

# Module 1: Preparation of Financial Statements of Sole Proprietorship

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## 1. Introduction to Accounting: Principles, Concepts, and Conventions

### 1.1 The Meaning and Purpose of Accounting

**Accounting** is the systematic process of identifying, measuring, recording, classifying, summarizing, analyzing, interpreting, and communicating financial information about an economic entity to interested users. It is universally recognized as the "language of business."

#### Objectives of Accounting:

- 1. Maintain Systematic Records:** To replace human memory with a permanent, chronological record of all financial events.
- 2. Ascertain Profit or Loss:** To determine the financial performance (Net Profit/Net Loss) over a specific period through the Income Statement.
- 3. Ascertain Financial Position:** To reveal the exact value of assets, liabilities, and capital at a given point in time through the Balance Sheet.
- 4. Facilitate Decision Making:** To provide management with data for budgeting, pricing, and strategic planning.

### 1.2 Branches of Accounting

- **Financial Accounting:** Focuses on recording historical transactions to prepare final accounts for external users.
- **Cost Accounting:** Focuses on ascertaining and controlling the cost of products or services.
- **Management Accounting:** Focuses on generating analytical reports exclusively for internal management to aid decision-making.

## 1.3 Users of Accounting Information

Internal Users (Inside the Business)	External Users (Outside the Business)
<b>Owners/Proprietors:</b> To assess profitability and return on investment.	<b>Investors:</b> To evaluate the safety and growth of their investments.
<b>Management:</b> For strategic planning, cost control, and performance evaluation.	<b>Creditors/Suppliers:</b> To assess the firm's short-term liquidity and ability to pay debts.
<b>Employees:</b> To assess job security and negotiate fair bonuses/wages.	<b>Banks/Lenders:</b> To evaluate solvency before approving loans.
	<b>Government/Tax Authorities:</b> To assess tax liabilities and regulatory compliance.

## 1.4 Accounting Principles, Concepts, and Conventions

Accounting is governed by **Generally Accepted Accounting Principles (GAAP)**. These rules ensure that financial statements are consistent, reliable, and comparable.

### A. Accounting Concepts (Fundamental Assumptions)

#### 1. Business Entity Concept

**Definition:** The business and its owner are treated as two separate and distinct legal entities.

**Explanation:** Only transactions affecting the business are recorded. Personal transactions of the owner are excluded unless they directly impact the business.

**Example:** If the owner takes ₹10,000 from the business cash register to pay their child's school fee, it is not treated as a business expense. It is recorded as **Drawings** (a reduction in owner's capital).

#### 2. Going Concern Concept

**Definition:** The assumption that the business will continue its operations indefinitely into the foreseeable future.

**Importance:** Because of this concept, we do not record assets at their liquidation (resale) value. Instead, we record them at cost and depreciate them over their useful life.

### 3. Money Measurement Concept

**Definition:** Only transactions and events that can be expressed in terms of monetary value are recorded in the books of accounts.

**Example:** The purchase of a delivery truck for ₹5,00,000 is recorded. The appointment of a highly skilled and brilliant manager—while vital to the business—cannot be quantified in monetary terms and is *not* recorded as an asset.

### 4. Dual Aspect Concept

**Definition:** Every financial transaction has two equal and opposite effects: a Debit and a Credit.

**Logic:** This is the foundation of the Double-Entry system. It gives rise to the fundamental Accounting Equation: **Assets = Liabilities + Capital.**

### 5. Accounting Period Concept

**Definition:** The indefinite life of a business is divided into smaller, equal time intervals (usually one year, April 1 to March 31) to measure performance and financial position.

### 6. Cost Concept (Historical Cost)

**Definition:** Assets are recorded in the books at the exact price paid to acquire them, regardless of changes in their market value over time.

**Example:** If a building was purchased for ₹20 Lakhs ten years ago, it remains in the books at ₹20 Lakhs (less accumulated depreciation), even if its current market value is ₹50 Lakhs.

### 7. Realization Concept

**Definition:** Revenue is recognized (recorded) only when the legal right to receive it is established, meaning when the sale is made or service is rendered, not necessarily when cash is received.

### 8. Matching Concept

**Definition:** All expenses incurred to generate revenue during a specific accounting period must be matched against that revenue to calculate the true profit.

