17. Business Organization or Business Units (I): The Sole Trader

Objective

At the end of this chapter, students should be able to explain the meaning of sole proprietorship (the sole trader), list his sources of capital, state the advantages and disadvantages and finally identify the different sections of the balance sheet of the sole trader.

17.1 Introduction

Business units can be either incorporated or unincorporated. While some are limited liability others are unlimited liability, e.g. the sole trader.

17.2 The Sole Trader

17.2.1 Meaning

The sole trader is the oldest, commonest and simplest form of business unit. It is otherwise referred to as *â€˜sole ownershipâ€™*, *â€˜sole proprietorshipâ€™*, *â€˜individual enterpriseâ€™*, or *â€˜individual proprietorshipâ€™* and above all, *â€œone-man businessâ€.*

(i) *Entrepreneurship:* Owner works there full-time or part-time, depending on the stage of development and size of business. He takes all the decisions by himself.

(ii) *Other sources of labour:* Apart from himself, he is sometimes assisted by his family members (who may be unpaid) and a few paid assistants (recommended by friends).

(iii) *Remuneration:* The owner does not draw salaries or take interest on the capital invested. Nevertheless, he takes certain amount from the sales and proceeds for his own upkeep and that of his immediate family.

(iv) *Profit making:* The owner takes all the profit and bears the losses alone.

17.2.2 Sources of Capital

Capital is mostly supplied by the owner. In addition, with luck, the owner may be able to take up a little loan from his friends, family and the commercial banks.

17.2.3 Advantages of Sole Proprietorship

The inherent advantages of the sole proprietorship or sole trader are:

(i) *Formation procedure:* This is very simple and there is no need for legal consultation or application to the Registrar of Companies.

(ii) *Independence of action:* He has freedom of action and he is not responsible to anybody. He is his own boss; there is no board of directors to consult.

(iii) *Personal supervision:* He takes personal interest in his business and gives it the attention it deserves.

(iv) *Personal knowledge of market:* He knows the market situation and he is adept in the customerâ€™s tastes and periods of the day convenient for his customers.

(v) *Organization and management:* This is simple. Management problems are, if any, not chronic or major.

(vi) *Flexibility:* Since he has a free hand, decision making processes are simple. He can easily adjust to changing prevalent economic and social conditions.

(vii) *Legal responsibilities:* These are minimal and limited to the ordinary business responsibilities to creditors, customers and the few workers. For instance, there is no publication of audited accounts.

(viii) *Secrecy:* Since there is no legal requirement for publication and filing of accounts. The sole trader enjoys absolute privacy in his enterprise. Industrial espionage (business spying) is not a common disease in sole proprietorship, as it is in the large firms.

(ix) *Share of profit:* Since the sole owner pockets the whole profit by himself, he works as hard as humanly possible to make his small business a success.

(x) *Pride of ownership:* Pride of ownership, as it is often said, turns dust into gold. This happy spirit of ownership is a propelling factor that keeps the business going at all costs.

(xi) *Economic inertia:* This is a compelling factor which states that the business must not only survive, it must succeed. This is explained by the fact that the business provides not only employment, but also the major source of living, not only for the sole trader but for his entire family as well. Consequently, the sole trader would see that the business succeeds under all circumstance.

17.2.4 Disadvantages of Sole Proprietorship

The disadvantages of sole trading are discussed below.

(i) *Nature of business:* Some small business are by nature small and they are unresponsive to large-scale expansion. Examples are local shoemaking, tailoring, etc.

(ii) *Limited sources of capital:* Source of capital for the small businesses are usually limited and restricted. For example, they cannot raise capital by shares or by loans from the investment development banks like NBCI (Nigerian Bank for Commerce and Industries) and NIDB (Nigerian Industrial Development Bank).

(iii) *Limited specialization:* The owner cannot afford to employ specialized skills. In essence, division of labour is very marginal. If there is any personnel at all, the same person may be marketing manager, stock-keeper, book-keeper, cleaner, etc., at the same time. Under these conditions, the owner is considerably burdened by the strains of the many facets of duties. Expansion of business in such circumstances is difficult.

