that only those transactions are recorded and measured in monetary terms. In simple words, only financial transactions are recorded in books of accounts.

3 – Periodicity Concept

The periodicity concept states that the entity or the business needs to carry out the accounting for a definite period, usually the financial year. The period for drawing financial statements can vary from monthly to quarterly to annually. It helps in identifying any changes occurring over different periods.

4 – Accrual Concept

According to Accrual Accounting, the transaction is recorded on a mercantile basis. In other words, transactions are to be recorded as and when they occur, not as and when the cash is received or paid, and for the period the transaction pertains.

5 – Matching Concept

The matching concept is linked to the Periodicity concept and Accrual concept. The matching concept states that during the period for which revenue has been considered, the entity needs to account for expenses only relating to that period. It means that the entity has to record revenue and expenses for the same period

6 – Going Concern Concept

Going concern concept assumes that the business will be carried out on an ongoing basis. Thus, the books of accounts for the entity are prepared such that the business will be carried on for years to come

7 – Cost Concept

The cost concept states that any asset that the entity records shall be recorded at historical cost value, i.e., the asset's acquisition cost.

8 – Realization Concept

This concept is related to the cost concept. The realization concept states that the entity should record an asset at cost until and unless the realizable value of the asset has been realized. Practically, it will be correct to say that the entity will record the realized value of the asset once the asset has been sold or disposed of off, as the case may be.

9 – Dual Aspect Concept

This concept is the backbone of the double-entry bookkeeping system. It states that every transaction has two aspects, debit and credit. The entity has to record every transaction and give effect to both debit and credit elements.

10 – Conservatism

This conservatism concept states that the entity needs to prepare and maintain its book of accounts on a prudent basis. Conservatism says that the entity has to provide for any expected losses or expenses; however, it does not recognize future revenue expected.

11 – Consistency

The accounting policies are followed consistently to achieve the intention of comparing the financial statements of various periods or for that matter of multiple entities.

12 – Materiality

The materiality concept explains that the financial statements should show all the items having a significant economic effect on the business. It allows ignoring the

other concepts if the item to be disclosed has an insignificant impact on the entity's business, and the efforts involved in recording the same are not worthwhile

Objectives of Accounting Concepts

- The main objective is to achieve uniformity and consistency in preparing and maintaining financial statements.
- It acts as the underlying principle that assists accountants in preparing and maintaining business records.
- It aims to achieve a common understanding of rules or assumptions to be followed by all types of entities, thereby facilitating comprehensive and comparable financial information.

Importance of Accounting Concept

- The importance of the accounting concept is visible in the fact that its application is involved in every step of recording a financial transaction of the entity.
- Following the generally accepted accounting concepts helps save the accountants' time, effort, and energy, as the framework is already set.
- It improves the quality of financial statements and reports concerning the understandability, reliability, relevance, and comparability of such financial statements and reports.

Accounting Convictions

Accounting conventions are certain guidelines for complicated and unclear business transactions. While standardizing the financial reporting process, these conventions consider comparison, relevance, full disclosure of transactions, and application in financial statements.

1 – Conservatism

The accountant has to follow the conservatism principle of "playing safe" while preparing financial statements, considering all possible loss scenarios while recording transactions. There are specific points used for criticizing such a principle. Two values occurred while logging assets, i.e., Market value and Book Value. A lower value is generally considered since these conventions consider the worst-case scenario. In some instances, it's observed that private reserves are being created by

showing excess provision for bad debt and doubtful debts, depreciation, etc. And this affects the principle of 'true and fair status of financial conditions.'

2 – Consistency

Once a particular method is selected by the business while reporting, it should be followed consistently in the ensuing years. This principle is helpful for investors and analysts to read, understand, and compare the company's financial statements. If the company wants to change the method, it should do so only with good reasons to make specific changes. Certain points criticize this principle, like considering certain items on a cost basis while others at market value void the principle of consistency in accounting. Still, accounting convention considers consistency in reporting methods over the years and not consistency with line items in comparison.

