THE FINANCIAL STATEMENTS OF SOLE PROPRIETORS

Introduction

This session is concerned with preparing from double entry records, the financial statements of sole proprietors (i.e. sole traders).

These statements include:

- Statement of profit or loss (i.e. income statement)
- Statement of financial position (i.e. Balance sheet)

Statements of profit or loss

Purpose of statements profit or loss

The main reason why people set up business is to make profits. Of course, if the business is not successful, it may well incur losses instead. The calculation of such profits and losses is probably the most important objective of the accounting function. The owner will want to know how the actual profits compare with the profit they had hoped to make. Knowing what profits are being made helps businesses to do many things including:

- Planning ahead
- Obtaining loans from the banks, from other businesses, or from private individuals
- Telling prospective business partner how successful the business is
- Telling someone who may be interested in buying the business how successful the business is
- Calculating the tax due on the profits so that the correct amount of tax can be paid to the tax authorities

Session three dealt with the grouping of revenue and expenses prior to bringing them together to compute profit.In the case of a trader (someone who is mainly concerned with buying and selling goods), the profit is calculated by drawing up a **statement of profit or loss**.

When it is shown in details rather than in summary form (as is the case for the published statements of profit or loss of companies), it contains something called the **trading account**. The trading account is prepared in order to arrive at a figure for **gross profit.**

Below the trading account is shown a summary of another account –**the profit and loss account**. This profit and loss account should not be confused with the 'statement of profit OR loss.' The profit AND loss account is prepared so as to arrive at the figure for **net profit.**

It is these two accounts that together comprise the statement of profit or loss. Both the trading account and the profit and loss account are part of the double entry system. At the end of a financial period, they are closed off. They are then summarized and then the information they contain is the copied into a statement of profit or loss. **Statements of profit or loss are part of the double entry system**

Gross profit

One of the most important uses of statement of profit or loss is that of comparing the result obtained with the result expected. In a trading organization, a lot of attention is paid to how much profit is made, before deducting expenses, for every sh. 1 of sales revenue.As mentioned above ,so that this can easily be seen in the profit calculations, the statement in which profit is calculated is split into two sections – one in which the gross profit is found **(this is the trading account section of the statement),** and the next section in which **the net profit** is calculated **(is the 'profit and loss account 'section of the statement**).

Gross profit is the excess of sales revenue over the **cost of goods sold**. Where the cost of goods sold is greater than the sales revenue the result is **gross loss.** By taking the figure of sales revenue less the cost of goods sold to generate that sales revenue, it can be seen in the accounting custom is to calculate a trader's profits **only on goods that has been sold.**

To summarize:

Gross profit (calculated in the **trading account**)	Is the excess sales revenue over the cost of goods sold in the period

Net profit

Net profit, found in the profit and loss account section of the statement of profit or loss, consists of gross profit plus any revenue other than from sales, such as rents received or commissions earned, less the total cost used up during the period other than those already included in the 'cost of goods sold' Where the costs used up exceed the gross profit plus other revenue, the result is said to be a **net loss.** Thus:

Net profit (calculated in the profit and loss account)	Is what is left of the gross profit after all other expenses have been deducted.

Before drawing up a statement of profit or loss you should prepare a trial balance. This contains nearly or the information needed.

We can now look at the trial balance of B. Swift drawn up as on 31st December 2016 after the completion of his first year in business.

B.Swift

Trial balance as at 31st December 2016

	Dr.	Cr.
	Sh.	Sh.
Sales		38,500
Purchases	29,000	
Rent	2,400	
Lighting expenses	1,500	
General expenses	600	
Fixtures and fittings	5,000	
Account receivable	6,800	
Account payable		9100
Bank	15,100	
Cash	200	
Drawings	7,000	
Capital		20,000
	67,600	67,600

Now you have all the information needed in order to prepare the statement of profit or loss account for the year ending 31st December 2016. It looks like this:

