

# Financial Statements of Sole Proprietors

Kerala · Class 11 · Accountancy — exam notes

Final accounts turn a year of scattered ledger balances into two clear answers: how much did the business earn, and where does it stand? Three statements do the work — the **TRADING ACCOUNT** gives gross profit, the **PROFIT & LOSS ACCOUNT** gives net profit, and the **BALANCE SHEET** shows the position on the closing date. The dividing line you must never blur is capital expenditure versus revenue expenditure.

## Key terms & definitions

### Final accounts

The Trading Account, Profit & Loss Account and Balance Sheet prepared at the end of an accounting period from the trial balance.

### Trading Account

The account prepared to find **GROSS PROFIT** — the result of buying and selling goods, before indirect expenses.

### Gross Profit

Net Sales minus Cost of Goods Sold. It measures trading efficiency only.

### Profit & Loss Account

The account that begins with gross profit, deducts all indirect expenses and adds other incomes, to arrive at **NET PROFIT**.

### Net Profit

The final profit belonging to the owner after every business expense has been met. It is added to capital in the Balance Sheet.

### Balance Sheet

A **STATEMENT** (not an account) showing assets, liabilities and capital as on the last day of the accounting period.

### Cost of Goods Sold (COGS)

Opening Stock + Net Purchases + Direct Expenses – Closing Stock.

### Direct expenses

Expenses incurred to bring goods to saleable condition — carriage inwards, wages, freight, octroi, fuel and power. They belong in the Trading Account.

### Indirect expenses

Expenses of running the business — rent, salaries, advertising, depreciation, bad debts. They belong in the Profit & Loss Account.

### Capital expenditure

Money spent to acquire a long-lived asset or to increase its earning capacity. It appears in the **BALANCE SHEET**, not in the P&L.

### Revenue expenditure

Money spent on the day-to-day running of the business, the benefit of which is consumed within the year. It appears in the P&L Account.

### Closing stock

Unsold goods at the end of the year. Shown on the **CREDIT** side of the Trading Account and as a **CURRENT ASSET** in the Balance Sheet — in both places, once each.

## Why final accounts are needed

- At 31 March your ledger holds dozens of balances — purchases, sales, rent, debtors, machinery — but none of them alone tells you whether you made money.
- Final accounts summarise those balances into a readable report.
- They answer two distinct questions: **HOW MUCH DID I EARN** (Trading and P&L), and **WHERE DO I STAND** (Balance Sheet).
- They also satisfy outside users — banks, the GST department, prospective buyers of the business.
- The trial balance is the raw material; the final accounts are the finished product.

## The Trading Account — gross profit only

- Its single job is to measure profit from BUYING AND SELLING GOODS, before any running costs.
- DEBIT SIDE: Opening Stock, Net Purchases (purchases less purchase returns), and all DIRECT EXPENSES — carriage inwards, wages, freight, fuel and power.
- CREDIT SIDE: Net Sales (sales less sales returns) and Closing Stock.
- The balancing figure is GROSS PROFIT (if credit exceeds debit) or GROSS LOSS.
- Gross profit is then carried down to the Profit & Loss Account.
- Only DIRECT expenses belong here. Putting rent or salaries in the Trading Account is a standard error.

## The Profit & Loss Account — net profit

- It opens with the gross profit brought down from the Trading Account.
- DEBIT SIDE: all INDIRECT expenses — rent, salaries, advertising, insurance, depreciation, bad debts, interest paid.
- CREDIT SIDE: other incomes — commission received, interest received, discount received, rent received.
- The balancing figure is NET PROFIT (or net loss).
- Net profit is transferred to the CAPITAL ACCOUNT in the Balance Sheet, where it increases the owner's capital.
- A net loss is deducted from capital instead.

## The Balance Sheet — a statement, not an account

- It is not an account: it has no debit and credit sides and no balancing figure of its own.
- It lists LIABILITIES and CAPITAL on one side, ASSETS on the other, as on the closing date.
- It is a snapshot at a POINT IN TIME, whereas the Trading and P&L accounts cover a PERIOD.
- Assets are usually grouped as fixed assets and current assets; liabilities as long-term and current.
- Capital is shown as: Opening capital + Net profit – Drawings (or – Net loss).
- The two sides must agree, because Assets = Liabilities + Capital.

