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Excerpt
More information

Unit 1
Accounts of the sole trader

This unit consists of one section only:

Section 1: Final accounts

Section 1 Final accounts

By the end of this section you should be able to:

- explain the position of a sole trader in relation to profit
- state the purpose of preparing the Trading and Profit and Loss Accounts
- differentiate between gross profit and net profit
- close off the nominal accounts affecting the Trading and Profit and Loss Accounts
- explain how the closing stock is valued (lower of cost or net realisable value)
- determine the cost of goods sold and the gross profit in the Trading Account
- draw up Trading and Profit and Loss Accounts in a horizontal/vertical format.
- draw up an Income Statement from a Trial Balance to calculate gross profit and net profit
- prepare simple columnar Trading and Profit and Loss Accounts when dealing with a business with departments
- explain the purpose of and define the term 'balance sheet'
- identify the components of the Balance Sheet
- prepare a Balance Sheet of a sole trader in a horizontal/vertical format (current assets to be listed in order of liquidity).

Position of the sole traders

The owner contributed all capital (borrowed capital or own capital) to start up a business. The main aim of any trading business is to make profit. The profit or loss made by a business belongs to the sole trader. In order to address the sole traders accounts, let us look at the following:

Measuring results – profit or loss?

Profit is the difference between the total sales revenue of a business and the total costs of running that business over a given time period.

Total Sales Revenue	minus	Total Costs	=	Profit

So, if a year's sales are N$20 000 and total costs are N$15 000, profit is N$5 000.

Profit is a key element in running any business and we must now consider:

- why it is important to measure it
- how profit (or loss) is shown in accounting statements.

Why measure profit?

Perhaps you know someone who runs their own business. It wouldn't be too surprising if you did – businesses come in all shapes and sizes. In retailing, for example, businesses range from a small trading store to a large supermarket.

All these different businesses have one thing in common – their main objective is usually **to make a profit** for their owners.

To understand why this is so, we have only to consider what would happen if there were no profit, that is, if the business made a **loss** instead.

Amongst other things, a **loss** would mean the business could not:

- pay the owner(s) a proper return on the money invested in it (the capital)
- provide funds for replacing old or worn out equipment, or to develop new products.

No owner could face such prospects for long – the value of their capital would fall and they would lose business to more efficient (and profitable) competitors. If losses continued, the owner(s) would have no choice but to close down the business or sell it (if a buyer could be found). Their capital would be better invested elsewhere, in a savings account or perhaps in another business.

So one very important reason for measuring profit is because it **tells the owner how well his business is doing.** But the owner will need to know more than that. He or she also needs to know:

- is the profit better than last year?
- is the profit more or less than he estimated it would be?
- how does the profit compare with that of other similar businesses?

Only when he has the answers to these questions will the owner know how his business is progressing.

A PRUDENT owner would also see how much of the profit he could safely take out of the business as personal DRAWINGS, without reducing his capital.

We can now see why it is important for the owner of a business to know what profit he or she has made – without such a measurement, he will lack essential financial information to guide his decisions. For example, if he or she asks his/her bank for a loan, he or she (and the bank!) will need to be sure that profits will meet the additional costs of repayments and interest. Other persons or groups – a potential

Glossary

PRUDENT – financially careful

DRAWINGS – amounts drawn out of a business by the owner (e.g. cash) for personal use

BUSINESS PARTNER – a person who shares in the running of a business in return for a share of the profits

BUSINESS PARTNER, employees, creditors – will view a business' profits from their own particular standpoint.

ACTIVITY 1

1 A business has total sales for a year of N$50 000 and total costs of N$35 000. What is the business' profit?

2 State one reason why the owner of a business needs to know what profit he has made.

3 Imagine that Mike Jenkins has asked you to join his business as a partner. He offers you a salary of N$10 000 a year and a one-quarter share of profits after paying all other expenses.

Answer the following question by writing down as many points as you can.

What information about Jenkins' business would you need to have before deciding whether to become his partner? (As an example, are profits going up or down?)

You should complete this activity in about 20 minutes.

The Trading Account and the Profit and Loss Account are drawn up using the accounts in the Nominal Accounts section of the General Ledger.

These accounts are closed off at the end of the financial period by means of the double entry system. The journal used is the General Journal. Remember there can be adjustments (accrued expenses, accrued income, prepaid expenses or income received in advance), which are also posted to these accounts.

The concept of prudence is used when stock is valued. Stock should not be over-valued, otherwise profits shown will be too high. Therefore, if the net realisable value of stock is less than the cost of the stock, the figure to be taken for the final accounts is that of net realisable value.

At some stage the terminology was "lower of cost a market value". Changing it to "lower of cost or net realisable value" gives a more precise definition to the terms used when indicating which stock amount to use.