**Example:** If you sell 100 units of goods in March, the cost of purchasing those specific 100 units, plus the sales commission for those units, must be recorded in March, even if the commission is paid in April.

## B. Accounting Conventions (Traditions & Customs)

### 1. Convention of Conservatism (Prudence)

**Definition:** "Anticipate no profit, but provide for all possible losses."

**Exam Tip:** This is the exact reason why Closing Stock is valued at **Cost or Net Realizable Value, whichever is lower**, and why we create a **Provision for Doubtful Debts**.

### 2. Convention of Consistency

**Definition:** Accounting policies and methods should remain unchanged from one period to the next so that financial statements are easily comparable over time. (e.g., sticking to the Straight Line Method of depreciation year after year).

### 3. Convention of Materiality

**Definition:** The accountant should focus on significant, material items. Trivial items that do not impact decision-making can be grouped together or expensed immediately.

**Example:** A stapler has a useful life of 5 years (technically a fixed asset), but because its value is immaterial (₹150), it is immediately written off as "Office Expense."

### 4. Convention of Full Disclosure

**Definition:** Financial statements must honestly and fully disclose all significant information that could affect the judgment of a user. Contingent liabilities (like pending lawsuits) must be disclosed in the footnotes.

## 2. Income Statement of Sole Proprietorship

### 2.1 Meaning and Purpose

The Income Statement is prepared at the end of the accounting period to determine the financial performance of the business. For a sole proprietorship, it is divided into two distinct accounts:

1. **Trading Account:** Calculates **Gross Profit / Gross Loss**.
2. **Profit & Loss (P&L) Account:** Calculates **Net Profit / Net Loss**.

### 2.2 The Trading Account (Direct Items)

The Trading Account deals exclusively with the core purchasing and manufacturing of goods. It contains **Direct Expenses** (costs incurred to bring the goods to the condition and location of sale).

Debit Side (Dr.) - Direct Expenses	Credit Side (Cr.) - Direct Revenues
Opening Stock	Sales (Less: Sales Returns)
Purchases (Less: Purchase Returns)	Closing Stock
Direct Wages / Factory Labor	
Carriage Inward / Freight Inward	
Factory Rent / Power & Fuel	
<b>Result: Gross Profit (transferred to P&amp;L)</b>	<b>Result: Gross Loss (transferred to P&amp;L)</b>

#### **Common Mistake:**

*Students often confuse Carriage Inward and Carriage Outward.*

- **Carriage Inward** (cost of bringing raw materials in) goes to the **Trading Account**.
- **Carriage Outward** (cost of delivering finished goods out to customers) goes to the **Profit & Loss Account**.

### 2.3 The Profit and Loss Account (Indirect Items)

The P&L Account starts where the Trading Account ends. It deals with **Indirect Expenses** (office, administration, selling, and distribution costs) and **Indirect Incomes**.

## FORMAT OF PROFIT AND LOSS ACCOUNT

Particulars (Dr. - Expenses & Losses)	Amount (₹)	Particulars (Cr. - Incomes & Gains)	Amount (₹)
To Gross Loss b/d (if any)	xxx	By Gross Profit b/d (if any)	xxx
<b>Office &amp; Administration Expenses:</b>			
To Salaries	xxx	By Discount Received	xxx
To Office Rent, Rates & Taxes	xxx	By Commission Received	xxx
To Printing & Stationery	xxx	By Interest on Investments	xxx
To Insurance	xxx	By Rent Received	xxx
<b>Selling &amp; Distribution Expenses:</b>			
To Advertising	xxx	By Profit on Sale of Assets	xxx
To Carriage Outward	xxx	By Bad Debts Recovered	xxx
To Bad Debts & Provision	xxx		
<b>Financial &amp; Other Expenses:</b>			
To Interest on Loan / Bank Charges	xxx		
To Depreciation on Assets	xxx		
To Loss on Sale of Assets	xxx		
<b>To Net Profit (Transferred to Capital)</b>	<b>XXX</b>	<b>By Net Loss (Transferred to Capital)</b>	<b>XXX</b>

### Calculation Logic:

- **Gross Profit** = Net Sales – Cost of Goods Sold (Opening Stock + Net Purchases + Direct Expenses – Closing Stock).
- **Net Profit** = Gross Profit + Indirect Incomes – Indirect Expenses.