3 – Full Disclosure

Relevant and important information regarding the company's financial status must be revealed in financial statements even after applying the accounting convention. E.g. Contingent Liabilities, and Law Suits against a business should be reported in adjoined notes in the company's financial statements.

4 – Materiality

Materiality Concept includes the impact of an event or item and its relevance in financial statements. It means materiality allows an accountant to ignore certain principles when items are not material. The accountant must report all such events and items that might influence the decision of investors or analysts. However, the information should be worthy of investigation and should have a higher value than the cost of preparation of statements. E.g., Low-cost assets like stationery and cleaning supplies are charged under expense account instead of regular depreciating assets.

Importance

- Monetary Impact: Accounting considers only items and events with monetary value. Items such as Market leadership, management efficiency, skills are not considered in accounting as it does not directly reflect the financial impact on business.
- Different Entity: Accounting convention ensures that owners' private transactions should not interfere with business transactions. Since businesses and

owners are treated as two separate legal entities by law, this should be followed in business.

- Realization: Convention concentrates on the completed transaction. Transfer of ownership or sale of an asset or product should not be considered at the point of contract but when the entire process completes.
- Understanding: There should be clarity of information in financial statements so that investors or analysts who read them must understand such data.
- Comparison: Many Investors and analysts compare the company's financial statements with their peers to analyze performance over a period. They make sure any information reported is in a way that will make it easy for investors.
- Reliable: They ensure reliable information is segregated and reported in financial statements.
- Neutral: They state that the accountant should make financial statements with no stake in a company or a biased opinion.

Advantages

- Credibility: Financial Statements prepared according to accounting standards and conventions are much more reliable and accurate. It increases the confidence of investors. The following specific methods disclose relevant information.
- Planning and Decision: It provides enough information regarding financial data.
- Easy to Compare: Accounting conventions ensure that multiple companies report the transaction in the same manner as described. Thus making it easy for investors, creditors, and analysts to compare the performance of peer groups of companies.
- Efficiency: Accounting standards and conventions provide efficiency in the reporting process, making it easier for an accountant. Even users of such financial statements benefitted as such standards are applicable and followed by all companies.
- Management Decisions: They help management make important decisions that affect business. E.g., the Prudence concept makes sure revenues are recorded when realized, but liabilities and expenses are recorded as soon as they occurred.
- Reduce Fraud: It is guidelines for certain business transactions, which are fully explained by accounting standards. Although not legally binding, accounting

conventions make sure that financial statements provide relevant information in a particular manner.

- Reduce Wastage and Save Time: Accounting conventions like materiality makes sure that financial statements record all items and events worth value. This convention helps the accountant to ignore certain principles and concentrate on relevant items.

Accounting Concept vs. Convention

Accounting Concepts Accounting Convictions

Refers to a set of rules and assumptions to be followed while recording financial transactions.It refers to generally accepted practices followed by the accountants.

The accounting bodies of the country set the rules and assumptions to be followed, generally in line with internationally accepted accounting policies. Conventions are the implied accounting practices followed by an entity. Any accounting authority does not govern the same; however, there is a general agreement between the accounting bodies to accept the conventions in practice

To be followed at every step of recording the transactions of the business. To be followed while preparing financial statements of the entity.

It is a theoretical approach for preparing and maintaining of books of accounts.
It is a procedural approach that comes into prepared picture post books.

ACCOUNTING STANDARDS

An accounting standard is a set of practices and policies used to systematize bookkeeping and other accounting functions across firms and over time. Accounting standards apply to the full breadth of an entity's financial picture, including assets, liabilities, revenue, expenses, and shareholders' equity.

AS-1 Disclosure of Accounting Policies

AS 1 refers to the disclosure of accounting policies. It states that an enterprise needs to disclose significant accounting policies followed by it to prepare and present its financial statements.

This is because a business entity's state of affairs gets significantly impacted by the accounting policies used in preparing its financial statements.