## Worked example — Mithun's printing shop

- Given: Opening Stock ₹15,000; Purchases ₹80,000; Sales ₹1,40,000; Closing Stock ₹12,000; Rent ₹10,000; Salaries ₹20,000; Depreciation ₹4,000; Machinery ₹30,000; Fixtures ₹8,000; Cash ₹5,000; Debtors ₹8,000; Creditors ₹6,000; Capital ₹34,000.
- TRADING A/C — Debit: Opening Stock ₹15,000 + Purchases ₹80,000 = ₹95,000. Credit: Sales ₹1,40,000 + Closing Stock ₹12,000 = ₹1,52,000.
- GROSS PROFIT = ₹1,52,000 – ₹95,000 = ₹57,000.
- P&L A/C — Gross profit ₹57,000 less Rent ₹10,000, Salaries ₹20,000 and Depreciation ₹4,000 (total ₹34,000).
- NET PROFIT = ₹57,000 – ₹34,000 = ₹23,000.
- BALANCE SHEET — Assets: Machinery ₹30,000 + Fixtures ₹8,000 + Closing Stock ₹12,000 + Debtors ₹8,000 + Cash ₹5,000 = ₹63,000.
- Liabilities and Capital: Creditors ₹6,000 + Capital ₹34,000 + Net Profit ₹23,000 = ₹63,000.
- Both sides agree at ₹63,000 ✓

## Capital expenditure versus revenue expenditure

- REVENUE EXPENDITURE keeps the business running day to day — rent, stationery, salaries, repairs. Benefit is consumed within the year → PROFIT & LOSS ACCOUNT.
- CAPITAL EXPENDITURE buys or improves a long-lived asset — machinery, a vehicle, a computer. Benefit lasts for years → BALANCE SHEET as an asset.
- Test: will the benefit outlast this accounting year? If yes, it is capital.
- Wages paid to INSTALL a new machine are capital; wages paid to run it are revenue.
- Confusing the two distorts BOTH profit and the Balance Sheet — it is an error of principle.

## Where closing stock goes — and why it is not an expense

- Closing stock appears TWICE, once in each statement: on the CREDIT side of the Trading Account, and as a CURRENT ASSET in the Balance Sheet.
- It is NOT shown in the Profit & Loss Account and it does NOT reduce profit.
- Logic: closing stock is goods you bought but have NOT yet sold. Crediting it removes its cost from the cost of goods sold, so only goods actually sold are charged against sales.
- Far from reducing profit, closing stock INCREASES gross profit by removing unsold cost from the charge.
- If closing stock appears in the trial balance itself, it is shown ONLY in the Balance Sheet, because it has already been adjusted against purchases.

## Handling adjustments

- **OUTSTANDING EXPENSE:** add to the expense in the P&L and show as a current liability.
- **PREPAID EXPENSE:** deduct from the expense in the P&L and show as a current asset.
- **ACCRUED INCOME:** add to the income in the P&L and show as a current asset.
- **INCOME RECEIVED IN ADVANCE:** deduct from the income and show as a current liability.
- **DEPRECIATION:** charge in the P&L and deduct from the asset in the Balance Sheet.
- Golden rule: an item appearing in the TRIAL BALANCE is recorded ONCE; an item given as an ADJUSTMENT outside the trial balance is recorded TWICE.
- If the adjustment is already inside an ADJUSTED trial balance, do not apply it again — it flows straight into the statements.

## Three misconceptions to clear

- **WRONG:** 'Closing stock goes in the Profit & Loss Account because it reduces profit.' It belongs on the credit side of the TRADING account and in the Balance Sheet, and it increases gross profit.
- **WRONG:** 'Depreciation should be added back in the Balance Sheet because no cash left the business.' It is charged as an expense in the P&L and DEDUCTED from the asset in the Balance Sheet.
- **WRONG:** 'A business showing net profit must have more assets than liabilities.' Net profit measures performance over a PERIOD; the relation between assets and liabilities is a POSITION on a date. A profitable business can still be heavily indebted.

### Formulas & formats

- Trading Account for the year ended .....

| Dr.                 |          |  | Cr.              |          |
|---------------------|----------|--|------------------|----------|
| To Opening Stock    | 15,000   |  | By Sales         | 1,40,000 |
| To Purchases        | 80,000   |  | By Closing Stock | 12,000   |
| To Direct Expenses  | —        |  |                  |          |
| To Gross Profit c/d | 57,000   |  |                  |          |
|                     | -----    |  |                  | -----    |
|                     | 1,52,000 |  |                  | 1,52,000 |

- Cost of Goods Sold:

