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B.Com Honours

Semester I

Calicut University

Fundamentals of Financial Accounting

Course Code: COM1MN103 • Module 4 Notes

1. Preparation of Trial Balance and Error Classification

The culmination of the ledger stage is the preparation of a Trial Balance, which verifies the mathematical consistency of the accounting database. From the Trial Balance, the final accounts are prepared to report performance and financial status. This final module covers the concepts, methods, and error classifications in Trial Balance preparation, the construction of Final Accounts (Trading, P&L, Balance Sheet) for a sole trader, and the adjustment entries required at fiscal year-end.

Trial Balance: Definition and Objectives

A Trial Balance is a statement prepared at a specific date, listing all debit and credit balances of the ledger accounts, including cash and bank balances. Its primary objectives are to verify the arithmetical accuracy of ledger postings, facilitate the detection of clerical errors, and serve as the source sheet for preparing final financial reports.

Classification of Accounting Errors

Errors in accounting can occur at any stage. They are classified into four main types:

- **Errors of Omission:** A transaction is completely or partially omitted from the books. Complete omission does not affect the Trial Balance agreement.
- **Errors of Commission:** Clerical errors in recording, posting, carrying forward, or totaling (e.g., posting ₹500 as ₹5,000, or posting to the wrong person's account).
- **Errors of Principle:** Recording transactions in violation of accounting principles (e.g., treating capital expenditure as revenue expenditure, like charging machinery repairs to Repairs A/c instead of Machinery A/c). Does not affect Trial Balance agreement.
- **Compensating Errors:** Multiple errors that cancel each other out (e.g., overcasting one account by ₹100 and undercasting another by ₹100). Does not affect Trial Balance agreement.

Trial Balance Agreement Limitations

Agreement of a Trial Balance proves only arithmetical accuracy. It is not conclusive proof of error-free books, as errors of principle, complete omission, and compensating errors can still

exist without causing a discrepancy.

2. Preparation of Final Accounts of a Sole Trader

Final accounts represent the final stage of the accounting cycle. They are prepared to determine profit/loss and financial position, consisting of three main components:

Trading Account

Measures the direct results of trading activities. It matches net sales against direct costs (Cost of Goods Sold - COGS) to find the Gross Profit or Gross Loss. $COGS = \text{Opening Stock} + \text{Direct Purchases} + \text{Direct Expenses} - \text{Closing Stock}$. Charged with carriage inward, wages, and power.

Profit & Loss Account

Measures net profitability. It credits Gross Profit and indirect incomes (e.g., discount received, rent received) and debits indirect operational/financial expenses (e.g., salaries, office rent, interest, depreciation, bad debts) to determine the Net Profit or Net Loss.

Balance Sheet

A statement of financial position at a specific date. It lists Assets (physical, digital, financial claims) and Liabilities (creditors, loans) and Capital (owner's equity adjusted for net profit and drawings). It satisfies: $\text{Assets} = \text{Liabilities} + \text{Capital}$.

3. Key Adjustments in Final Accounts

Adjustments are journal entries passed at the end of the accounting period to update books, satisfying the accrual concept and matching principle. Each adjustment has a dual effect in final accounts:

Adjustment Item	Core Meaning	Effect on Trading/P&L Account	Effect on Balance Sheet
Closing Stock	Unsold goods at the end of the fiscal year.	Credited to the Trading Account.	Shown as a Current Asset under Assets.
Outstanding Expenses	Expenses incurred but not yet paid (e.g., unpaid salaries).	Added to the respective expense on the Debit side of P&L or Trading.	Shown as a Current Liability.
Prepaid Expenses	Expenses paid in advance for the next year (e.g., prepaid insurance).	Deducted from the respective expense on the Debit side of P&L.	Shown as a Current Asset.
Accrued Income	Income earned but not yet received (e.g., accrued interest).	Added to the respective income on the Credit side of P&L.	Shown as a Current Asset.
Income Received in Advance	Income received in the current year but not yet earned (e.g., rent in advance).	Deducted from the respective income on the Credit side of P&L.	Shown as a Current Liability.

Example Adjustment Entry Treatment

Outstanding Wages: If wages of ₹1,000 are outstanding, the adjustment entry is: "Debit Wages A/c and Credit Outstanding Wages A/c". In the Trading Account, ₹1,000 is added to Wages on the debit side. In the Balance Sheet, ₹1,000 is shown on the Liabilities side under current liabilities. This ensures that the current year's wages are fully matched against current year's revenues, even if cash is not paid yet.

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