UNIT 6
Preparation of Final Accounts for Sole Proprietors

(10 Hours) — Financial Accounting (CACS152)

1. Introduction to Final Accounts

Final Accounts are the set of accounts and statements prepared at the end of an accounting period, using the balances carried forward from the trial balance, to ascertain the profit or loss earned during the period and the financial position of the business at the end of that period. For a sole proprietorship, the final accounts normally comprise the Manufacturing Account (where applicable), the Trading Account, the Profit & Loss Account, and the Balance Sheet.

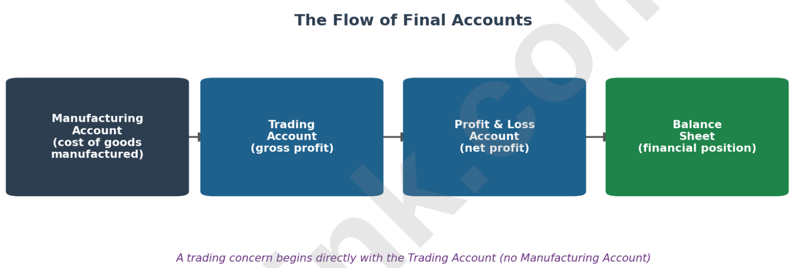

Fig 6.1 — The flow of final accounts, from cost of production through to the Balance Sheet.

- Manufacturing Account — prepared only by a manufacturing concern, to ascertain the total cost of goods manufactured during the period.
- Trading Account — ascertains the gross profit or gross loss on the buying/manufacturing and selling of goods.
- Profit & Loss Account — ascertains the net profit or net loss after accounting for all indirect (operating) expenses and incomes.
- Balance Sheet — a statement (not an account) showing the assets, liabilities, and capital of the business as at the last day of the accounting period.

2. Concept of Closing Entries in Respect of Trading and Profit & Loss Account

2.1 Meaning of Closing Entries

Closing entries are journal entries passed at the end of an accounting period to close all nominal accounts (accounts of expenses, losses, incomes, and gains) by transferring their balances to the Trading Account and the Profit & Loss Account. Since nominal accounts relate only to the

bcalink.com

transactions of the current period, they must be reduced to a nil balance before the next accounting period begins, so that they can start afresh.

2.2 Format of the Trading Account

The Trading Account brings together all items directly connected with the purchase, manufacture, and sale of goods.

Dr. — Trading Account for the year ended ...	Rs.
To Opening Stock	xxx
To Purchases Less: Purchases Return	xxx
To Direct Expenses (carriage inward, wages, freight, octroi, etc.)	xxx
To Gross Profit c/d (transferred to P&L A/c)	xxx
Total	xxx

Cr. — Trading Account for the year ended ...	Rs.
By Sales Less: Sales Return	xxx
By Closing Stock	xxx
By Gross Loss c/d (if any, transferred to P&L A/c)	xxx
Total	xxx

bcalink.com

2.3 Format of the Profit & Loss Account

The Profit & Loss Account is prepared by transferring the gross profit (or gross loss) from the Trading Account and further adjusting it for all indirect (operating and non-operating) expenses and incomes not connected with the direct buying or making of goods.

Dr. — Profit & Loss Account for the year ended ...	Rs.
To Gross Loss b/d (if any)	xxx
To Office & Administrative Expenses (salary, rent, printing, insurance)	xxx
To Selling & Distribution Expenses (advertisement, carriage outward, commission)	xxx
To Financial Expenses (interest, discount allowed)	xxx
To Depreciation and Provisions	xxx
To Net Profit (transferred to Capital A/c)	xxx

Dr. — Profit & Loss Account for the year ended ...	Rs.
Total	xxx

Cr. — Profit & Loss Account for the year ended ...	Rs.
By Gross Profit b/d	xxx
By Other Incomes (rent received, commission received, interest received)	xxx
By Net Loss (transferred to Capital A/c, if any)	xxx
Total	xxx

2.4 Illustrative Closing Journal Entries

Closing Entries — Trading Account

(i) Trading A/c ... Dr. To Opening Stock A/c, To Purchases A/c, To Direct Expenses A/c(s) (Being opening stock, purchases, and direct expenses transferred to Trading A/c)

(ii) Sales A/c ... Dr. Closing Stock A/c ... Dr. To Trading A/c (Being sales and closing stock transferred to Trading A/c)

(iii) Trading A/c ... Dr. To Profit & Loss A/c (Being gross profit transferred to Profit & Loss A/c)