B.Swift

Statement of profit or loss for the year ending 31st December 2016

	Sh.	Sh.
Sales		38,500
Less cost of goods sold:		
Purchases	29,000	
Less Closing stock	(3000)	
		(26,000)
Gross profit		12,500
Less Expenses		
Rent	2,400	
Lighting expenses	1,500	
General expenses	600	
Net profit		(4,500)
		8,000

Statements of financial position

Introduction

In this topic you will learn how to present assets, liability and capital balances in the statement of financial position and the importance of adopting a consistent and meaningful layout

In our previous session we learnt that statements of financial position contains details of assets, liabilities and capital. The items and amounts to be entered in the statement of financial position are found in the accounting books.As shown earlier, they comprise those accounts with balances that were not included in the statement of profit or loss. All these accounts that continue to have balances must be assets, capital or liabilities.

Drawing up a statement of financial position

B.Swift

Trial balance as at 31st December 2016

	Sh	Sh
Fixtures and fittings	5,000	
Account receivable	6,800	
Account payable		9,100
inventory	3,000	
Bank	15,100	
Cash	200	
Capital		21,000
	30,100	30,100

Let now draw up statement of financial position for B,Swaft as at 31st December 2016

Statement of financial position as at 31st December 2016

	Sh.
Assets	
Fixtures and fittings	5,000
Inventory	3,000
Account receivable	6,800
Bank	15,100
Cash	200
Total assets	30,100
Liabilities	
Account payable	(9,100)
Net asset	21,000
Capital	21,000

No double entry in the statements of financial position

When we draw up account such as a cash account, rent account, a sales account, a trading account or profit and loss account, we are preparing them as part of the double entry system.

As with the statement of profit or loss when we draw up a statement of financial position, we don't not enter anything in various accounts. We don't not actually *transfer* i.e fixtures and fittings account balances or the account payable balance, or any other balance, to the statement of financial position.

All we do is to *list* the assets, capital and liabilities balances so as to form a statement of financial position. This means none of these accounts has been closed off.

When the next accounting period starts, these accounts are still open and they all contain balances. As a result of future transactions, entries are then made in these accounts that add or deduct from these opening balances using double entry

If you see the word 'account' you will know that what you are looking at is part of the double entry system and will include debit and credit entries if the word 'account' is not used, it is not part of the double entry. For instance, the following are not ' accounts', and are therefore not part of the double entry:

Trial balance: this is a list of the debit and credit balances in the accounts.

Statement of profit or loss: This is the list of revenues and expenditures arranged so that to produce figures for gross profit and net profit for a specific period of time.

Statement of financial position: this is a list of balances arranged according to whether they are assets, capital or liabilities and so depict the financial situation on a specific date.

Assets

We are going to show the assets under the two headings, non- current assets and current assets

Non-current assets

Non-current assets are assets that:

1. were not bought primarily to be sold; but
2. are to be used in the business; and
3. are expected to be of use to the business for a long time.

Examples: buildings, machinery, motor vehicles, fixture and fittings

Non- current assets are listed first in the statement of financial position starting with those the business will keep for the longest, down to those which will not be kept so long. For instance:

Non-current assets

1. Land and buildings
2. Fixtures and fittings
3. Machinery
4. Motor vehicles

Current assets

Current assets are assets that are likely to change in the short term and certainly within twelve months of the date of the statement of financial position. They include items held for resale at a profit, accounts receivable, cash in the bank and cash in hand.

These are added in increasing order of liquidity-that is starting with the asset furthest away from being turned into cash, and finishing with cash itself.For instance:

1. Inventory
2. Accounts receivable
3. Cash at bank
4. Cash in hand

Some students feel that the accounts receivable should appear before inventory because at the first sight, inventory would appear to be more easily realizable (i.e. convertible into cash) than accounts receivable. In fact, accounts receivable can normally be more quickly turned into cash- you can often factor them by selling the rights to the amounts owed by debtors to finance company for an agreed amount.

As all retailers would confirm it is not easy to quickly turn inventory into cash. Another advantage of using this sequence is that it follows the order in which full realization of assets in a business takes place: before there is a sale, there must be an inventory of goods which, when sold on credit, turns into accounts receivable and, when payment is made by the debtors, turns into cash.