Typically, every enterprise follows accounting policies appropriate to its own business as well as industry. Thus, an enterprise mandatorily needs to disclose its significant accounting policies in order to present a true and fair view of its state of affairs.

AS-2 Valuation of Inventory

A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard deals with the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. Inventory should be valued at lower cost and net realisable value. Following are the steps for valuation of inventories. A. Determine the cost of inventory B. Determine the net realisable value of inventory C. On comparison with the net realisable value and cost of inventory the lower of the two is considered as the value of inventory.

AS-3 Cash Flow Statement

This accounting standard accounts for information about changes in cash and cash equivalents of an entity during a particular period. Such information is disclosed in the cash flow statement indicating cash flows from operating, investing and financing activities during an accounting period.

Cash flow statement is one of the important financial statements prepared along with income statement and balance sheet. This statement is prepared to provide information regarding the cash flows of an enterprise.

Such information helps the stakeholders to assess the ability of the enterprise to generate cash and cash equivalents. This assessment regarding an entity's ability to generate cash, its timing and certainty helps the stakeholders in taking various economic decisions.

AS-4 Contingencies And Event Occurring After Balance Sheet Date

Events Occurring After The Date of Balance Sheet refer to the ones that: take place between the date of balance sheet and the date on which such financial statements are approved and. such events suggest a requirement to adjust assets and liabilities on the balance sheet date or may need a disclosure.

A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Accounting Treatment:
If it is likely that a contingency will result in

LOSS: It is prudent to provide for that loss in the financial statements.
PROFIT: Not recognized as revenue (However, when the realization of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.)

AS-5 Net Profit Or Loss For The Period, Prior Period Items And Changes In Accounting Policies

Accounting Standard 5 (AS 5) deals with the classification and disclosure of specific items in the Statement of Profit and Loss.
The purpose of AS 5 is to suggest such a classification and disclosure in order to bring uniformity in the preparation and presentation of statement of net profit or loss across enterprises.
This enables the enterprises to compare their financial statements over time as well as draw comparison of their financial statements with other enterprises.
Thus, the statement of net profit or loss requires:
- Disclosure of certain items within profit or loss from ordinary activities
- Classification and disclosure of extraordinary and prior period items
- Accounting treatment and disclosure for changes in the accounting estimates
- Disclosure of changes in the accounting policies

AS-6 Depreciation Accounting

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, passage of time or obsolescence through technology and market changes.
Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset.
Depreciation includes amortisation of assets whose useful life is predetermined.
The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

Trial Balance

Trial Balance is a statement summarizing the closing balance of all the ledger accounts, prepared with the view to verify the arithmetical accuracy of ledger posting. In Trial balance, all the ledger balances are posted either on the debit side or credit side of the statement.

The total of debit balance in trial balance should match with a total of credit balance, only then it is said to be arithmetically accurate. Trial balance is a primary source for preparing various financial statements such as Trading and Profit & Loss account, Balance sheet etc.

Trial balance objective

As the name suggests, it's a statement prepared to ensure that journal and ledger postings are done correctly so that closing balances can be considered for preparing the final accounts and other financial statements. Trial Balance acts as a pre-check before preparing the other financial statements. The following are some of the important objectives of trial balance.

- To ascertain the arithmetical accuracy of ledger accounts:

As a summary of all the ledger accounts closing balance, trial balance helps in determining the accuracy of journal and ledger posting. The trial balance is assumed to be accurate only when the total debit is equal to the credit.

- Helps to locate errors

If there any difference in the trial balance, it signals that journal or ledger posting is not carried out efficiently. It clearly implies that there are errors and it is high time for accountants to find and correct it. The error may have occurred at any of the following stages of accounting.

- Posting journal entries to the ledger account
- Totaling of subsidiary books
- Calculation errors
- Posting of Balance from Ledger account to trial balance
- Error in totalling Trial balance and so on ...
- Helps to prepare financial statement

Trial balance is a bridge between accounting records and financial statements. Trial balance is the steppingstone for preparing all the financial statements such as Trading and Profit & loss account, balance sheet etc. Using the trial balance, all the

income and expenses related ledger accounts are compiled to create Profit and loss account and rest are used for preparing a balance sheet.