(iv) *Unlimited liability:* If he pockets all the profits, he also carries all the losses even to the extent of making good the losses by the sale (by auction if possible) of his personal property.

(v) *Risks in expansion:* The combined *effects* of (i) to (iv) above mean that any expansion is a risky operation fraught with danger.

(vi) *Lack of perpetual existence:* The surviving children or relations of most sole traders are not capable of or interested in carrying on the family business; the result is that most small businesses do not survive the deaths of their founding proprietors.

17.3 The Balance-sheet of the Sole Trader

The balance-sheet is a common terminology in book-keeping and accounts. It is explained as a financial statement showing the summary of assets and liabilities of any business or organization at a given date. What then are assets and liabilities?

17.3.1 Assets

These are all the resources of any business or organization used in carrying out the objectives of the organization such as in the production of goods and services (wealth), or in generating revenue. It is usual to classify assets into two categories.

(i) *Fixed assets:* These are assets that remain permanent in the organization and are used year in, year out. They do not alter form except that they wear out generally over time. Fixed assets can be physical and, therefore, referred to as *tangible,* e.g. land and building, plant and machinery, vehicles, etc.

Depreciation accounts for the wear and tear of the fixed assets by writing off a fraction or a percentage of the normal value of fixed assets on yearly basis to the accounts of the business. By doing this the profit of the year is reduced by the estimated value of fixed assets used in the year.

(ii) *Current assets:* These are assets that keep changing form in an organization. Examples are cash, raw materials, semi-finished goods, debtors. Current assets are also known as *circulating capital,* e.g. cash is used to buy raw materials, while the latter can be changed into semi-finished and finished products; which are also sold into cash or on credit first to debtors and debtors pay cash finally. The diagram below illustrates the point.

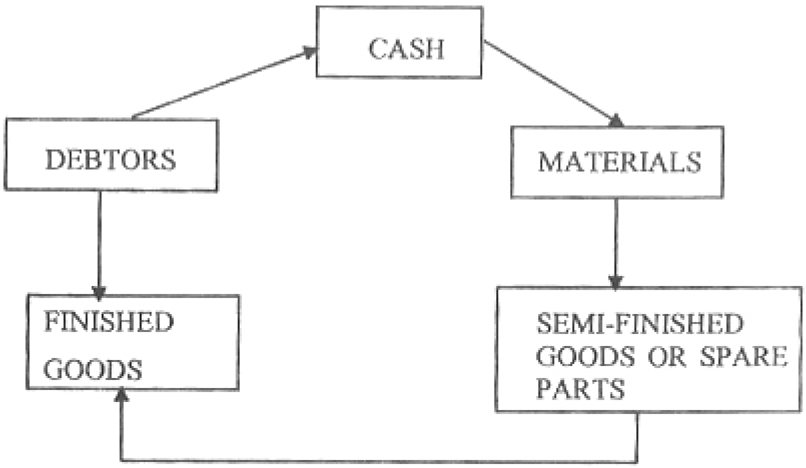

Fig. 17.1: *Current Assets (Circulating capital)*

17.4 The Nature of the Assets of the Sole Trader

While every organization or enterprise has both fixed and current assets, the nature of such assets differs from enterprise to enterprise. The assets of a sole trader, e.g. bookseller may be put thus:

Fixed Assets

Land and Building:	A shop within a building (either owned personally, i.e. freehold or by rent, i.e. by lease).
Furniture & fittings:	Bookshelves (for displaying books); chairs and tables for shop assistantsâ€™ use.

Equipment::	Typewriters, photocopy machines, staplers (for office use).
Vehicles:	The fleet of vehicles used in carriage and delivery of stock of books.

Current Assets

Stock:	Books, pencils, pens, rulers, staplers, etc. (for sale)
Debtors:	List of customers to whom books and other goods are sold on credit.
Pre-payment:	Payments made in advance to suppliers.
Cash in bank:	Any bank deposits (current or savings).
Cash in hand:	Any cash in the office safe or till.

