Date: 01 July 2020

VIRTUAL COACHING CLASSES
ORGANISED BY BOS, ICAI

FOUNDATION LEVEL
PAPER 1: PRINCIPLES AND PRATICE OF ACCOUNTING

Faculty: CA VS Hiranmai

CHAPTER 7- Preparation of final accounts of sole proprietors- Unit 1

- This chapter has 2 units wherein the Unit 1 deals with final accounts of non-manufacturing entities where we need to prepare the Trading, Profit and loss account and the Balance sheet.
- **TRADING AC**- This is prepared by the non manufacturing entities meaning as to those entities which deal in goods. All the expenses are debited and the income/ closing stock is credited to trading account.
- The result from this account is the gross profit (debit side) or gross loss (credit side) which is then transferred to the profit and loss account.
- Trading account is prepared for the year ended hence the words- "Trading account for the year ended on------" is very important as a part of the presentation.
- **PROFIT AND LOSS ACCOUNT-** This records all the indirect expenses (debit side) and the indirect incomes (credit side).
- The result of the profit and loss account is the net profit (debit side) and net loss (credit side) which is added / subtracted with the **Capital in the Balance sheet.**

CHAPTER 7- Preparation of final accounts of sole proprietors

- **PROFIT AND LOSS ACCOUNT-** Profit and loss account is prepared for the year ended hence the words- “Profit and loss account for the year ended on------” is very important as a part of the presentation.
- There is another word for P and L termed as **Income statement**
- **BALANCE SHEET-** This is a statement as at a particular date which reveals the assets and liabilities position of the business.
- This is also termed as **Position statement** but made on a particular date.
- Based on the accounting equation approach of Assets= Liabilities + Capital , the balance sheet shall tally at all times.
- **Closing entries** are prepared after preparing the Trading A/c and Profit and loss A/c has to be passed in the Journal proper. The **debit items** shall be **credited** (even in trading or Profit and loss A/c) and all the **credit items** shall be **debited** (even in trading or Profit and loss A/c).

CHAPTER 7- Preparation of final accounts of sole proprietors

- **TRADING AC-** the formula for Cost of goods sold= Opening stock+ Purchases+ Direct expenses- Closing stock (or) Sales – Gross Profit (or) Opening stock + Adjusted purchases.
- **Adjusted purchases= Purchases- Closing stock -** this comes when the closing stock is given in the trial balance, then the purchases shall become adjusted purchases automatically.
- So when the closing stock is given in the trial balance, then the purchases become adjusted purchases and the illustration 1 shall be solved in that way.
- **PROFIT AND LOSS AC-** The expenses shall be classified as-
  - **Management expenses-** salaries, office rent, printing & stationery, telephone charges, insurance, audit fees, legal charges, electricity.
  - **Maintenance expenses**- Repairs and renewals and depreciation
  - **Selling and distribution expenses**- Advertisement, bad debts, carriage outwards, selling commission.
  - **Financial expenses-** bank charges, interest charges and discount.
  - **Abnormal losses-** loss on sale of assets, loss by fire.

CHAPTER 7- Preparation of final accounts of sole proprietors

- **PROFIT AND LOSS AC-** The income shall be classified as-
  - **Other income-** Discount or commission received
  - **Non trading income-** Bank interest, rent from property, dividend from shares
  - **Abnormal gains**- Profit on sale of assets/investments
- The trial balance is the base for preparing the three accounts. There is information given inside the trial balance and also **outside the trial balance**. This are called as **adjustments** which will have **two effects- either in Trading and PL- PL and Balance sheet- trading and balance sheet.**
- So the information given in the trial balance and the adjustments have to be filled in two places-either the Trading A/c, Profit and loss A/c and Balance sheet.
- **BALANCE SHEET-**there are two ways of preparing the Balance sheet- one is in the order of permanency or in the order of liquidity. Permanency means those assets/liabilities which will remain in the business for a longer accounting period and the liquidty oreder means writing those assets/liabilities first which will be easily converted into cash within the accounting period.

CHAPTER 7- Preparation of final accounts of sole proprietors

- **ADJUSTMENTS-**
- The major and the most important type of adjustment is the **expenses/income not pertaining for the current period-** As per the accrual concept – all the transactions having an effect on the current period shall be recorded in the final accounts of the business.
- **The adjustments can be classified as follows-**
  - **Outstanding expenses-** This refers to the expenses of the current year which has not been paid- Effect- Add it with the current expense in the Profit and loss ac and show it under liability in the Balance sheet until paid.
  - **Prepaid or advance expenses-** This refers to the expenses of the next year which has been paid in advance during the current period. Since it does not pertain to the current period - Effect- Reduce it from the current expense in the Profit and loss ac and show it under Assets in the Balance sheet until paid.

CHAPTER 7- Preparation of final accounts of sole proprietors

- **The adjustments can be classified as follows-**
  - **Accrued Income-** This refers to the income of the current year which has not been received but is receivable by the company- **Effect- Add it with the current income in the Profit and loss ac and show it under Asset in the Balance sheet until paid.**
  - **Income received in advance-** This refers to the income of the next year which has been received in advance during the current period. Since it does not pertain to the current period - **Effect- Reduce it from the current income in the Profit and loss ac and show it under liabilities in the Balance sheet until paid.**
- **Adjustments can also be classified whether they are for the purpose of business or personal use of the proprietor-** Where the goods/money is taken by the owner for his personal use then , it has t be debited to a separate account called the **Drawings a/c**. **In case of goods taken then credit purchases A/c or in case of cash/bank taken- credit cash/Bank a/c**

CHAPTER 7- Preparation of final accounts of sole proprietors

- **The adjustments can be classified as follows-**
- The goods can be given as donations or free samples as a part of CSR activities or advertisement respectively- in such cases- debit Donation A/c/ Advertisement A/c and credit purchases A/c as the goods are reduced from the purchases made.
- **Depreciation**- the rate of depreciation shall be given in the adjustment- which shall be applied to the opening balance + purchases- sales during the current period. The amount of depreciation shall be debited in the profit and loss ac and deducted from value of asset in the balance sheet.
- **Loss of goods by fire** – When there is loss of goods by fire- the total cost of the abnormal loss shall be credited to the trading account (reduction from purchases). The loss amount to be debited to the Profit and loss account, if there is any insurance claim admitted by the insurance co, then such insurance co to be shown as debtor (trade receivables) in the balance sheet.
- **Goods sent on approval basis-** At the end of the year- reverse the sale and add it with the closing stock at cost.

CHAPTER 7- Preparation of final accounts of sole proprietors

- **The adjustments can be classified as follows-**
- **Provision for bad and doubtful debts**- the business can create a provision before hand to protect itself from any future bad debts. Where there is provision created, first the bad debts, if any incurred will be deducted from the provision and the remaining shortfall, if nay will be debited to the profit and loss account. The amount of provision required each year will be debited to the profit and loss account.
- **Commission payable to manager-** Where there is manager who is entitled to commission as agreed- then we need to compute his commission. The commission can be payable in two methods-
  - **Before charging such commission= Net profit before commission*** $\frac{\textbf{\% of commission}}{\textbf{100}}$
  - **After charging such commission= Net profit before commission*** $\frac{\textbf{\% of commission}}{\textbf{100+\%}}$

THANK YOU