Liabilities

There are two categories of liabilities, current liabilities and non- current liabilities.

Current liabilities

Current liabilities are items that have to be paid within a year of the date of the statement of financial position.

Examples: Bank overdrafts, accounts payable resulting from purchases on credit of goods for resale

Non-current liabilities

Non- current liabilities are items that have to be paid more than a year after the date of the statement of financial position.

Examples: bank loans, loans from other businesses

A PROPERLY DRAWN UP STATEMENT OF FINANCIAL POSITION

B. Swift

Statement of financial position as at 31st December 2016

	Sh.	Sh.
Non -current assets		
Fixtures and fittings		5,000
Current assets		
Inventory	3,000	
Accounts receivable	6,800	
Bank	15,100	
Cash	200	
		25,100
Total assets		30,100
Current liabilities		
Account payable		(9,100)
Net assets		21,000
Capital		
Cash introduced		20,000
Add net profit		8,000
		28,000
Less drawings		(7,000)
		21,000

Notes

(a) There are four categories of entries shown in this a statement of financial position. In practice, the fifth, non-current liabilities, often appears. It is positioned after the current liabilities; and its totals is added to the total current liabilities to get the figure of total liabilities Example above shows where this would be if B. Swift had non-current liabilities.
(b) The figure for each item within each category should be shown and a total for the category produced. An example of this is the sh. 25,100 total of current assets. The figure for each assets are listed and the total shown before them.
(c) The total for non-current asset is added to the total for current assets and the total is labelled 'total assets'

(d) The total for current liabilities is added to the total of non-current liabilities and the total is labelled ‘total liabilities’

(e) The total liabilities amount is subtracted from the total assets to get amount labelled ‘net assets’. This amount will be the same as capital (which, in the company financial statements is called ‘ total equity’).

(f) You don’t write the word ‘account’ after each item.

(g) The owners will be most interested in their capital and the reason why it has changed during the period. To show only the final balance of sh. 21,000 means the owners will not know how it was calculated. So we show the full details of capital account.

(h) Look at the dates on the statement of financial position. Now compare it with the dates put on top of the statement of profit or loss account above. The statement of financial position is a position statement- it is shown as being at one point in time,e.g. ‘ *as at* 31st December 2016’ The statement of profit or loss is different. It is for a period of time, in this case for a whole year, and so it uses the phrase ‘for the year ending.’

NOTE

The difference between current asset and total liabilities is known as ‘net current assets’ or working capital and the amount of resources the business has in form that is readily convertible into cash .this figure is not shown in the statement of financial position but easy to produce from a completed statement of financial position.

B. Swift

Statement of financial position as at 31st December 2016

(Showing the position of non-current liabilities)

	Sh	sh
Non -current assets		
Fixtures and fittings		5,000
Current assets		
Inventory	3,000	
Accounts receivable	6,800	
Bank	15,000	
Cash	200	
		25,100
Total assets		30,100
Current liabilities		
Account payable	9,100	
Non-current liabilities	-	
Total liabilities		(9,100)
Net assets		21,000
Capital		
Cash introduced		20,000
Add net profit		8,000
		28,000
Less drawings		(7,000)
Total capital		21,000

Statement Of Profit Or Loss And Statement Of Financial Position: Further Considerations

Introduction in this chapter you 'll build on what you learned in session three and how to treat goods returned from customers and goods returned to suppliers in the trading account. you'll also learn how to deal with the cost of transporting goods into and out of a business. you will learn how to record inventory in an inventory account and then carry it forward in the account to the next period. You will also learn how to enter opening inventory in trading account. You will learn that there are other costs that must be added to the cost of goods in the trading account. Finally, you will learn how to prepare profit or loss and statement of financial position when any of these items are included in the list of balances at the end of the period.

Returns inwards and returns outwards.