Features of trial balance

- It is a summary of debit and credit balances which are extracted from various ledger accounts
- It is a summary of debit and credit balances
- The motive behind the preparation of Trial balance is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts
- Trial balance does not prove any arithmetical accuracy of accounts which can only be determined by the audit
- It is not an account. It is only a statement of account
- It is not a part of the final statements
- A Trial balance at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly
- It acts as a bridge between books of accounts and the Profit and Loss Account and Balance sheet

Preparation of trial balance

Preparing trial balance is one of the first steps towards preparing final accounts and other financial statements. Following are the steps to prepare trial balance:

- Preparing ledger accounts to determine the closing balance of each account.
- Post the ledger Accounts into trial balance and place the balance in the debit or credit column. The format of the trial balance is explained in the next section.
- All the assets and expenses should have debit balance while liabilities and income should have a credit balance.
- Calculate the total of the debit balance
- Similarly, compute the total of the credit column
- Finally, the sum of debit balance should match the sum of credit balance.
- If there is any difference, the process of error rectification should be started.

Errors could be of commission errors, errors of omissions, errors of principle, compensating error and so on...

Format

Account Title	L.F	Debit Balance (₹)	Credit Balance (₹)
Capital			
Buildings and Land			
Machinery and Plant			
Equipment			
Fixtures and Furniture			
Cash in Hand			
Cash at Bank			
Debtors			
Receivable Bills			
Raw Materials Stocks			
Finished Goods Stocks			
Purchases			
Carriage Outwards			

Sales			
Sales Return			
Interest Paid Purchases Return			
Commission / Discount Received			
Salaries			
Long Term Loan			
Bills Payable			
Creditors			
Advances from Customers			
Drawings			
Total			

Errors in a Trial Balance

A trial balance can trace the mathematical inaccuracy of the general ledger. However, there are a number of errors that cannot be detected by this report:

- Error of omission: The transaction was not entered into the system.

- Error of original entry: The double-entry transaction includes the wrong amounts on both sides.
- Error of reversal: When a double-entry transaction was entered with the correct amounts, but the account to be debited is credited and the account to be credited is debited.
- Principle error: The entered transaction violates the fundamental principles of accounting. For example, the amount entered was correct and the appropriate side was chosen, but the type of an account was wrong (e.g., expense account instead of liability account).
- Error of commission: The transaction amount is correct, but the account debited or credited is wrong. It is similar to the principle error described above, but commission error is usually a result of oversight, while principle error is a consequence of a lack of knowledge of accounting principles.

Trading and Profit and Loss Account

Trading account

A trading account helps in determining the gross profit or gross loss of a business concern, made strictly out of trading activities. Trading involves buying and selling activities. In the trading account, the cost of goods sold is subtracted from net sales for the period to calculate gross profit. Only direct revenue and direct expenses are considered in it. Trading account is prepared mainly to know the profitability of the goods bought by the businessman.

The difference between selling price and cost of goods sold is the earning for the businessman, which is also known as gross profit. Whereas, net profit means all revenues minus all expenses including the cost of goods sold, the selling, general and administrative expenses, and the non-operating expenses. Thus in order to calculate the gross earning, it is necessary to know the cost of goods sold and sales figures. Also,

Gross Profit = Sales – COGS (Sales + Closing Stock) – (Stock in the beginning + Purchases + Direct Expenses)

Items included on the debit side are opening stock, purchases, and direct expenses and on the credit side are sales and closing stock. The resultant figure is either gross profit or gross loss.

Format

TRADING ACCOUNT (Horizontal Format)

for the year ended.....

