Revision Notes

Chapter-8

Financial Statements of Sole Proprietorship

Learning Objectives

After studying this lesson you should be able to;

- State the nature of the financial statements;
- Distinguish between the capital and revenue expenditure and receipts.
- Explain the concept of trading and profit and loss account and its preparation.
- State the nature of gross profit, net profit and operating profit.
- Describe the concept of balance sheet and its preparation.
- Explain grouping and marshalling of assets and liabilities.
- Prepare profit and loss account and balance sheet of a sole proprietor firm.

Teaching methodology
For teaching this topic the teacher should use discussion method, explanation method, illustration method etc.

Financial Statements
Financial statement are those statement that show the profitability (Income statement) and the financial position (Balance Sheet) of the business at the end of accounting period.
In the word of John N. Myer "The financial statement provide a summary of the accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the result of operation during a certain period"

Financial statements include the following statements:

i. **Income statement (Trading and Profit and Loss Account)** - prepared to ascertain gross profit/loss and net profit/loss during an accounting period.
ii. **Statement of Financial Position (Balance Sheet)** - prepared to ascertain position (assets, liabilities and capital) of an enterprise at a particular point of time.
iii. **Schedules and notes forming part of Balance sheet and Income statement** - to give

details of various items shown in both the statements.

These two Financial Statements (Income Statement and Statement of Financial Position) are termed as 'Final Accounts'.

Objective of Preparing Financial Statements.

i. To present a true and fair view of the financial performance (Profit/Loss) of the business.
ii. To present a true and fair view of the financial position (Assets/Liabilities) of the business.

Capital Expenditure

The non-recurring expenditure whose benefit is derived by the business for more than a year is called Capital Expenditure.

It includes the amount spent or liabilities incurred to acquire or improve any fixed asset or acquiring any legal rights or first-time expenses incurred to make fixed assets workable e.g. purchase of machinery/building/furniture etc., expenses incurred to acquire Patents, Trade-marks etc. and expenditure incurred for making an asset ready to use (like installation exp., carriage, first time expenses incurred on second hand fixed asset for making it ready to use). Capital expenditures are recorded on the assets side of the Balance sheet.

Revenue Expenditure

The recurring and routine nature expenditures which are incurred for operating the business smoothly and which help to maintain business's earning capacity, are called Revenue expenditures e.g. expenses incurred for producing finished goods such as direct expenses, purchase of raw material and other expenses as rent, salary, repairs etc.

The benefit of these expenses last up to one year (give benefit up to one year). These expenses are shown on Debit side of the income statement (trading and profit and loss account).

Deferred Revenue Expenditure

The expenditure which is revenue in nature, but the heavy amount spent and benefit likely to be derived over a number of years called deferred revenue expenditure e.g. heavy expenses on advertising on launching of a new product and hence it is capitalized like any fixed asset.

Accounting treatment of Deferred Revenue Expenditure

As per matching principle, expenses incurred in an accounting period are matched with the revenue recognized in that accounting period. So the whole deferred revenue expenditure should be spread over the number of years over which the benefit is likely to be derived. During the current accounting year: (a) Only that portion of the expenditure should be charged to the profit and loss account which has facilitated the enterprise to earn revenue during current year (b) Remaining amount of expenditure should be carried forward to the next year and shown on the assets side of the balance sheet.

Capital Receipt

Capital receipts are those irregular receipts that don't affect profit or loss of the business; it either increases the liabilities (raising of loans) or reduces the fixed assets (sale of fixed assets), so they will be shown in the balance sheet.
Capital receipts are not made available for distribution as profit to the owner.

Revenue Receipt

Revenue receipts are received in the normal and regular course of business like Receipts from sale of goods and rendering services to customers. Income from non-operating business activities like income from investment i.e. interest and dividend received and rent received, Commission and other fees received for non-operating business etc. These receipts increases profit and are shown on the credit side of the Trading and Profit and Loss account.

Types of Expenses

Direct Expenses: Those expenses which are incurred on purchasing of goods and for converting the raw materials into the finished goods e.g. Manufacturing wages, Expenses on purchases (including all duties and taxes paid on purchases), Carriage/Freight/Cartage inwards, Production expenses (such as power and fuel, water etc.), factory expenses (e.g. lighting, rent and rates), Royalty based on Production etc.
Note: All direct expenses are debited to Trading account.

Indirect Expenses: Those expenses which are not directly related to production or purchase of the goods are called indirect expenses. It includes those expenses which are related to office and administration, selling and distribution of goods and financial expenses etc. These expenses are shown on the debit side of the Profit and Loss A/c.

