Chapter 8

Financial Statements – Final Accounts of Sole Proprietorship Entities

1. FINANCIAL STATEMENTS

1.1Meaning of Financial Statements

1. **Financial Statements** (also called General Purpose Financial Statements) consist of the following –
   (a) Statement of Performance — Profit and Loss Account,
   (b) Statement of Financial Position — Balance Sheet,
   (c) Statement of Movement of Funds — Funds Flow and Cash Flow Statement.

2. **Meaning:** The above terms are explained below –

Item	Description
(a) Statement of Performance	• This Statement / Account shows the **result of operations**, i.e. Profit or Loss of the Entity for the period. • It is also called "**Performance Statement**", or "**Income Statement**". • Income Statement consists of – (i) Manufacturing Account, (ii) Trading Account, and (iii) Profit and Loss Account. • For Not–for–Profit Entities, it is referred as "Income and Expenditure Account".
(b) Statement of Financial Position	• This Statement (not an Account) shows the **financial position**, i.e. Assets and Liabilities of the entity as on a particular date. • It is also called "**Position Statement**", or "**Balance Sheet**".
(c) Statement of Movement of Funds	• These Statements (Funds Flow and Cash Flow Statements) are prepared in the case of Corporate Entities, for better understanding of financial position. • Receipts and Payments Account is prepared in the case of Not–for–Profit Entities.

Financial Statements / Final Accounts of Sole Proprietorship Entities

Non–Manufacturing /Trading Entities, i.e. Entities engaged in purchase and sale of goods, without involving any production process	Manufacturing Entities i.e. Entities engaged in converting Raw Materials into Finished Goods through a production process
1. Trading Account 2. Profit and Loss Account 3. Balance Sheet	1. Manufacturing Account 2. Trading Account 3. Profit and Loss Account 4. Balance Sheet

1.2 Relationship between Income Statement and Position Statement

Income Statement (i.e. Trading and P&L Account), and Position Statement (i.e. Balance Sheet) are **inter–related.** This inter–relationship can be understood from the following points / items –

1. Closing Stock of Finished Goods is credited to Trading A/c and is also considered in the Assets Side of Balance Sheet.
2. Depreciation on Assets (Machinery, Furniture, etc.) is debited to Profit and Loss Account, and the Net Book Value (i.e. Cost less Depreciation thereon) is shown on the Assets Side of the Balance Sheet.
3. Matching Principle is followed in recognizing expenses in Trading and P&L A/c. So, Expenses / Incomes relating to other periods are recorded as Prepaid Expenses / Outstanding Expenses / Incomes Receivable / Incomes received in advance, as the case may be, are adjusted in the P&L, and shown in Balance Sheet.

1.3 General Principles for Preparation of Financial Statements

1. **Business Entity Recognition:** Final Accounts are intended to show the profitability of the business and not that of its proprietors. Hence, all personal income and expenditure should be separated from business income and expenditure. If any goods have been withdrawn by the Proprietor for his personal use, they should be debited to Drawings Account and credited to Purchases Account.
2. **Capital–Revenue Distinction:** Distinction should be made between Capital and Revenue, both receipts and expenditure. Whether a particular expenditure is of a Capital Nature, or Revenue Nature or Deferred Revenue nature, should be judged based on the information available and other appropriate factors.
3. **Accrual and Matching Principle:** Adequate care should be exercised in order to ensure that the income and expenditure relate to the current period. For this purpose, entries relating to prepaid / accrued expenses, incomes received in advance etc. should be recorded in the books.
4. **Inventory Valuation:** The valuation of inventory (Raw Materials, WIP and Finished Goods) should be based on the generally accepted accounting principles. Such valuation should be fair, relevant and consistent with the basis adopted for the previous periods.
5. **Depreciation:** Depreciation in respect of Fixed Assets should be charged as per the method usually adopted by the enterprise. The relevant provisions of Accounting Standards and the applicable laws should be considered in this regard.
6. **Cut Off Procedures:** Though the record of the transactions should be maintained continuously, at the end of each accounting year, the transactions of the period which has ended should be cut off from those of the succeeding period.
7. **Effect of Year End Transactions:** The effect of transactions which were concluded before the close of accounting period should be adjusted in the accounts of the year, e.g. Goods on Sale or Return despatched, but approval is still awaited from the customer.
8. **Materiality:** Every information, considered material for judging the profitability of the business or its financial position, should be disclosed, e.g. non–saleability of certain items of stock, increase in wages of workmen, insolvency of certain major customers etc.
9. **Liability ascertainment:** All liabilities should be adequately estimated and measured. Provision should be made in respect of all accepted and recognized liabilities. Contingent Liability may have to be disclosed in respect of certain other items.
10. **Presentation & Classification:** Different types of Income and Expenditure should be classified under separate heads in the P&L Account. Assets should be included in the Balance Sheet at a valuation arrived at on the basis at which these were valued in the preceding year. Liabilities should be suitably classified, presented and disclosed.