Liabilities

These represent the various forms of capital (funds) put into use by the business or organization. Basically, liabilities like assets, are classified into two groups – long term liability and short term liability

(i) *Long-term liability:* This is capital put into the business e.g. capital by those who buy shares in a company or give loans to the company on long-term basis, i.e. debenture holders. Long-term liability can be described as long-term capital. When the capital is by the owners of the business, then it is *equity capital;* if it is given by debenture holders (those who give out loans, i.e. creditors) it is a *loan capital.*

(ii) Current liability: This is the short-term debt of an organization. Examples are goods and materials obtained on credit – referred to as *creditors;* bank overdrafts; electricity bills, or any other bills (telephone, etc.) outstanding; any expenses owing wages and, salaries unpaid – referred to as *accruals;* taxes collected by deduction from employeesâ€™ wages and salaries, but not yet paid to the Inland Revenue.

Nature of Liability and the Sole Traderâ€™s Liabilities

As in the case of assets, the nature of the liability of an organisation would centre around the nature of the organization. The liabilities of the sole trading organization would be conditioned by the following factors:

It follows that the popular sources of funds for a sole trader for long-term capital are:

(i) Personal savings, i.e. ownerâ€™s capital or equity capital

(ii) Ploughed back from the business profit

(iii) Loans from relatives, friends and sometimes from the commercial banks

Current liabilities

(i) Credit facilities

(ii) Some bills outstanding from electricity, rent, wages, salaries

(iii) Income tax proceeds not yet paid to the Inland Revenue

Here is a typical balance-sheet of a sole trader.

(a) *The Modern Method*

Table 17.1 The Balance Sheet of Olubi Woodworks and Company – A Sole Trader as at

December 31, 2002

Modern style	*Cost*	*Depreciation*	*Net values*
Fixed Assets	₦	₦	₦
Land and building (freehold)	130	NIL	150
Shop fittings	110	22	88
Plant and machinery	115	23	92
Vehicles	112	22.4	89.6
	487	67.4	419.6
Add Current Assets			
Stock of raw materials	15		
Stock of finished goods	112		
Debtors	14		
Pre-payments	12		
Cash at bank	16		
Cash in hand	11		
	180		
Less Current Liabilities			
Creditors	7		
Accrued expenses	6		
Electricity	11		
Rent	5		
Tax (owing to Inland Revenue)	21	50	
Working Capital (i.e. current assets – current liabilities) [180-50]	130	130	
Net assets (net fixed assets + working capital [419.6 + 130]	549.6		
Financed by			
Capital (from ownerâ€™s savings)	349		
Profit (ploughed back)	150.6		
Equity capital (i.e. ownerâ€™s capital	499.6		
Long-term bank loans	50		
i.e. loan capital			
Total capital		549.6	

(b) *The Conventional Style*

Table 17.2 The Balance Sheet of Olubi Woodworks & Co. (A Sole Trader) as at December 31

Long-term Liabilities		*Assets*	₦	₦	₦
Capital	349.6	Fixed Asset	Cost	Depr.	Net Value
+		Land & Building	150	--	150
Profit	150	Shop fittings	110	22	88
Equity C or	499.6	Plant mach.	115	23	92
(Owners Capital)		Vechicles	112	22.4	89.6
Add loan capital	50		487	67.4	419.6
	549				
Add Current Liabilities		*Add Current Assets*			
Creditors	7	Raw materials		15	
Accrued exps.	6	Finished work		112	
Electricity	11	Debtors		14	
Rent	5	Pre-payments		12	
Tax (owing)	21	Cash in bank		16	
	50	Cash in hand		11	180
	599.6	Total capital			599.6

Notes

(a) Modern and conventional methods are always of two styles.

(b) Agreement of the two totals on the balance-sheet. This is shown easily by the unconventional style. It is equally demonstrated in the old method since the net assets figure agrees with the total capital employed, i.e. equity capital + loan capital.