Accounting for profit

The **profit (or loss)** of a business is measured over a specified time period and is shown in the **Trading and Profit and Loss Account**. We have looked at the "why" of measuring profit. Now we must consider the "how".

Gross and net profit

Suppose that an electrical goods retailer bought 10 TV sets for N$100 each and sold them for N$125 each. His profit can be simply calculated as:

		N$
	Sales income/revenue (10 x N$125)	1 250
Less	Cost of TV sets sold (10 x N$100)	1 000
	This is the retailer's **GROSS PROFIT**	250

To find the true profit, however, we must **deduct any other expenses** of running the business **from his gross profit**.

If these other expenses (such as rent, insurance and advertising) come to N$100, we can complete the calculation to show his **net profit**.

		N$
	Gross profit (as above)	250
Less	Expenses	100
	NET PROFIT	150

SALES INCOME/REVENUE **less** COST OF GOODS SOLD = GROSS PROFIT

GROSS PROFIT **less** EXPENSES plus INCOME = NET PROFIT

Cost of sales is: [Opening Stock + (Purchases – Purchases Returns) + Carriage Inwards] – Closing Stock

We must now see how these basic profit calculations are set out in the form of accounting statements.

The accounting statements

A business prepares a Trading and Profit and Loss Account at the end of its financial year. This account consists of two parts:

- the Trading Account, which shows the calculation of the gross profit
- the Profit and Loss Account, which shows the calculation of net profit.

We will look at each account separately.

The Trading Account

A Trading Account in T-form is drawn up in a horizontal or traditional way. This is a completion of the double entry system when closing transfers are done at the end of the financial period.

Joe Kover owns a clothing and general store. He has been in business for two years. His Trading Account below is in the typical 'T' form.

Joe Kover
Trading Account

dr					**cr**
20.2		N$	20.2		N$
Dec 31	Stock (01.01.02)	4 000	Dec 31	Sales	100 000
	Purchases	62 000		Stock (31.12.02)	6 000
	Profit & Loss (Gross profit)	40 000			
		106 000			106 000

Notes

1. Sales are shown on the **credit (right-hand)** side of the account.
2. The cost of goods actually sold during the year is the total of:
   Purchases plus opening stock minus stock unsold at the end of the year.
   This is shown on the **debit (left-hand)** side of the account.
3. The total cost of goods sold is deducted from sales to show Joe's **gross profit** for the year.

The Trading Account can also be drawn up in a vertical format. The gross profit now is Sales – Cost of Sales. This is dealt with later on in the section.

In our studies in Module 1 we learnt that sometimes a business has to return goods to a supplier. These are known as **purchase returns** or **returns outward**. We first recorded these in the Creditors Returns Journal and then debited the supplier. The monthly total of the Creditors Returns Journal was transferred to the credit side of the Purchases Returns account.

Sometimes customers return goods to the business **(sales returns or returns inward)**. We learnt how these returns are first recorded in the Debtors Returns Journal and then credited in the customer's account. The monthly total of the Debtors Returns Journal was transferred to the debit side of the Sales Returns account.

The year-end totals of the Purchases Returns account and the Sales Returns account appear in the Trial Balance, as do the totals of the Purchases account and the Sales account. It is obvious that the returns reduce the amount of goods bought and sold.

In order to show the correct figures for purchases and sales in the Trading Account, we must deduct the purchase returns from the purchases and deduct the sales returns from the sales.

Glossary
CARRIAGE INWARDS – cost of bringing goods to the buyer's premises

Sometimes a business has to pay for purchased goods to be delivered to its premises. This is known as CARRIAGE INWARDS. Suppose that we have a retail shop and buy goods costing N$1 000 but have to pay a further N$100 to have them delivered to our shop. When fixing the selling price of these goods, we must remember that the total cost of the goods was N$1 100, not N$1 000.

Hint
Any goods taken for private use during the year will not affect the stock at the end of the year. The closing stock is the total of the goods actually in stock on that particular day.

Carriage inwards must be **added** to the **purchases** in the **Trading Account** as it is part of the cost of the goods sold.

In our previous studies we learnt that when the owner of a business takes any value out of the business for his or her own use it is known as **drawings**. If money is taken by the owner we credit the Cash Book and debit the Drawings account. Sometimes the owner takes **goods for his own use** (which the business had bought with the intention of selling to customers). Examination questions usually state the cost price to the business of these goods. The Drawings account is debited and the Purchases account is credited with this cost price. The total goods available for sale are reduced if some have been taken by the owner. By deducting the cost of such goods from the purchases they are ELIMINATED from the calculation of cost of goods sold.