COGS = Opening Stock + Net Purchases + Direct Expenses – Closing Stock

Gross Profit = Net Sales – COGS

- Profit & Loss Account:

|                         |        |                                                      |
|-------------------------|--------|------------------------------------------------------|
| Gross Profit b/d        | 57,000 |                                                      |
| Less: Indirect expenses | 34,000 | (Rent 10,000 + Salaries 20,000 + Depreciation 4,000) |
| NET PROFIT              | 23,000 |                                                      |

- Balance Sheet as at .....

| LIABILITIES            |        |  | ASSETS        |        |
|------------------------|--------|--|---------------|--------|
| Creditors              | 6,000  |  | Machinery     | 30,000 |
| Capital                | 34,000 |  | Fixtures      | 8,000  |
| Add: Net Profit 23,000 | 57,000 |  | Closing Stock | 12,000 |
| (Less: Drawings)       |        |  | Debtors       | 8,000  |
|                        | -----  |  | Cash          | 5,000  |
|                        | 63,000 |  |               | -----  |
|                        |        |  |               | 63,000 |

- Capital in the Balance Sheet:

Closing Capital = Opening Capital + Net Profit – Drawings (or – Net Loss)

## Important questions & model answers

**2 marks** What are final accounts? Name the statements included.

- Final accounts are the statements prepared at the end of an accounting period from the trial balance to ascertain the profit or loss and the financial position of the business.
- They comprise the TRADING ACCOUNT (to find gross profit), the PROFIT & LOSS ACCOUNT (to find net profit) and the BALANCE SHEET (to show financial position).

**3 marks** Distinguish between gross profit and net profit.

- GROSS PROFIT is the excess of net sales over the cost of goods sold, found in the Trading Account. It measures trading efficiency only.
- NET PROFIT is what remains after deducting all indirect expenses from gross profit and adding other incomes, found in the Profit & Loss Account.
- Gross profit ignores running expenses such as rent and salaries; net profit takes them into account.
- Net profit is the amount that finally belongs to the owner and is added to capital in the Balance Sheet.

**5 marks** From Mithun's figures — Opening Stock ₹15,000, Purchases ₹80,000, Sales ₹1,40,000, Closing Stock ₹12,000, Rent ₹10,000, Salaries ₹20,000, Depreciation ₹4,000 — compute gross profit and net profit.

- TRADING ACCOUNT: Debit side = Opening Stock ₹15,000 + Purchases ₹80,000 = ₹95,000.
- Credit side = Sales ₹1,40,000 + Closing Stock ₹12,000 = ₹1,52,000.
- GROSS PROFIT = ₹1,52,000 – ₹95,000 = ₹57,000.
- PROFIT & LOSS ACCOUNT: Gross profit ₹57,000 less indirect expenses (Rent ₹10,000 + Salaries ₹20,000 + Depreciation ₹4,000 = ₹34,000).
- NET PROFIT = ₹57,000 – ₹34,000 = ₹23,000.
- This ₹23,000 is added to capital in the Balance Sheet.

**3 marks** Why is the Balance Sheet called a statement and not an account?

- An account has a debit side and a credit side and produces a balancing figure; the Balance Sheet has neither.
- It merely LISTS the assets on one side and the liabilities and capital on the other, as on a particular date.
- The words 'To' and 'By', which are used in accounts, are not used in a Balance Sheet.
- It shows a POSITION at a point of time, whereas the Trading and Profit & Loss Accounts cover a PERIOD of time.
- Its two sides agree automatically because Assets = Liabilities + Capital.

**4 marks** Distinguish between capital expenditure and revenue expenditure, with one example of each.

- CAPITAL EXPENDITURE is incurred to acquire a fixed asset or to increase the earning capacity of an existing one; its benefit extends beyond the current year. Example: purchase of machinery.
- REVENUE EXPENDITURE is incurred for the day-to-day conduct of the business; its benefit is consumed within the year. Example: rent or salaries paid.
- TREATMENT: capital expenditure is shown as an ASSET in the Balance Sheet; revenue expenditure is charged to the PROFIT & LOSS ACCOUNT.
- TEST: ask whether the benefit outlasts the current accounting year. If it does, the expenditure is capital.
- Wrongly classifying one as the other is an error of principle and distorts both profit and the Balance Sheet.

**4 marks** How is closing stock treated in the final accounts, and why does it not reduce profit?

- Closing stock is shown on the CREDIT side of the Trading Account and as a CURRENT ASSET in the Balance Sheet — once in each statement.
- It is never shown in the Profit & Loss Account.
- Closing stock represents goods purchased but not yet sold. Crediting it removes their cost from the cost of goods sold, so that only the cost of goods actually SOLD is charged against sales.
- Its effect is therefore to INCREASE gross profit, not reduce it.
- However, if closing stock already appears inside the trial balance, it is shown only in the Balance Sheet, because it has already been adjusted against purchases.