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To Opening Stock	xxx	By Sales xxx	
To Purchases xxx		*Less*: Returns inwards (xxx)	xxx
Less: Returns		By Closing Stock	xxx
outwards **(xxx)**	xxx	By Gross Loss c/d*	xxx
To Frieght & Carriage	xxx		
To Customs & Insurance	xxx		
To Wages	xxx		
To Gas, Water & **Fuel**	xxx		
To Factory Expenses	xxx		
To Royalty on Production	xxx		
To Cargo Expenses	xxx		
To Shipping Expenses	xxx		
To Import Duty	xxx		
To Custom Duty			
To Dock Charges			
To Octroi			
. To Commission on Purchases			
To Gross Profit c/d*			
	xxx		xxx

* Either of two will appear

Items in a Trading Account

Opening Stock – The unsold stock remaining from the previous accounting period is the opening stock of the current accounting period. It consists of raw material, work in progress, and finished goods.

Purchase and Purchase Returns – Goods and services bought for resale are collectively termed as purchases for the business. The goods may have been acquired in cash or credit and once purchased if the goods are returned to the supplier for any reason it becomes a part of purchase returns or returns outward.

Direct Expenses – Expenses incurred while purchasing goods till the time they are brought to a saleable condition are called direct expenses. These are expenses

related to the core business operations of a company. For example – Wages, Carriage Inwards, Power, Freight, etc.

Sales and Sales Return – Goods sold in cash and credit by the business to earn profits are included under the head "Sales". Items once sold may be returned by the customers due to various reasons which are termed as sales returns or returns inward.

Closing Stock – The unsold stock in hand at the end of the current accounting period is placed under the head "closing stock". It is valued at the end of an accounting period at cost or net realisable value whichever is lower.

Gross Profit or Gross Loss – After all items of trading are arranged in the prescribed trading account format the account must be balanced to determine loss or profit arising out of selling activities.

If sales are higher than purchases i.e. Credit side is bigger than the Debit side then the difference is termed as "Gross Profit", this is then transferred to the Profit & Loss account.

Features of trading account

A trading account can offer varying features depending on where you open the account. Brokers are generally categorized as either traditional (full-service broker) or budget (discount broker) brokers. Traditional brokers provide all kinds of add-on services, which can include:

- Wealth building
- Retirement planning
- Tax returns
- Insurances
- Investment Advice

They charge a hefty amount for these services, which includes commissions, annual fees and a percentage of the assets managed by them.

On the other hand, budget brokers or discount trading accounts are unlikely to dump a whole lot of confusing add-on services on the customer. They, however, do deliver more value on a smaller budget. Discount brokers are ideal for value-conscious investors who trust their own judgment and research. Discount brokers charge a minimal commission for their services and are rapidly gaining in popularity all over the globe.

Both kinds of brokers, however, are likely to offer you features such as margin trading, which allows traders to leverage their cash and trade in much larger volumes than their cash would allow.

Objectives of trading account

Traders looking to open a trading account have fairly simple and concise needs - to facilitate the multiple tasks essential for all types of securities trading.

- The trader (you) or the broker can keep a track of all the orders placed using the trading account - including executed orders, partially executed orders, and failed orders. This is usually referred to as the Order Book by all brokers.
- A trading account thus helps you monitor your progress by comparing your present figures with the figures of the previous trading year, all of it available in the Trade Book history.
- You can also check all the stocks at the start (open) and end (close) of a particular trading day.
- The stock turnover ratio can be determined from the trading account. This rate can be used to measure the failure or success of businesses.

Profit and Loss Account

A profit and loss (P&L) account shows the annual net profit or net loss of a business. It is prepared to determine the net profit or net loss of a trader. The P&L account is a component of final accounts.

A profit and loss account is prepared to determine the net income (performance result) of an enterprise for the year/period. This is the most significant information to be reported for decision making.

Net income or net profit is calculated by charging all operating expenses and by considering other incomes earned in the form of commission, interest, rent, discounts, and fees.

In fact, the profit and loss account is prepared by following the accrual system of accounting, in which gross profit and other operating incomes are credited and all operating expenses are debited.

The resulting effect is either net profit or net loss. If the total amount of gross profit and other operating incomes exceeds the operating expenses, the difference is treated as net income or net profit.