Closing Entries — Profit & Loss Account

(i) Profit & Loss A/c ... Dr. To Various Expense Accounts (Being indirect expenses transferred to Profit & Loss A/c)

(ii) Various Income Accounts ... Dr. To Profit & Loss A/c (Being indirect incomes transferred to Profit & Loss A/c)

(iii) Profit & Loss A/c ... Dr. To Capital A/c (Being net profit transferred to the proprietor's Capital Account)

Note: For a sole proprietor, the net profit (or net loss) shown by the Profit & Loss Account is transferred directly to the Capital Account, increasing (or decreasing) the owner's capital, since a sole proprietorship has no separate 'Retained Earnings' account as a company would.

3. Concept of Accrual Basis of Accounting

3.1 Cash Basis vs. Accrual Basis

Under the cash basis of accounting, revenue is recorded only when cash is actually received, and expenses only when cash is actually paid, regardless of the period to which they relate. Under the accrual basis of accounting, revenue is recognized when it is earned, and expenses are

bcalink.com

recognized when they are incurred, irrespective of whether cash has actually been received or paid. The accrual basis is the basis required by accounting standards and generally accepted accounting practice for preparing financial statements.

Basis	Cash Basis of Accounting	Accrual Basis of Accounting
Recognition of Revenue	When cash is actually received	When revenue is earned, whether or not cash is received
Recognition of Expense	When cash is actually paid	When expense is incurred, whether or not cash is paid
Outstanding / Prepaid Items	Not recognized	Recognized through adjusting entries
Accuracy of Profit Measurement	Less accurate; distorted by timing of cash flows	More accurate; matches revenue with related expenses
Acceptability	Generally not accepted for financial reporting by businesses	Required under accounting standards for business enterprises

bcalink.com

3.2 Adjustments Arising from the Accrual Basis

- Outstanding (unpaid) expenses — expenses incurred during the period but not yet paid, added to the relevant expense and shown as a current liability.
- Prepaid (unexpired) expenses — expenses paid in advance for a future period, deducted from the relevant expense and shown as a current asset.
- Accrued (earned but not received) income — income earned during the period but not yet received, added to the relevant income and shown as a current asset.
- Income received in advance (unearned income) — income received during the period but relating to a future period, deducted from the relevant income and shown as a current liability.

Example 3.1 — Adjusting for Outstanding and Prepaid Expenses
Salary paid during the year, as per the trial balance, was Rs. 60,000. Of this, Rs. 5,000 relates to next year (prepaid), and a further Rs. 4,000 for the current year remains unpaid (outstanding). Determine the salary expense to be charged to the Profit & Loss Account for the current year.

Solution

Salary paid (as per trial balance) Rs. 60,000

Less: Prepaid salary (relates to next year) Rs. 5,000

Add: Outstanding salary (relates to current year, not yet paid) Rs. 4,000

Salary to be charged to Profit & Loss Account Rs. 59,000

(Prepaid salary of Rs. 5,000 is shown as a current asset, and outstanding salary of Rs. 4,000 is shown as a current liability, in the Balance Sheet.)

4. Matching Concept and Dual Aspect

4.1 Matching Concept

The matching concept requires that the expenses of a period be matched against the revenues earned in that same period, so that the net profit or loss reported truly reflects the result of the period's operations. This is precisely why adjustments for outstanding and prepaid items, and for depreciation, are necessary — to ensure that each period bears only the expenses relating to the revenue it has generated, and no more or less.

- Revenue earned in a period is recognized in that period, regardless of when cash is received.
- Expenses incurred in earning that revenue are recognized in the same period, regardless of when cash is paid.
- The matching concept is, in effect, the practical application of the accrual basis of accounting to the measurement of periodic profit.

4.2 Dual Aspect Concept

The dual aspect concept holds that every transaction has two aspects — a debit aspect and an equal and opposite credit aspect — and that both aspects must be recorded. This concept is the very foundation of the double entry system and is expressed at all times through the fundamental accounting equation.

The Accounting Equation

Assets = Liabilities + Capital

(or, equivalently: Capital = Assets – Liabilities)

- Every transaction, however varied, can only do one (or more) of the following: increase an asset and increase a liability/capital; increase one asset and decrease another asset; decrease an asset and decrease a liability/capital; or a corresponding change entirely within

bcalink.com

liabilities/capital or entirely within assets.

- Because of the dual aspect concept, the Balance Sheet must always balance: total assets must equal total liabilities plus capital.