In Session 3, the idea of different accounts for different movements of inventory was introduced. There are four accounts involved, the sales account and the **returns inwards account** deal with goods sold and good returned by customers. The purchases account and return outwards account deals with goods purchased and goods returned to the supplier respectively .In our first look at the preparation of trading account, return inwards and return outwards were omitted. This was done deliberately, so that your first sight of statement of profit or loss would be as straightforward as possible.

A large number of businesses return goods to their suppliers (returns outwards) and will have goods returned to them by their customers (returns inwards). When the gross profit is calculated, these returns will have to be included in the calculation.

Let us look at the first two lines of the trial balance you saw

Example 1

B.Swift

Trial balance as at 31st December 2016

	Dr.	**Cr.**
	Sh.	Sh
Sales		38,500
Purchases	29,000	

Now suppose that in the above example the trial balance of B. Swift, rather than simply containing a sale account balance of sh. 38,500 and purchase account balance of sh. 29,000 the balances included those for return inwards and return outwards:

Example 2

B. Swift

Trial balance as at 31st December 2016 (extract)

	Dr.	Cr
	Sh.	Sh.
Sales		40,000
Purchases	31,200	
Return inwards	1,500	
Return outwards		2,200

Comparing these two exhibits reveals that they amount to the same thing so far as gross profit is concerned. Sales were sh. 38,500 in the original example because return inwards had already been deducted in arriving at the amount shown in example 1.In the amended version, return inwards should be shown separately in the trial balance and then deducted on the face of statement of profit or loss to get correct figure of goods sold to customers and *kept* by them, i.e.sh 40,000-sh 1,500 =sh. 38,500. Purchase were originally shown as being sh. 29,000in the new version return outwards should be deducted to get the correct figure of purchase *kept* by Swift. both the return accounts are included in the calculation of gross profit which now becomes:

(sales *less* Return inwards- (cost of goods sold *less* Return outwards) =Gross profit

The gross profit is therefore unaffected and is the same above trading profit or loss account

The trading account section of the statement of profit or loss will appear as below:

B. Swift

Trading account section of statement of profit or loss for the year ending 31 December 2016

	Sh.	Sh.
Sales		40,000
Less Return inwards		(1,500)
		38,500
Less cost of goods sold:		
Purchases	31,200	
Less Return outwards	(2,200)	
	29,000	
Less closing inventory	(3,000)	
		(26,000)
Gross profit		12,500

Carriage

If you have ever purchased anything by a telephone or over the internet , you have probably been charged for 'postage and packaging '.When goods are delivered by a supplier or send by a customer the cost of transporting goods is often an additional charge to the buyer. This charge is called 'carriage'. When its charged for the delivery of goods purchased, it is called **carriage inwards**. Carriage charged on goods sent out by a business to its customers is called **carriage outwards.**

When goods are purchased, the cost of carriage inwards may either be included as hidden part of the purchase price, or be charged separately, for example suppose your business was buying exactly the same goods from two suppliers.one supplier might sell them at sh. 100 and not charge anything for carriage. Another supplier might sell the goods for sh. 95, but you would have to pay sh. 5 to a courier for carriage inwards i.e the total cost of sh. 100. In both cases, the same goods cost you the same total amount. It would not be appropriate to leave out the cost of carriage inwards from the 'cheaper' supplier in Calculation of gross profit, as the real cost to you having the goods available for resale is sh. 100.

As a result in order to ensure that the true cost of buying goods for resale is always included in the calculation of gross profit, **carriage inwards is *always* added to the cost of purchase in the trading account.**

Carriage outwards is not part of the selling price of goods. Customers could come and collect the goods for themselves, in which case there would be no carriage outwards expense for the seller to pay or to recharge customers. **Carriage outwards is always entered in the profit and loss account section of the statement of profit or loss .It is *never* included in the calculation of gross profit.**

Suppose that in the illustration shown in this session, the goods had been bought for the same total figure of sh. 31,200 but in fact sh. 29,200 was the figure for purchases and sh. 2000 for carriage inwards. The trial balance extract would appear as follows:

B. Swift

Trial balance as at 31st December 2016 (extract)