By contrast, if the total amount of gross profit and other operating incomes is less than the operating expenses, then the difference is treated as a net loss.

The following items usually appear on the debit and credit side of a profit and loss account.

On the debit side:

1. Gross loss (transferred from trading account)
2. All indirect expenses

On the credit side:

1. Gross profit (transferred from trading account)
2. All indirect revenues

Net Profit or Net Loss

Net profit or net loss is the difference between the total revenue for a certain period and the total expenses for the same period.

A company reports net profits when its total revenues exceed its total expenses. If the value for total revenues is less than the total expenses, a net loss is incurred.

The resulting balance at the bottom of a profit and loss account (see below) represents either a net profit or net loss that will be transferred to the capital account.

Format of Profit and Loss Account

ABC Company
Profit and Loss Account
For the year ended 31st Dec. ....

	$		$
Gross Loss (Transferred from Trading A/c)	xxxx	Gross Profit (Transferred from Trading A/c)	xxxx
Office and Administration Expenses:		Commission Received	xxxx
Salaries	xxxx	Rent Received	xxxx
Rent, Rates and Taxes	xxxx	Interest received	xxxx
Postage and Telegram	xxxx	Discount received	xxxx
Telephone Charges	xxxx	Discount from Creditors	xxxx
Printing and Stationery	xxxx	Discount on Purchases	xxxx
Office Electricity	xxxx	Dividend Received	xxxx
Insurance	xxxx	Interest on Drawings	xxxx
Legal Charges	xxxx	Reserve for Discount on Creditors	xxxx
Marketing and Selling Expenses		Interest on Renewal of bills	xxxx
Carriage outwards	xxxx	Bad Debts Recovered	xxxx
Freight Outwards	xxxx	Provision for Bad Debts (Cr.)	xxxx
Sales Salaries	xxxx	Royalty Received	xxxx
Advertisement	xxxx	Apprentice Premium	xxxx
Godown Rent	xxxx	Miscellaneous Income	xxxx
Commissions	xxxx	Sundry Income	xxxx
Discount Allowed	xxxx		
Bad Debts	xxxx		
Financial and Other Expenses:			
Bank Charges	xxxx		
Interest	xxxx		
Depreciation	xxxx		
Repairs and Maintenance	xxxx		
Audit Fees	xxxx		
Loss by Theft, Accident and Fire	xxxx		
Miscellaneous and Sundry Expenses	xxxx		
Net Profit Transferred to Capital	xxxx	Net Loss (Transferred to Capital)	xxxx

Balance Sheet

In financial accounting, a balance sheet is a summary of the financial balances of an individual or organization, whether it be a sole proprietorship, a business partnership, a corporation, private limited company or other organization such as government or not-for-profit entity.

A balance sheet serves as reference documents for investors and other stakeholders to get an idea of the financial health of an organization. It enables them to compare current assets and liabilities to determine the business's liquidity, or calculate the rate at which the company generates returns. Comparing two or more balance sheets from different points in time can also show how a business has grown.

With this information, stakeholders can also understand the company's prospects. For instance, the balance sheet can be used as proof of creditworthiness when the company is applying for loans. By seeing whether current assets are greater than current liabilities, creditors can see whether the company can fulfill its short-term obligations and how much financial risk it is taking.

Features of Balance Sheet:

The features of a balance sheet are as follows:

- It is regarded as the last step in final accounts creation
- It is a statement and not an account
- It consists of transactions recorded under two sides namely, assets and liabilities. Assets are placed in the lefthand side, while the liabilities are placed on the righthand side
- The total of both side should always be equal
- The balance sheet discloses financial position of the business
- It is prepared after trading and profit and loss account is prepared.

Importance of Balance Sheet:

Balance sheet analysis can say many things about a company's achievement. Few essential factors of the balance sheet are listed below:

- Creditors, investors, and other stakeholders use this financial tool to know the financial status of a business.
- It is used to analyse a company's growth by comparing different years.
- While applying for a business loan, a company has to submit a balance sheet to the bank.