Glossary
ELIMINATED – removed

If we are preparing final accounts from a Trial Balance, the figures shown for both purchases and drawings will be after goods for own use have been recorded, so no further action is required. Sometimes a note to a Trial Balance states that goods for own use have not been recorded. In this case we must **reduce** the **purchases** figure in the **Trading Account** and **increase** the **drawings figure** in the **Balance Sheet**.

We will now see how purchase returns, sales returns, carriage inwards and goods for own use appear in a Trading Account.

Study the following example:
Look back to the Trading Account for Joe Kover which we prepared on the previous page. Let us suppose that the figures for purchases and sales were after taking into account the following:

	N$
Goods taken by J. Kover for personal use	1 500
Returns Outwards	5 000
Returns Inwards	4 000
Carriage inwards	4 500

If these items had been shown in the Trading Account, which is the usual practice, the Trading Account would look like this:

Joe Kover
Trading Account

dr					**cr**
20.2		N$	20.2		N$
Dec 31	Returns Inwards	4 000	Dec 31	Sales	104 000
	Opening Stock	4 000		Closing Stock	6 000
	Purchases	64 000		Returns Outwards	5 000
	Carriage Inwards	4 500		Purchases	
	Profit and Loss			(Drawings)	1 500
	(Gross Profit)	40 000			
		116 500			116 500

In practice, most businesses prepare their final accounts in vertical format. The NSSC Syllabus allows you to use either the horizontal or the vertical method.

A vertical Trading Account shows exactly the same information as one prepared using the horizontal method. It is simply shown in a different way. The columns of figures are not set out with a division into debit (left) and credit (right). Instead it appears almost like an arithmetic calculation based on the formula mentioned earlier (Sales less Cost of goods sold equals Gross profit). It is often easier for a person with no accounting knowledge to understand the vertical method of presenting final accounts.

Study the following example:
Look back to the Trading Account for Joe Kover above which included returns, goods for own use and carriage inwards.

Using the vertical method of presentation, the Trading Account would look like this:

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Joe Kover
Trading Account for the year ended 31 December 20.2

		N$	N$	N$
Sales			104 000	
Less	Returns Inwards		4 000	100 000
Less	Cost of sales			60 000
	Opening stock		4 000	
	Purchases	64 000		
	Less Returns Outwards	5 000		
		59 000		
	Less Purchases (Drawings)	1 500		
		57 500		
	Plus Carriage inwards	4 500	62 000	
			66 000	
	Less Closing stock		6 000	
Gross profit				40 000

Hint
Remember that in Module 1 we learnt that stock is always valued at the lower of cost or net realisable value.

ACTIVITY 2

Peter Hiskia owns a retail shop selling waterproof jackets. On 1 April he had a stock of 40 jackets which had cost him N$10 each. During the month of April he purchased 150 jackets for N$12 each. Peter sells the goods in the order in which he received them. His sales for the month of April were 130 jackets at N$16 each.

Prepare Peter's Trading Account for the month ending 30 April 20.6 showing the stock on 30 April and the gross profit for the month.

This should take you no more than 10 minutes.

The Profit and Loss Account

Gross profit plus Other income less Expenses equals Net profit

Joe's gross profit of N$40 000 is transferred (brought down) from the Trading Account to the credit side of the Profit and Loss Account. All his **business expenses** are entered on the debit side of this account. The **total** of these is **deducted from gross profit** to show Joe's **net profit** for the year.

Joe Kover
dr **Profit and Loss Account** **cr**

20.2		N$	20.2		N$
Dec 31	Wages	17 000	Dec 31	Trading Account	
	Lighting and			(Gross Profit)	40 000
	heating	5 000			
	Advertising	1 000			
	Insurance	2 000			
	Depreciation of				
	Fixtures and Fittings	3 000			
	Capital				
	(Net Profit)	12 000			
		40 000			40 000

Later in our studies we learnt about the **matching concept** and how it is important to match the income of the period against the costs of the same period. We found that some expenses may be **prepaid**, meaning that a payment is made in advance of the accounting period to which it relates. Other expenses may be **accrued**, meaning that an amount due in an accounting period is unpaid at the end of that period.

Applying the matching concept to expenses

The expenses shown in a Profit and Loss Account must be adjusted so that they relate only to the period of time covered by this account. Any portion of an expense relating to a future accounting period is deducted from the amount paid for that expense, so that only the amount relating to the current period appears in the Profit and Loss Account. The amount prepaid will appear in the Balance Sheet as a current asset. Where an expense for the current accounting period is still unpaid, this amount is added to the amount actually paid for that expense and the total shown in the Profit and Loss Account. The amount owing will appear in the Balance Sheet as a current liability.