Calculation of Gross Profit

Gross Profit = Net Sales - Cost of Goods Sold
Net Sale = Total Sale - Sale Return
Cost of goods sold = Opening Stock + Net Purchases + Direct Expenses (Wages, Expenses on Purchases, Carriage inward etc.) - Closing Stock.
Net Purchases = Total Purchases - Purchases Return

Calculation of Operating Profit
Operating profit = Net sales - Operating cost
OR = Gross Profit - (Office and Administrative Expenses + Selling and distribution exp.)
Operating Cost = Cost of Goods Sold + Office and Administrative Expenses + Selling and distribution exp.
Net Profit = Operating Profit + Non-operating Income - Non-operating expenses.

Operating expenses: The expenses which are related to the main or normal activities of the business e.g. office and Administrative expenses, selling and distribution expenses.
Operating profit is also called EBIT (Earnings before interest and taxes).

Income Statement
It is divided into two pars:

1. Trading Account which shows the gross profit or gross loss.
2. Profit and Loss Account which shows the net profit or net loss.

Format of Trading Account

Name of Business Firm
Trading Account

Dr.					Cr.
Particulars		**Rs.**	**Particulars**		**Rs.**
To Opening Stock		____	By Sales	__	
To Purchases	__		Less: Returns Inward/Sales Returns	__	
Less: Purchases Returns/ Returns outwards	__	____	By Scrap sales		___

To All Direct Expenses	____	By Closing Stock	___
To Wages	____		
To Wages & Salaries			
To Carriage of Carriage Inwards Carriage on purchases	____		
To Direct Expenses	____		
To Gas, Fuel and power	____		
To Freight, octroi and cartage	____		
To Manufacturing Expenses or Productive expenses	____		
To Custom or import duty	____		
To Dock and clearing charge	____		
To Excise duty	____		
To Factory rent and lighting	____		
To other direct charges	____		
To Royalty	____		
To Gross Profit transferred to Profit & Loss A/c) (Balance figure)	____	By Gross Loss transferred to Profit & Loss A/c) (Balance figure)	(Balance figure)

Formal of Profit & Loss Account

Profit & Loss A/c
for the Year Ended……

Dr			Cr
Particulars	**Rs.**	**Particulars**	**Rs.**
To Gross Loss (Transferred from Trading A/c)		By Gross Profit (Transferred from Trading A/c)	
To Office & Admin. Expenses		By Rent Received	

To Salaries		By Rent (Cr.)	
To Rent Rates Taxes		By Discount Received	
To Printing and Stationery		By Discount (Cr.)	
To Salaries & Wages		By Rebates	
To Postages and Telephones		By Commission Received	
To Office Lighting		By Interest Received	
To Insurance Premium		By Dividend Received	
To Legal Expenses		By Bad Debts Recovered	
To Establishment Expenses		By Apprentice fees or premium	
To Audit Fees		By Gain on Sale of Fixed Asset	
To Trade Expenses		By Miscellaneous Receipts	
To Travelling Expenses		By Net Loss (If Dr. side > Cr. side) (Transferred to capital Account)	
To General Expenses			
To Selling & Distribution Exp.			
To Carriage and Freight Outwards			
To Commission			
To Brokerage			
To Advertisement			
To Publicity			
To Bad Debts			
To Export Duty			
To Packing Expenses			
To Salaries of Salesman			
To Delivery Van Expenses			
To Financial Exp.			
To Interest paid on loans			

To Interest (Dr.)			
To Discounts (Dr.)			
To Rebate Allowed			
To Bank Charges			
To Miscellaneous Exp.			
To Repairs			
To Depreciation on Fixed Assets			
To Conveyance Expenses			
To Entertainment Expenses			
To Donations & Charity			
To Loss on Sale of Fixed Assets			
To Stable Expenses			
To Loss by Fire			
To Loss by theft			
To Unproductive Expenses			
To Net Profit Transferred to Capital Account (If Cr. side > Dr, side)			

- The words 'To' and 'By' are generally not used these days.
- The name of Business Firm is stated on the top of trading & P & L A/c.

Balance Sheet
Meaning of Balance Sheet
Balance sheet is a summarised statement of assets and liabilities, prepared generally at the end of financial year to show the financial position of the business. All liabilities are put on the lef hand side of balance sheet where all assets are shown on its right hand side.