## 3. Balance Sheet of Sole Proprietorship

### 3.1 Meaning and Objectives

The Balance Sheet is a statement (not an account) prepared on a specific date (usually the last day of the financial year) that outlines the assets, liabilities, and capital of a business. It tests the arithmetic accuracy of the ledger via the equation: **Assets = Liabilities + Capital**.

### 3.2 Classification of Items

#### 1. Assets (Resources Owned):

- **Non-Current (Fixed) Assets:** Assets held for long-term use, not for resale (e.g., Land, Building, Machinery, Furniture, Goodwill).
- **Current Assets:** Assets that will be converted into cash within one year (e.g., Cash in Hand, Bank Balance, Sundry Debtors, Closing Stock, Prepaid Expenses).

#### 2. Liabilities (Obligations Owed):

- **Non-Current (Long-term) Liabilities:** Debts payable after more than one year (e.g., Long-term Bank Loans).
- **Current Liabilities:** Debts payable within one year (e.g., Sundry Creditors, Bills Payable, Outstanding Expenses, Bank Overdraft).

#### 3. Capital (Owner's Equity):

The owner's residual claim on the business. (Opening Capital + Net Profit – Drawings).

### 3.3 Balance Sheet Format (Horizontal/T-Format)

Liabilities	Amount (₹)	Assets	Amount (₹)
<b>Current Liabilities:</b>		<b>Current Assets:</b>	
Bank Overdraft	xxx	Cash in Hand	xxx
Bills Payable	xxx	Cash at Bank	xxx
Sundry Creditors	xxx	Sundry Debtors	xxx
Outstanding Expenses	xxx	Closing Stock	xxx
Income Received in Advance	xxx	Prepaid Expenses	xxx
		Accrued Income	xxx

Liabilities	Amount (₹)	Assets	Amount (₹)
<b>Long-Term Liabilities:</b>		<b>Non-Current / Fixed Assets:</b>	
Bank Loan	xxx	Furniture & Fixtures	xxx
<b>Capital:</b>		Plant & Machinery	xxx
Opening Balance	xxx	Land & Building	xxx
Add: Net Profit (or Less: Net Loss)	xxx	Intangibles (Goodwill, Patents)	xxx
Less: Drawings	(xxx)		
<b>Closing Capital</b>	<b>xxx</b>		
<b>TOTAL</b>	<b>XXXX</b>	<b>TOTAL</b>	<b>XXXX</b>

(Note: In modern accounting, a "Vertical Format" is also used, presenting Assets first, followed by Equity & Liabilities in a single column downward. However, for Sole Proprietorships in university exams, the traditional T-format above is standard).

## 4. Treatment of Adjustments

### Exam Tip - The Golden Rule of Adjustments:

Any item given **INSIDE** the Trial Balance has only **ONE** effect (it goes to Trading, P&L, OR Balance Sheet).

Any item given as an **ADJUSTMENT (Outside the Trial Balance)** has **TWO** effects to satisfy the Dual Aspect concept.

Below is the detailed, step-by-step treatment for the 10 core adjustments.

### 4.1 Closing Stock

**Meaning:** The value of unsold goods lying in the godown at the end of the year. Valued at Cost or Net Realizable Value, whichever is lower.

**Adjustment Logic:** Matches the exact cost of goods sold against current year revenue.

**Journal Entry:** Closing Stock A/c Dr. TO Trading A/c

**1st Effect**

**2nd Effect**

**Trading Account:** Credit Side

**Balance Sheet:** Assets Side (under Current Assets)

## 4.2 Outstanding Expenses

**Meaning:** Expenses incurred during the current accounting year but not yet paid in cash. (e.g., March salary paid in April).

**Adjustment Logic:** Accrual and Matching concept. The expense belongs to this year, so it must be added to this year's P&L.

**Journal Entry:** Expense A/c Dr. TO Outstanding Expense A/c

**1st Effect**

**2nd Effect**

**Trading / P&L Account:** Debit Side. **Add** it to the respective expense (e.g., Wages + O/s Wages).

**Balance Sheet:** Liabilities Side (under Current Liabilities).

## 4.3 Prepaid Expenses (Unexpired Expenses)

**Meaning:** Expenses paid in cash during the current year but relating to the next accounting year. (e.g., Annual insurance premium paid in October).