Applying the matching concept to income

It is, of course, not only expenses that may have to be adjusted for accruals and prepayments. Similar adjustments may have to be made where amounts of income such as rent received, do not match the accounting period. Any amount prepaid at the end of the period is deducted from the total amount received and any amount accrued at the end of the period is added to the total amount received. The amount shown in the Profit and Loss Account is therefore the amount relating to the period covered by this account. Income prepaid will appear as a current liability in the Balance Sheet and income accrued will appear as a current asset.

Study the following example:
Look back to the Profit and Loss Account which we prepared for Joe Kover on page 4. We are now given further information:

At 31 December 20.2	N$
Wages owing amount to	350
Insurance prepaid amounts to	500
Rent receivable due amounts to	600

The Profit and Loss Account would now look like this:

Joe Kover
Profit and Loss Account

dr					cr
20.2		N$	20.2		N$
Dec 31	Wages		Dec 31	Trading Account	
	(17 000 + 350)	17 350		(Gross Profit)	40 000
	Electricity	5 000		Rent Income	600
	Advertising	1 000			
	Insurance				
	(2 000 – 500)	1 500			
	Depreciation of shop				
	Fixtures and Fittings	3 000			
	Capital (Net Profit)	12 750			
		40 600			40 600

> **Hint**
> The double entry for the Net profit is made by crediting J. Kover's Capital account in the ledger.

We now need to learn how a Profit and Loss Account can be prepared using the vertical method. The information contained in the account is exactly the same but it is set out in a different way. A vertical Profit and Loss Account is almost like an arithmetic calculation based on the formula we learnt earlier (Gross profit plus Other income less Expenses equals Net profit).

Study the following example:
Look back to the Profit and Loss Account for Joe Kover above which included adjustments for accruals and prepayments.

Using the vertical method of presentation the Profit and Loss Account would look like this:

Joe Kover
Profit and Loss Account for the year ended 31 December 20-2

		N$	N$
Gross profit			40 000
Add	Rent Income		600
			40 600
Less	Expenses		27 850
	Wages (17 000 + 350)	17 350	
	Electricity	5 000	
	Advertising	1 000	
	Insurance (2 000 – 500)	1 500	
	Depreciation of shop fixtures & fittings	3 000	
Net profit			12 750

The types of expenses shown in a Profit and Loss Account will obviously vary from business to business. Suppose Business A rents premises and Business B owns its own premises. Business A will have an expense of rent whereas Business B will have expenses of repairs to premises and insurance of premises.

Earlier in this unit we learnt that carriage inwards appears in the Trading Account. Sometimes a business also has to pay CARRIAGE OUTWARDS. Where a business has delivered goods to its customers free of charge, this is regarded as a selling expense and appears in the Profit and Loss Account.

> **Glossary**
> CARRIAGE OUTWARDS – cost of taking goods to the customers of a business

In Module 1 Unit 2 we learnt how to record cash discount in the Cash Book and the Ledger. The total of the **Discount Allowed** account appears in the debit column of the Trial Balance and the total of the **Discount Received** account appears in the credit column. Both discounts appear in the Profit and Loss Account; discount allowed is an expense and discount received is an income.

> **Hint**
> The Trading and the Profit and Loss Accounts are usually combined into one statement rather than as two separate accounts.

ACTIVITY 3

The Trial Balance of David Akande at 31 March 20.6 includes the following balances.

	Dr N$	Cr N$
Sales		95 000
Purchases	55 000	
Returns Inwards	2 500	
Carriage Inwards	500	
Carriage Outwards	240	
Discount Allowed	1 600	
Discount Received		1 400
Stock 1 April 20.5	12 000	
Salaries	18 000	
General Expenses	4 400	
Bad Debts	800	
Rent Received		1 800

Additional information:

1

On 31 March 20.6	N$
Stock is valued at	7 000
General expenses owing amount to	200

2 The rent received covers a period of 15 months to 30 June 20.6.

3 During the year David took goods for his own use costing N$4 000. No entry has been made in the accounting records.

Prepare the Trading and Profit and Loss Account of David Akande for the year ended 31 March 20.6. Use the vertical style of presentation.

This should take you no more than 25 minutes.

Hint
A Trading and Profit and Loss Account must always have a heading showing the name of the trader, or business, and the period of time covered by the account.

Depreciation

Fixed assets (such as machinery and equipment) enable the business to earn profits over a number of years (the benefit they provide isn't all used up in the year of purchase, but lasts over several years). Their **cost** is therefore also spread over a number of years by making an **annual charge** against profits. This charge is **depreciation** and is **shown with other expenses on the debit side of the Profit and Loss Account**. In this way, no one accounting period carries costs which should, correctly, be charged against profits over the whole of the asset's life.

Glossary
DEPRECIATION – decrease in value of fixed assets over time