Grouping and Marshalling of Assets and Liabilities

Grouping: The term 'Grouping' means putting together items of a similar nature under a common heading. For example, under the heading 'trade Creditors' the balances of the ledger accounts of all the suppliers from whom goods have been purchased on credit, will be shown.

Marshalling: It refers to the order in which the various assets and liabilities are shown in the Balance Sheet. The assets and liabilities can be shown either in the order of liquidity or in the order of permanence.

Order of Liquidity

1. The assets are arranged in the order of their liquidity i.e., the most liquid asset (e.g., cash-in-hand), is shown first. The least liquid asset (e.g., goodwill) is shown last.
2. The liabilities are arranged in the order of timing i.e., the liabilities which are to be paid immediately {e.g., Creditors) are shown first and which are to be paid later are shown at last (long-term loans).
   A general format of a Balance Sheet in order of liquidity is shown below:

Balance Sheet of ……….
As at…………..

Liabilities	Rs.	Assets	Rs.
Current Liabilities:		**Current Assets:**	
Bank Overdraft		Cash-in hand	
Bills Payable		Cash at Bank	
Sundry Creditors		Bills Receivable	
Outstanding Expenses		Short Term Investment	
Income received-in-advance		Sundry Debtors	
Long-term Liabilities:		Prepaid Expenses	
Long term loan		Accrued Income	
Reserve and Surplus		Closing Stock	
Capital:		**Investment: (Long term)**	
Add : Interest on Capital		**Fixed Assets:**	
Add : Net Profit		Furniture and Fixtures	

Less : Drawings		Plant & Machinery	
Less : Interest on Drawings		Building	
Less : Income Tax		Land	
Less : Life Insurance Premium		Goodwill	
Less : Net Loss			

Order of Permanence: This order is exactly reverse of the liquidity order

1. The assets are arranged in the order of their permanence i.e., the least liquid asset (e.g., goodwill) is shown first and the most liquid asset (e.g., Cash-in-hand) is shown last.
2. The least urgent payment to be made (e.g., short-term creditors) is shown last.
3. A company is required to prepare the balance sheet in the order of permanence.

A general format of a Balance Sheet in the order of performance is shown below:

Balance Sheet of …………
As at………….

Liabilities	Rs.	Assets	Rs.
Capital:		**Fixed Assets:**	
Opening Balance XX		Good will	
Add: Net Profit XX		Land	
(Less: Net Loss)		Building	
Less: Drawings XX	XXX	Plant & Machinery	
Long-term Liabilities:		Furniture & Fixtures	
Long term loan		Investment: (long term)	
Current liabilities:		Current Assets:	
Income received-in-advance		Closing stock	
Outstanding Expenses		Accrued income	
Sundry Creditors		Prepaid expenses	

Bills Payable		Sundry Debtors	
Bank Overdraft		Bills Receivable	
		Cash at Bank	
		Cash in Hand	

Adjustment in preparation of financial statements of Sole-proprietor

Meaning of Adjustment entries: Those entries which need to be passed at the end of the accounting year to show the accurate profit or loss and fair financial position of the business.

Need of Adjustment: There are number of transactions that may not find the place in the Trial Balance due to any reason such as Closing Stock (because it is valued at the end of the year), Manager’s Commission based on Net profits (because its calculation requires preparation of Income Statement first). These transactions can only be taken into account by passing Adjustment entries so that their impact on the profitability and financial position can be shown.

Closing Stock: the closing stock represents the cost of unsold goods lying in the stores at the end of the accounting period.

Outstanding Expenses: When expenses of an accounting period remain unpaid at the end of an accounting period, they are termed as outstanding expenses.
As they relate to the earning of revenue during the current accounting year, it is logical that they should be duly charged against the revenue for computation of the correct amount of profit or loss.

Prepaid Expenses: At the end of the accounting year, it is found that the benefits of some expenses have not yet been fully received; a portion of its benefit would be received in the next accounting year. This portion of expenses, is carried forward to the next year and is termed as prepaid expenses.

Accrued Income: It may sometime happen that certain items of income such as a interest on loan, commission, rent, etc. are earned during the current accounting year but have not been actually received by the end of the same year. Such incomes are known as accrued income. .

Income Received in Advance: Sometimes, a certain income is received but the whole amount of it does not belong to the current period. The portion of the income which belongs to the next accounting period is termed as income received in advance or an Unearned Income.

Depreciation: It is the decline in the value of assets on account of wear and tear and passage of time. It is treated as a business expense and is debited to profit and loss account.
This, in effect, amounts to writing-off a portion of the cost of an asset which has been used in the business for the purpose of earning profits.