Note: The dual aspect concept is the theoretical basis for the entire double entry system studied in Unit 2, while the matching concept is the theoretical basis for most of the year-end adjustments studied in this unit.

5. Concept of Manufacturing Account

5.1 Meaning and Purpose

A Manufacturing Account is prepared by a business that itself manufactures the goods it sells (rather than merely buying finished goods for resale), in order to ascertain the total cost of goods manufactured during the period. This figure is then transferred to the Trading Account in place of 'purchases,' since a manufacturer does not purchase finished goods but produces them.

5.2 Format of the Manufacturing Account

Dr. — Manufacturing Account for the year ended ...	Rs.
To Opening Work-in-Progress (WIP)	xxx
To Raw Materials Consumed (Opening Stock of Raw Materials + Purchases of Raw Materials – Closing Stock of Raw Materials)	xxx
To Direct (Productive) Wages	xxx
To Direct Expenses (royalty on production, fuel and power)	xxx
To Factory Overheads (factory rent, factory insurance, depreciation on plant)	xxx
Total	xxx

Cr. — Manufacturing Account for the year ended ...	Rs.
By Sale of Scrap (if any)	xxx
By Closing Work-in-Progress (WIP)	xxx
By Cost of Goods Manufactured (transferred to Trading A/c)	xxx
Total	xxx

- Direct costs — costs that can be directly and wholly identified with the units produced (raw materials consumed, direct wages, direct expenses) — are charged to the Manufacturing Account.

bcainf.com

- Factory (indirect production) overheads — costs incurred in running the factory as a whole, and not identifiable with any single unit (factory rent, power, depreciation on plant) — are also charged to the Manufacturing Account, but as indirect costs.
- Office, administrative, and selling expenses are not part of the cost of manufacture and are instead charged to the Profit & Loss Account.

Note: Where a business only trades in ready-made goods and does not manufacture them, no Manufacturing Account is prepared; the final accounts begin directly with the Trading Account.

6. Preparation of Balance Sheet

6.1 Meaning and Purpose of the Balance Sheet

A Balance Sheet is a statement, prepared as at a particular date, showing the assets owned, and the liabilities and capital owed by, a business. It is not an account and therefore has no debit or credit sides in the accounting sense, though it is conventionally presented with assets and liabilities/capital shown side by side, or one below the other.

bcalink.com

6.2 Forms of Presenting the Balance Sheet

- Account (Horizontal) Form — liabilities and capital are shown on the left-hand side and assets on the right-hand side, resembling the two sides of a ledger account (or vice versa, depending on convention).
- Statement (Vertical) Form — assets, liabilities, and capital are listed one below the other in a single continuous statement, typically starting with fixed assets and ending with capital and long-term liabilities; this form is now the more widely used format in modern financial reporting.

6.3 Illustrative Balance Sheet (Account Form)

Liabilities	Rs.	Assets	Rs.
Capital Add: Net Profit Less: Drawings	xxx	Fixed Assets (land, building, machinery, furniture)	xxx
Long-Term Liabilities (long-term loan)	xxx	Investments	xxx
Current Liabilities (creditors, bills payable, outstanding expenses)	xxx	Current Assets (closing stock, debtors, prepaid expenses, cash and bank)	xxx
		Intangible / Fictitious Assets (goodwill, preliminary expenses)	xxx
Total	xxx	Total	xxx

Note: The two totals of the Balance Sheet must always be equal, in keeping with the dual aspect concept and the accounting equation discussed earlier in this unit.

7. Arrangement and Classification of Assets and Liabilities

The individual items appearing in the Balance Sheet are grouped together under broad headings, and then arranged (marshalled) in a particular order, so that the statement is easy to read and interpret.

7.1 Classification of Assets

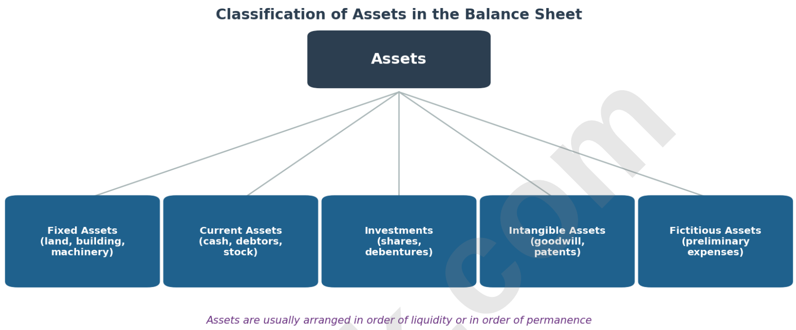

Fig 6.2 — Classification of assets shown in the Balance Sheet.