**Adjustment Logic:** Matching concept. It is not an expense of this year, so it must be removed from the P&L and treated as an asset until used.

**Journal Entry:** Prepaid Expense A/c Dr. TO Expense A/c

**1st Effect**

**2nd Effect**

**Trading / P&L Account:** Debit Side. **Deduct** it from the respective expense.

**Balance Sheet:** Assets Side (under Current Assets).

#### 4.4 Accrued Income (Income Earned but Not Received)

**Meaning:** Income that has been earned during the current year but cash has not yet been received. (e.g., Interest on investments due but not paid by the bank).

**Adjustment Logic:** Accrual concept. It is income for this year and a receivable asset.

**Journal Entry:** Accrued Income A/c Dr. TO Income A/c

1st Effect	2nd Effect
<b>P&amp;L Account:</b> Credit Side. <b>Add</b> it to the respective income.	<b>Balance Sheet:</b> Assets Side (under Current Assets).

#### 4.5 Income Received in Advance (Unearned Income)

**Meaning:** Income received in cash during the current year, but the service/goods will be provided in the next year.

**Adjustment Logic:** Since we owe a service, it is a liability, not current revenue.

**Journal Entry:** Income A/c Dr. TO Income Received in Advance A/c

1st Effect	2nd Effect
<b>P&amp;L Account:</b> Credit Side. <b>Deduct</b> it from the respective income.	<b>Balance Sheet:</b> Liabilities Side (under Current Liabilities).

#### 4.6 Depreciation

**Meaning:** The gradual decrease in the value of a fixed asset due to wear, tear, passage of time, or obsolescence.

**Adjustment Logic:** Cost concept and Matching concept. Spreading the cost of the asset over its useful life.

**Journal Entry:** Depreciation A/c Dr. TO Asset A/c

#### 1st Effect

#### 2nd Effect

**P&L Account:** Debit Side (shown as a separate expense).

**Balance Sheet:** Assets Side. **Deduct** the depreciation amount from the specific Fixed Asset.

### 4.7 Bad Debts (Further Bad Debts)

**Meaning:** The amount owed by a debtor that is permanently irrecoverable. When given in the adjustments, it means it happened at the very end of the year and hasn't been recorded yet.

**Journal Entry:** Bad Debts A/c Dr. TO Sundry Debtors A/c

#### 1st Effect

#### 2nd Effect

**P&L Account:** Debit Side. **Add** to existing Bad Debts (if any).

**Balance Sheet:** Assets Side. **Deduct** from Sundry Debtors.

### 4.8 Provision for Doubtful Debts

**Meaning:** An estimated amount created out of profits to cover potential future losses from debtors who *might* fail to pay.

**Adjustment Logic:** Convention of Conservatism. We anticipate the loss before it becomes a confirmed bad debt.

**Calculation Rule:** Always calculate the Provision percentage on the Debtors amount **AFTER** deducting "Further Bad Debts" given in adjustments.

#### Step-by-Step P&L Presentation (The Formula):

In the P&L Account (Debit Side), present it like this:

- Old Bad Debts (from Trial Balance)
- *Add:* Further Bad Debts (from Adjustments)
- *Add:* New Provision for Doubtful Debts (from Adjustments)
- *Less:* Old Provision for Doubtful Debts (from Trial Balance)

**= Net Amount transferred to outer column** (If the result is negative, move it to the Credit side of P&L).

#### 1st Effect

**P&L Account:** Debit Side (Add to Bad Debts as shown above).

#### 2nd Effect

**Balance Sheet:** Assets Side. **Deduct** New Provision from Sundry Debtors (after deducting Further Bad debts).

### 4.9 Interest on Capital

**Meaning:** An allowance given to the proprietor out of business profits for the capital invested.

**Adjustment Logic:** Business Entity Concept. The business treats the owner as an internal creditor. Interest is an expense for the business and an income for the owner.