**3 marks** State how each of the following is treated: (i) outstanding salaries, (ii) prepaid insurance, (iii) depreciation on machinery.

- (i) OUTSTANDING SALARIES: added to salaries on the debit side of the Profit & Loss Account, and shown as a current liability in the Balance Sheet.
- (ii) PREPAID INSURANCE: deducted from insurance in the Profit & Loss Account, and shown as a current asset in the Balance Sheet.
- (iii) DEPRECIATION ON MACHINERY: charged as an expense in the Profit & Loss Account, and deducted from the machinery on the assets side of the Balance Sheet.
- In each case the item given as an adjustment outside the trial balance receives a DOUBLE treatment.

**3 marks** Distinguish between direct expenses and indirect expenses, with examples.

- DIRECT EXPENSES are incurred to bring goods to a saleable condition — carriage inwards, wages, freight, octroi, fuel and power. They are debited to the TRADING ACCOUNT.
- INDIRECT EXPENSES are incurred in running and administering the business — rent, salaries, advertising, insurance, depreciation. They are debited to the PROFIT & LOSS ACCOUNT.
- Direct expenses affect gross profit; indirect expenses affect net profit only.
- Placing an indirect expense such as rent in the Trading Account is a common and costly error.

**3 marks** 'A business earning a net profit must have more assets than liabilities.' Comment.

- The statement is not necessarily true.
- Net profit is a measure of PERFORMANCE over a period, computed in the Profit & Loss Account.
- The relation between assets and liabilities is a matter of POSITION on a particular date, shown in the Balance Sheet.
- A business may earn a good profit this year and yet carry heavy loans taken earlier, so that liabilities remain large.
- Equally, a business with few liabilities may make a loss. Profitability and solvency are different questions.

**3 marks** Explain the rule for treating items that appear inside the trial balance as against items given as adjustments.

- An item appearing INSIDE the trial balance is recorded ONLY ONCE in the final accounts, because its double entry is already complete in the books.
- An item given as an ADJUSTMENT outside the trial balance is recorded TWICE, because neither side of its entry has yet been made.
- Example: salaries in the trial balance go only to the Profit & Loss Account; outstanding salaries given as an adjustment are added to salaries in the P&L AND shown as a liability in the Balance Sheet.
- If an ADJUSTED trial balance is supplied, the adjustments have already been incorporated and must not be applied a second time.

## Exam tips

- Write the correct headings in full: 'Trading and Profit & Loss Account FOR THE YEAR ENDED ...' but 'Balance Sheet AS AT ...'. The wording is marked.
- Put only DIRECT expenses in the Trading Account. Rent, salaries and advertising belong in the P&L.
- Closing stock: credit side of the Trading Account AND assets side of the Balance Sheet — unless it already appears in the trial balance, in which case Balance Sheet only.
- Remember the once/twice rule: trial-balance items once, adjustment items twice.
- Show capital workings clearly — Opening Capital + Net Profit – Drawings — rather than writing a single unexplained figure.
- Always check that your Balance Sheet totals agree before finishing; if they differ, an adjustment has been applied once instead of twice, or vice versa.
- Do not use 'To' and 'By' in the Balance Sheet — it is a statement, not an account.

## Quick revision

- Trading A/c → GROSS profit. P&L A/c → NET profit. Balance Sheet → POSITION.
- $\text{COGS} = \text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Stock}$ .
- $\text{Gross Profit} = \text{Net Sales} - \text{COGS}$ .  $\text{Net Profit} = \text{Gross Profit} + \text{Other income} - \text{Indirect expenses}$ .
- Mithun:  $\text{GP} = 1,52,000 - 95,000 = ₹57,000$ ;  $\text{NP} = 57,000 - 34,000 = ₹23,000$ ; Balance Sheet ₹63,000 both sides.
- Direct expenses (carriage in, wages, freight) → Trading. Indirect (rent, salaries, depreciation) → P&L.
- Capital expenditure → Balance Sheet. Revenue expenditure → P&L.
- Closing stock: Trading A/c credit side + Balance Sheet asset. It INCREASES gross profit.
- Trial-balance item → once. Adjustment item → twice.
- $\text{Closing Capital} = \text{Opening Capital} + \text{Net Profit} - \text{Drawings}$ .
- Balance Sheet is a STATEMENT, not an account — no 'To' and 'By'.