bcalink.com

- Fixed Assets — held for continued use in the business over several years, not for resale (land, building, plant and machinery, furniture, vehicles).
- Current Assets — expected to be converted into cash, sold, or consumed within the normal operating cycle, usually one year (cash, bank balance, debtors, closing stock, prepaid expenses).
- Investments — funds invested outside the business in shares, debentures, or other securities, generally to earn a return rather than for use in operations.
- Intangible Assets — assets without physical existence, but possessing value because of the rights or advantages they confer (goodwill, patents, trademarks, copyrights).
- Fictitious Assets — not really assets in the true sense, but expenditure or losses not yet written off, carried forward to be written off over future periods (preliminary expenses, discount on issue of shares, debit balance of Profit & Loss Account).

7.2 Classification of Liabilities

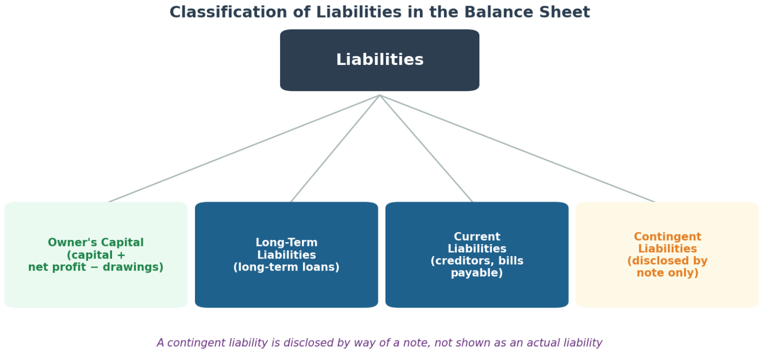

Fig 6.3 — Classification of liabilities shown in the Balance Sheet.

- Owner's Capital — the proprietor's investment in the business, adjusted for net profit (added) or net loss (deducted) and drawings (deducted) during the period.
- Long-Term Liabilities — obligations not due for payment within the next year (long-term bank loan, long-term borrowings).
- Current Liabilities — obligations due for payment within the next year (creditors, bills payable, bank overdraft, outstanding expenses).
- Contingent Liabilities — possible obligations that are not recognized in the Balance Sheet total, but disclosed separately by way of a note (as discussed in Unit 2), such as a claim against the business not acknowledged as a debt.

7.3 Marshalling of the Balance Sheet

Marshalling refers to the order in which assets and liabilities are listed in the Balance Sheet. Two orders are commonly used.

Basis	Order of Liquidity	Order of Permanence
Assets are listed	Starting with the most liquid asset (cash) and ending with the least liquid (goodwill, fixed assets)	Starting with the most permanent asset (goodwill, land) and ending with the most liquid (cash)
Liabilities are listed	Starting with those payable first (current liabilities) and ending with capital	Starting with capital and ending with those payable first (current liabilities)
Typically used by	Sole proprietors and partnerships	Companies, following a statutory format

Note: Whichever order is chosen, it must be applied consistently to both sides of the Balance Sheet — for example, if assets are listed in order of liquidity, liabilities are also listed in order of liquidity (most urgent to least urgent), so that the statement reads consistently from one side to the other.

bcalink.com

Key Takeaways

✓ Final accounts of a sole proprietor comprise the Manufacturing Account (if applicable), Trading Account, Profit & Loss Account, and Balance Sheet, prepared from the trial balance at period end.

✓ Closing entries transfer the balances of all nominal accounts to the Trading Account and Profit & Loss Account, and finally transfer net profit or loss to the proprietor's Capital Account.

✓ The accrual basis recognizes revenue when earned and expenses when incurred, requiring adjustments for outstanding expenses, prepaid expenses, accrued income, and income received in advance.

✓ The matching concept ensures expenses are matched against the revenue of the same period; the dual aspect concept underlies the double entry system and the accounting equation, Assets = Liabilities + Capital.

✓ A Manufacturing Account ascertains the cost of goods manufactured, which is transferred to the Trading Account in place of purchases.

✓ The Balance Sheet is a statement, not an account, showing assets, liabilities, and capital as at a given date, presentable in account or statement form.

✓ Assets and liabilities are classified into broad categories and marshalled either in order of liquidity or in order of permanence.

— End of Unit 6 —

bcalink.com