- Stakeholders can find out the business accomplishment and liquidity position of a company.
- Company's balance sheet analysis can detect business expansion and future expenses.

Purpose of Balance Sheet

1. Compose a trial balance- It is a regular report included in any accounting programme. If it is a manual mode, then create a trial balance by transferring every general ledger account's ending balance to a spreadsheet.
2. Arrange the trial balance- It is important to arrange the initial trial balance to assure that the balance sheet similar to the relevant accounting structure. While using adjusting entries to adjust the trial balance all the entry should be completely recorded so the auditors can understand why it was made.
3. Discard all expense and revenue accounts- The trial balance includes expenses, revenue, losses, gains, liabilities, equity, and assets. Delete all from the trial balance except equity, liabilities, and assets. However, the deleted accounts are used to create an income statement.
4. Calculate the remaining accounts- In this stage, sum up all the trial balance account used to create a balance sheet. The typical line items used in the balance sheet are:
    - Cash
    - Accounts receivable
    - Inventory
    - Fixed assets
    - Other assets
    - Accounts payable
    - Accrued liabilities
    - Debt
    - Other liabilities
    - Common stock
    - Retained earnings
5. Validate the balance sheet- The total for all assets recorded in the balance sheet should be similar to the liabilities and stockholders' equity accounts.
6. Present in the required balance sheet format.

Format

Balance Sheet Template

Company Name Here

Balance Sheet

For the Period Ended ____________

Assets			
Current Assets			
Cash		000000	
Short-term investments		00000	
Accounts Receivables		00000	
Inventories		0000000	
Prepaid insurance		000000	
Others		00000	000000
Long Term Investments			
Stock investments		000000	
Cash Value of insurance		0000000	000000
Fixed Assets			
Land		000000	
Building and Equipment	0000000		
Less Accumulated Depreciation	(00000)	000000	0000000
Intangible Assets			
Good Will			0000000
Other Assets			
Receivables from Employees			00000000
Total Assets			000000000

Liabilities			
Current Liabilities			
Accounts Payable		000000	
Salaries Payable		00000	
Accrued Interest		00000	
Taxes Payable		0000	
Current Portion of Notes		000000	00000000
Long Term Liabilities			
Note Payable		000000	
Mortgage Liability		000000	00000000
Total Liabilities			00000000
Stock Holder's Equity			
Capital Stock		00000000	
Retained Earnings		0000000	
Total Stock Holder's Equity			000000
Total Liabilities			000000000

Key elements & components of a balance sheet

A balance sheet consists of two main headings: assets and liabilities.

Assets

An asset is something that the company owns and that is beneficial for the growth of the business. Assets can be classified based on convertibility, physical existence, and usage.

a. Convertibility: This describes whether the asset can be easily converted to cash. Based on convertibility, assets are further classified into current assets and fixed assets.

1. Current assets: Assets which can be easily converted into cash or cash equivalents within a duration of one year. Examples include short-term deposits, marketable securities, and stock.
2. Fixed assets: Assets which cannot be easily or readily converted to cash. For example, buildings, machinery, equipment, or trademarks.

b. Physical existence: Assets can be of two types, tangible and intangible.

1. Tangible assets: Assets which you can see and feel, like office supplies, machinery, equipment, and buildings.
2. Intangible assets: Assets which do not have physical existence, like patents, brands, and copyrights.

c. Usage: Assets can be classified as operating and non-operating assets.

1. Operating assets: Assets which are necessary to conduct business operations. For example, buildings, machinery, and equipment.
2. Non-operating assets: Short-term investments or marketable securities that are not necessary for daily operations.

Liabilities

Liabilities are what the company owes to other parties. This includes debts and other financial obligations that arise as an outcome of business transactions. Companies settle their liabilities by paying them back in cash or providing an equivalent service to the other party. Liabilities are listed on the right side of the balance sheet.

Depending on context, liabilities can be classified as current and non-current.