	Dr.	**Cr.**
	Sh.	Sh.
Sales		40,000
Purchases	31,200	
Return inwards	1,500	
Return outwards		2,200
Carriage inwards	2,000	

The accounting section of the statement of profit or loss would then be shown as below:

B. Swift

Trading account section of statement of profit or loss for the year ending 31 December 2016

	Sh.	Sh.
Sales		40,000
Less Return inwards		(1,500)
		38,500
Less cost of goods sold:		
Purchases	29,200	
Less Return outwards	(2,200)	
	27,000	
Carriage inwards	(2,000)	
	29,000	
Less closing inventory	(3,000)	
		(26,000)
Gross profit		12,500

It can seen that the three versions of B. Swift's trial balance have all been concerned with the same overall amount of goods bought and sold by the business, at the same overall prices.Therefore, in each case, the same gross profit of sh. 12,500 has been found.

The second year of the business

At the end of his second year of trading, on 31 December 2017, B.Swift draw up another trial balance.

B. Swift

Trial balance as at 31st December 2017

	Dr.	Cr.
	Sh.	Sh.
Sales		67,000
Purchases	42,600	
Lighting and heating expenses	1,900	
Rent	2,400	
Wages: shop assistant	5,200	
General expenses	700	
Carriage outwards	1,100	
Buildings	20,000	
Fixtures and fittings	7,500	
Account receivable	12,000	
Account payable		9,000
Bank	1,200	
Cash	400	
Drawings	9,000	
Capital		31,000
Inventory (at 31 December 2016)	3,000	
	107,000	107,000

Adjustments needed for inventory

So far, we have been looking at new businesses only. When a business starts, it has no inventory brought forward. B. Swift started a business in 2016. Therefore, when we were preparing Swift's statement of profit or loss for 2016, there was only closing inventory to worry about.

When we prepare the statement of profit or loss for the second year we can see the difference. If you look back to the statement of profit or loss above, you can see that there was a closing inventory of sh. 3,000. This is, therefore, the opening inventory figure for 2017.We will need to incorporate in the trading account. It is also the figure for inventory that you can see in the trial balance at 31st December 2017.

The closing inventory for one period is *always* brought forward as the opening inventory for the next period.

Swift checked his inventory at 31st December 2017 and valued it at that date at sh.5,500.

We can summarize the opening and closing inventory account position for Swift over the two years as follows:

Trading account for the period→	Year ending 31st December 2016	Year ending 31st December 2017
Opening inventory 1.1.2016 Closing inventory 31.12.2016 Opening inventory 1.1.2017 Closing inventory 31.12.2017	None Sh. 3,000	 Sh.3,000 Sh.5,500

Inventory account

Let's look at the inventory account for both years

inventory

2016	sh.	2016	Sh.
Dec 31 Trading	3,000	Dec. 31 Balance c/d	3,000
2017		2017	
Jan 1 balance b/d	3,000	Dec 31 Trading	3,000
Dec 31 Trading	5,500	31 Balance c/d	5,500
	8,500		8,500

You can see that in 2017 there is a debit and credit double entry made at the end of the period to the trading account. First, the inventory account is debited with opening inventory amount of sh. 3,000and the trading account is debited with the same amount. Then, the inventory account is debited with the closing inventory amount of sh.5,500 and the trading account is credited with the same amount.

Thus, while the first year of trading only include the inventory figure in the trading account, for the second year of trading both opening and closing inventory figures will be in the calculations

Let's calculate the cost of goods sold in 2017

	Sh.
Inventory of goods at the start of the year	3,000
Add Purchases	42,600
Total goods available for sale	45,600
Less what remains at the end of the year (i.e closing inventory)	(5,500)
Therefore the cost of goods that have been sold is	40,100

The calculation of gross profit can now be done. You know from the trial balance that sales were sh.67,000and from the calculation above the cost of goods sold is sh.40,100.gross profit is therefore, sh. 26,900

Now the profit or loss and the statement of financial position can be drawn up,as shown below