Closing Stock	**Closing Stock A/c**	**Dr.**	**(i) Credit side of Trading A/c.**
	To Trading A/c		**(ii) Show on the assets side of BALANCE SHEET.**
Outstanding/Unpaid Expenses	Expenses A/c	Dr.	(i) Add to the concerned item on the Debit side of Trading/Profit & Loss A/c.
	Outstanding Expenses A/c		(ii) Shown on the liabilities side of BALANCE SHEET.
Prepaid expenses/Unexpired expenses	Prepaid Expenses A/c	Dr.	(i) Deduct from the concerned expenses on the debit side of Profit & Loss A/c
	To Expenses A/c		(ii) Show on the assets side of BALANCE SHEET.
Accrued income/ Income due but not received	Accrued Income A/c	Dr.	(i) Add to the concerned income on Credit side of Profit and Loss A/c
	To Income A/c		(ii) Show on the assets side of BALANCE SHEET.
Unearned income/Income received in Advance	Income A/c	Dr.	(i) Deduct from the concerned income on the credit side of Profit & Loss A/c
	To Unearned Income A/c		(ii) Show on the liabilities side of Balance Sheet.

Depreciation	Depreciation A/c	Dr.	(i) Show on the debit side of Profit Loss A/c
	To Asset A/c		(ii) Deduct from the concerned asset in the Balance Sheet.

Bad Debts : The debtors from whom amounts cannot be recovered are treated in the books of accounts as bad and are termed as bad debts.

Further Bad Debts : These Bad debts is a loss that occurred after reparation of Trial Balance. Further bad debts be added in the bad debts already appearing in the Profit and Loss Ae and Debtors would be reduced with the same amount.

Provision for Bad Debts : In the balance sheet, debtors appears on the assets side of the Balance Sheet, which is their estimated realisable value during next year. It is quite possible that the whole of the amount may not be realized in future. However it is not possible to accurately know the amount of such bad debts.
Hence, a reasonable estimate of such loss is provided in the book. Such provision is called provision for bad debts. Provision for doubtful debts is shown as a deduction from the debtors on the asset side of the balance sheet.
Note : The provision for doubtful debts brought forward from the previous year is called the opening provision or old provision. When such a provision already exists, the loss due to bad debts during the current year are adjusted against the same and while making provision for doubtful debts required at the end of the current year is called new provision. The balance of old provision as given in trial balance should also be taken into account.

Provision for discount on Debtors : Discount is allowed to customers to encourage them to make prompt payment. The discount likely to be allowed to customers in an accounting year can be estimated and provided for by creating a provision for Discount on debtors.
Provision for discount on debtors is made on good debtors which are arrived at by deducting further bad debts and provision for bad debts out of Debtors shown in the Balance sheet.

To write off bad debts	Bad Debts A/c	Dr.	(i) Debit side of P&L A/c.
	To Debtors		(ii) Deduct from debtors on the as- sets side of Balance Sheet.

Provision for bad and doubtful debts	Provision for Doubtful Debts A/c	Dr.	(i) Debit side of P & L A/c.
	To Debtors A/c		(ii) Deduct from debtors on the assets side of Balance Sheet.
Provision for discount on debtors	P & L A/c	Dr.	(i) Debit side of P & L A/c.
	To Provision for Discount on Debtors Debtors A/c		(ii) Deduct from debtors on the assets side of Balance Sheet.

Manager's Commission

The manager of the business is sometimes given the commission on the net profit of the company. The percentage of the commission is applied on the profit either before charging such commission or after charging such commission. In the absence of any such information, it is assumed that commission is allowed as a percentage of the net profit before charging such commission.

1. Commission on net profits before charging such commission

$$\text{Commission} = \frac{\text{Net profit before commission} \times \text{Rate of Commission}}{100}$$

2. Commission on net profits after charging such commission

$$\text{Commission} = \frac{\text{Net profit before commission} \times \text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

Interest on Capital	Interest on Capital A/c	Dr.	(i) Debit side of P & L A/c.
	To Capital A/c		(ii) Add to capital on the liabilities side of Balance Sheet.
Interest on drawings	Capital/Drawings A/c	Dr.	(i) Credit side of P & L A/c.
	To Interest on Drawings A/c		(ii) Deduct from capital on the liabilities side of Balance Sheet.
Interest payable on loan (borrowed)	Interest on Loan A/c	Dr.	(i) Debit side of P & L A/c.
	To Loan A/c		(ii) Add to loan on the liabilities side of Balance Sheet.
Commission payable to	P& L A/c	Dr.	(i) Debit side of P & L A/c.

manager	To Comm. Payable to manager A/c		(ii) Show on the liabilities side of Balance Sheet.