1. Current liabilities: These include debts or obligations that have to be fulfilled within a year. Current liabilities are also called short-term assets, and they include accounts payable, interest payable, and short-term loans.
2. Non-current liabilities: These are debts or obligations for which the due date is more than a year. Non-current liabilities, also called long-term liabilities, include bonds payable, long-term notes payable, and deferred tax liabilities.

Owner’s Equity/ Earnings

Owner’s equity is equal to total assets minus total liabilities. In other words, it is the amount that can be handed over to shareholders after the debts have been paid and the assets have been liquidated. Equity is one of the most common ways to represent the net value of the company. Part of shareholder’s equity is retained

earnings, which is a fixed percentage of the shareholder's equity that has to be paid as dividends.

The equity value can be positive or negative. If the shareholder's equity is positive, then the company has enough assets to pay off its liabilities. If it is negative, then liabilities exceed assets.

General sequence of accounts in a balance sheet

According to Generally Accepted Accounting Principles (GAAP), current assets must be listed separately from liabilities. Likewise, current liabilities must be represented separately from long-term liabilities. Current asset accounts include cash, accounts receivable, inventory, and prepaid expenses, while long-term asset accounts include long-term investments, fixed assets, and intangible assets.

Under your current liability accounts, you can have long-term debt, interest payable, salaries, and customer payments, while long-term liabilities include long-term debts, pension fund liability, and bonds payable.

Asset accounts will be noted in descending order of maturity, while liabilities will be arranged in ascending order. Under shareholder's equity, accounts are arranged in decreasing order of priority.

Balance sheet formula & equation

The balance sheet equation follows the accounting equation, where assets are on one side, liabilities and shareholder's equity are on the other side, and both sides balance out.

Assets = Liabilities + Shareholder's Equity

According to the equation, a company pays for what it owns (assets) by borrowing money as a service (liabilities) or taking from the shareholders or investors (equity).

Types of Balance Sheet

Classified Balance Sheet

This format groups information about liabilities, an entity's assets, and equity into subcategories of accounts (or classifies it). It is the most common balance sheet presentation, and it does an excellent job of merging many different funds into a readable format. To make data more comparable, accountants should present balance sheet data in the same classification structure throughout various periods.

A classified balance sheet divides asset, liability, and equity accounts into manageable divisions for the reader's advantage. To put it another way, it breaks down each of the balance sheet accounts into smaller sections, making the report more valuable and informative.

Vertical Balance Sheet

This type is shown as a single column of data, with assets appearing first, liabilities appearing second, and shareholders' equity appearing last. Within each of these categories, line items are shown based on their liquidity (how fast they can be turned to cash).

For example in the asset side, it begins with cash and ends with non-current assets, which are considerably less liquid than cash or credit. For the same basis, the liabilities section is often ordered from accounts payable to long-term debt.

A vertical balance sheet is intended to allow the reader to examine all of the balance sheet information at the same time. Comparing total current assets to entire current liabilities to establish a company's financial status as of the balance sheet date.

Other Useful Ways to Present the Balance Sheet

1. Comparative Balance Sheet

Comparative balance sheets show if a company's net worth is increasing or decreasing and whether its debt commitments are decreasing.

It is also possible to generate a classified comparative balance sheet. A comparative balance sheet is a financial statement that depicts an organisation's financial situation across a period for which a comparison is made or is required. The financial position is compared with two or more periods to indicate the trend, direction of change, appraisal, and relevant measures.

Given the importance of the comparative balance sheet, most organisations in various business sectors prepare one compared to their competitors as a benchmark.

2. Common size balance sheet

A common size balance sheet presents the information of the balance sheet as a percentage of the total assets for the asset line and percentage of total liabilities and owners' equity for their corresponding side.

It is another way that can assist the analyst to identify the percentages and compare it historically and between different businesses.

3. Final Thoughts

Building and managing balance sheets is crucial for every business, whichever type is there, however, we should always keep in mind that is is a utility and every business have their own way in preparing and interpreting their information.