B. Swift

statement of profit or loss for the year ending 31 December 2017

	Sh.	Sh.
Sales		67,000
Less cost of goods sold:		
Opening inventory	3,000	
Add Purchases	42,600	
	45,600	
Less Closing inventory	(5,500)	
		(40,100)
Gross profit		26,900
Less Expenses:		
Wages	5,200	
Lighting and heating expenses	1,900	
Rent	2,400	
General expenses	700	
Carriage outwards	1,100	
		(11,300)
Net profit		15,600

B. Swift

Statement of financial position as at 31st December 2017

	Sh.	Sh.
Non current assets		
Buildings		20,000
Fixtures and fittings		7,500
		27,500
Current assets		
Inventory	5,500	
Account receivable	12,000	
Bank	1,200	
Cash	400	
		19,100
Total assets		46,600
Current liabilities		
Account payable		(9000)
Net assets		37,600
Capital		
Balance as at 1 January 2017		31,000
Add net profit for the year		15,600
		46,600
Less Drawings		(9,000)
Total capital		37,600

Other expenses in trading account

You already know that carriage inwards is added to the cost of purchases in trading account. You also need to add to the cost of goods in the trading account any other cost incurred in converting purchases into goods for resale. In the case of a trader, it is very unusual for any additional cost to be incurred getting the goods ready for sale.

For goods imported from abroad it is usual to find that the cost of importing duty and insurance are treated as part of the cost of goods, along with any other cost incurred in repackaging the goods. Any such additional cost incurred in getting goods ready for sale are debited to the trading account.

Review questions

Q 1.

From the following trial balance of I. Lamb, extracted after one year 's trading, prepare a statement of profit or loss for the year ending 31 October 2016.

Trial balance as at 31 October 2016

	Dr.	Cr.
Sales		100,250
Purchases	60,400	
Salaries	29,300	
Motor expenses	1,200	
Rent	950	
Insurance	150	
General expenses	85	
Premises	47,800	
Motor vehicles	8,600	
Accounts receivable	13,400	
Accounts payable		8,800
Cash at bank	8,200	
Cash in hand	300	
Drawings	4,200	
Capital		65,535
	174585	, 174,585

The inventory at 31 December 2016 was sh.15,600.

B) prepare the statement of financial position as at 31 October 2016.

Q2.

From the following trial balance of G.Still draw up the statement of profit or loss for the year ending 30 September 2017 and statement of financial position as at that date.

	Dr.	Cr.
	Sh.	Sh.
Inventory: 1 October 2016	41,600	
Carriage outwards	2,100	
Carriage inwards	3,700	
Return inwards	1,540	
Return outwards		3,410
Purchases	188,430	
Sales		380,400
Salaries and wages	61,400	
Warehouse rent	3,700	
Insurance	1,356	
Motor expenses	1,910	
Office expenses	412	
Lighting and heating expenses	894	
General expenses	245	
Premises	92,000	
Motor vehicles	13,400	
Fixtures and fittings	1,900	
Accounts receivable	42,560	
Account payable		31,600
Cash at bank	5,106	
Drawings	22,000	
Capital		68,843
	484,253	484,253

Inventory at 30 September 2017 was sh.44,780.

Q3.

The following trial balance was extracted from the books of F. Sorley on 30 April 2017.From it, and the note about inventory, prepare his statement of profit or loss for the year ending 30 April 2017, and a statement of financial position as at that date.

	Dr.	Cr.
	Sh.	Sh.
Sales		210,420
Purchases	108,680	
Inventory: 1 May 2016	9,410	
Carriage outwards	1,115	
Carriage inwards	840	
Returns inwards	4,900	
Returns outwards		3,720
Salaries and wages	41,800	
Motor expenses	912	
Rent	6,800	
Sundry expenses	318	
Motor vehicles	14,400	
Fixtures and fittings	912	
Accounts receivable	23,200	
Account payable		14,100
Cash at bank	4,100	
Cash in hand	240	
Drawings	29,440	
Capital		18,827
	247,067	247,067

Inventory at 30 April 2017 was sh. 11,290.