**Journal Entry:** Interest on Capital A/c Dr. TO Capital A/c

#### 1st Effect

**P&L Account:** Debit Side (as a business expense).

#### 2nd Effect

**Balance Sheet:** Liabilities Side. **Add** it to Capital.

### 4.10 Interest on Drawings

**Meaning:** A charge levied by the business on the amount withdrawn by the owner for personal use.

**Adjustment Logic:** It is an income for the business and a reduction in the owner's capital.

**Journal Entry:** Drawings / Capital A/c Dr. TO Interest on Drawings A/c

#### 1st Effect

**P&L Account:** Credit Side (as business income).

#### 2nd Effect

**Balance Sheet:** Liabilities Side. **Deduct** it from Capital.

## 5. Comprehensive Numerical Illustration

### Question:

The following is the Trial Balance of Mr. Arjun as on 31st March 2023.

Particulars	Debit (₹)	Credit (₹)
Capital		2,50,000
Drawings	20,000	
Machinery	1,00,000	
Opening Stock	40,000	
Purchases and Sales	1,50,000	3,20,000
Wages	30,000	
Salaries	45,000	
Rent	12,000	
Sundry Debtors & Creditors	60,000	40,000
Bad Debts	3,000	
Commission Received		5,000
Cash in Hand	25,000	
Cash at Bank	1,30,000	
<b>Total</b>	<b>6,15,000</b>	<b>6,15,000</b>

#### Adjustments to be made:

1. Closing Stock as on 31st March 2023 is valued at ₹55,000.
2. Wages outstanding amount to ₹5,000.
3. Prepaid Rent amounts to ₹2,000.
4. Depreciate Machinery by 10% p.a.
5. Provide 5% for Doubtful Debts on Sundry Debtors.

#### Solution:


**TRADING AND PROFIT & LOSS ACCOUNT OF MR. ARJUN FOR THE YEAR ENDED 31ST MARCH 2023**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	40,000	By Sales	3,20,000
To Purchases	1,50,000	By Closing Stock (Adj 1)	55,000
To Wages	30,000		
Add: Outstanding Wages (Adj 2)	<u>5,000</u>		
Total Wages	35,000		
To Gross Profit c/d	1,50,000		
<b>TOTAL</b>	<b>3,75,000</b>	<b>TOTAL</b>	<b>3,75,000</b>
To Salaries	45,000	By Gross Profit b/d	1,50,000
To Rent	12,000	By Commission Received	5,000
Less: Prepaid Rent (Adj 3)	<u>(2,000)</u>		
Net Rent	10,000		
To Depreciation on Machinery (10% of 1,00,000) (Adj 4)	10,000		
To Bad Debts	3,000		
Add: New Provision (5% of 60,000) (Adj 5)	<u>3,000</u>		
Total Bad Debts	6,000		
To Net Profit (Transferred to Capital)	84,000		
<b>TOTAL</b>	<b>1,55,000</b>	<b>TOTAL</b>	<b>1,55,000</b>

### BALANCE SHEET OF MR. ARJUN AS ON 31ST MARCH 2023

Liabilities	Amount (₹)	Assets	Amount (₹)
<b>Current Liabilities:</b>		<b>Current Assets:</b>	
Sundry Creditors	40,000	Cash in Hand	25,000
Outstanding Wages (Adj 2)	5,000	Cash at Bank	1,30,000

Liabilities	Amount (₹)	Assets	Amount (₹)
<b>Capital Account:</b>		Closing Stock (Adj 1)	55,000
Opening Capital	2,50,000	Prepaid Rent (Adj 3)	2,000
Add: Net Profit	<u>84,000</u>		
<i>Total</i>	3,34,000	<b>Sundry Debtors</b>	60,000
Less: Drawings	<u>(20,000)</u>	Less: Provision for Doubtful Debts (Adj 5)	<u>(3,000)</u>
<i>Closing Capital</i>	3,14,000	<i>Net Debtors</i>	57,000
		<b>Fixed Assets:</b>	
		Machinery	1,00,000
		Less: Depreciation (10%) (Adj 4)	<u>(10,000)</u>
		<i>Net Machinery</i>	90,000
<b>TOTAL</b>	<b>3,59,000</b>	<b>TOTAL</b>	<b>3,59,000</b>

 **Exam Tip for Checking Accuracy:**

*In the Balance Sheet, total Assets must exactly equal total Liabilities + Capital. In this solved example, both sides sum up perfectly to ₹3,59,000, confirming the mathematical accuracy of our dual-aspect adjustments.*

End of Module 1 • Subject: Financial Accounting