Adjustment in Respect of Goods

Abnormal Loss : Sometimes losses occur due to some abnormal circumstances such as accident, fire, flood, earhquakes etc. Such losses are called Abnormal losses. These may be divided into two categories :-

(A) Loss of Goods (B) Loss of fixed assets

Good taken for personal use {Drawings in goods) : When the goods are withdrawn by proprietor for personal use the cost of such goods deduct from purchases and the amount should be deduct from capital in Balance Sheet.

Goods distributed as free samples : Sometime goods are distributed as free sample by the businessman for the purpose of advertisement. The cost of free sample deduct from purchase and shown in Debit side of profit and loss account.

Abnormal loss of goods by fire, theft, accident, etc.

Adjustment	Treatment in Trading & P & L A/c		Treatment in Balance Sheet
1) Loss of Goods (By accident, Fire, Theft)	1) Loss of … A/c	Dr.	(i) Gross Loss: Deduct from Purchases or show on the credit side of Trading A/c.
	To Trading A/c (or)		
	To Purchases A/c		
If goods were note insured	2) P & L A/c	Dr.	(ii) Net Loss: Debit side of P & L A/c.
	To Loss by …… A/c		
If goods were insured and full claim accepted by insurance company	2) Insurance company A/c	Dr.	(iii) Insurance claim: Assets side of Balance Sheet.
	To Loss by …		

	A/c		
If full claim not accepted by Insurance Company	2) Insurance Company A/c	Dr.	
	Profit & Loss A/c	Dr.	
	To Loss By …. A/c		
2) Goods taken by the proprietor for his personal use	Drawings A/c	Dr.	(i) Deduct the amount of goods from the purchases in Trading A/c.
	To Purchases A/c		(ii) Deduct the amount from the capital on the liabilities side of Balance Sheet.
3) Goods distributed as free samples	Advertising A/c	Dr.	(i) Deduct the amount of goods from the purchases in Trading A/c.
	To Purchases A/c		(ii) Show on the debit side of P & L A/c.
4) Goods given as charity	Charity A/c		(i) Deduct the amount from the purchases on the debit side of Trading A/c.
	To Purchases a/c		(ii) Show on the debit side of P & L A/c.

Key Points:

1. **If closing stock** is shown in Trial Balance then it will be shown in balance sheet only. It is assumed that purchases amount already gets adjusted in trial balance.
2. **Salary and wages** will be shown in profit and loss A/c debit side (assuming that salary is prominent) while wages and salary will be shown in trading A/c debit side, (wages are prominent).
3. **Freight, carriage, cartage** will be shown in Dr. side of trading A/c. if inward word attached with these then it also debited to trading A/c, if outward word attached with

these item then it will be debited to profit and loss account.

4. Any expenses related to factory are debited to trading account like factory lighting, factory rent if factory word is not given then lighting and rent will be debited to profit and loss account.
5. **Trade expenses** always debited to profit and loss A/c not as name indicate trading A/c.
6. **Packaging material**: cost of packaging material used in product are direct expenses as it refers to small containers which form part sold, it will debited to trading A/c.
7. **Packing**: the packing refers to the big containers that are used for transporting the goods and regarded as indirect expenses and debited to profit and loss account.
8. **Adjusted purchases** mean the amount of purchases is adjusted by way of adding opening stock and reduced by the amount of closing stock, e.g., purchases Rs. 1,00,000; opening stock Rs. 12,000, closing stock Rs. 8,000. Calculate adjusted purchases.
   Adjusted purchases = purchases + opening stock - closing stock
   = Rs. 1,00,000 + Rs. 12,000 - Rs. 8,000 = Rs. 1,04,000
   When adjusted purchases is given in trail balance, then there is no need of debiting opening stock and crediting closing stock in trading A/c.
   In this case closing stock will be shown in balance sheet only.

Remember

While preparing Final Accounts the items which are given inside the Trial Balance are written only once either in Income Statement or in the Balance Sheet. (Assuming that they have been already adjusted in the respective account). On the other hand, the items which are given outside the Trial Balance (known as adjustment) are to be written twice because the double entry in respect of all adjustments is to be completed in the final accounts itself.