(c) In drawing up a balance-sheet, it is important to state the following information as heading:

(i) Name of business or organization for whom the balance sheet is being prepared.

(ii) The last day on which the balance-sheet is being drawn, i.e. balance-sheet of *Olubi Woodworks and Company as at December 31, 2002.* Balance-sheet is normally prepared at a date and for a period like a month or a year.

(d) Sub-headings: In all balance sheets, the four important sub-headings must be stipulated distinctly, i.e. fixed assets; current assets; long-term liabilities; current liabilities.

(e) Fixed assets are usually considered under three headings:

(i) Cost;

(ii) Depreciation;

(iii) Net Value (W.D.V.).

The net value is usually arrived at by subtracting depreciation from actual cost. The net value is alternatively referred to as *Written Down Value* of asset (W.D.V.) Land and buildings normally do not have depreciation since they usually increase in value with time, i.e. appreciate.

(f) Working capital (as shown in the modern style) is current assets minus current liabilities. Working capital is an indication of the ability of the business to generate enough cash, for the day-to-day working of the business. In addition, it indicates whether the organization has enough liquid asset to pay up all its current liabilities should all its creditors demand prompt payment. In this illustration, current assets of ₦30,000 against current liabilities of ₦10,000 shoes a surplus of liquid assets of ₦420,000. This is a comfortable financial position for the organization.

(g) The importance of value of net assets, net fixed assets plus working capital is that it must agree with and show total of capital (ownerâ€™s and loan capital).

Summary

â€¢ Business organizations can be either incorporated or unincorporated; others have limited liability and others unlimited liability.

â€¢ Sole trading which is otherwise known as â€˜sole proprietorshipâ€™ is a good example of an unincorporated company with unlimited liability. He takes the whole profit or loss of the business. He also has independence of action in the business. His sources of capital are limited to private means, as he cannot raise money in the capital market. The form of final account is like that of the limited liability company, i.e. trading profit and loss account and the balance-sheet, with the balance-sheet showing the sources of finance referred to usually as the liability and the property of the business known as the assets.

Revision Questions

A. Essay Questions

1. (a) Who is a sole trader?
   (b) Give four of its features.
2. In spite of large efficient firms, with large scale and cheap production unit costs and lower prices, why has the sole trader managed to survive? Give six reasons.
3. Give six problems of sole proprietorship.
4. (a) What are assets?
   (b) Mention the types.
5. (a) What are liabilities?
   (b) Explain long-term and current liability.

B. Objective Questions

1. Which of the following is a feature of sole proprietorship?
   A. Business name must be registered
   B. Liability of the owner is limited
   C. It is a legal entity
   D. Decisions are promptly made

   (WASSCE 2000)
2. Furniture and fittings used in a business are classified as
   A. fixed asset
   B. circulating capital
   C. current asset
   D. working capital

   (WASSCE 2000)
3. Capital plus profit minus drawings is equal to

A. fixed capital
B. liquid capital
C. capital owned
D. capital employed

(WASSCE 2000)

4. Which of the following is a source of capital to a sole proprietor
A. shares
B. savings
C. debentures
D. bonds

(WASSCE 1999)

5. â€œCapital Ownedâ€ by a sole proprietor is the difference between
A. sundry creditors and sundry debtors
B. current assets and current liabilities
C. total assets and current liabilities
D. fixed and current assets

(WASSCE 1999)

6. Malam Soho started a business with a capital of N20,000 and spent Nl5,000 of it to buy machines and equipment. The remaining N5,000 is his
A. capital owned
B. nominal capital
C. working capital
D. fixed capital

(WASSCE 1999)

7. Which of the following is an internal source of capital to a business concern?
A. Trade credit
B. Debenture
C. Overdraft
D. Retained profit

(WASSCE 2002)

8. In what service will a sole trader NOT be found?
A. business consultant
B. electrician
C. decorator
D. national electric power authority
E. surveyor

(NECO 2001)

9. One of these is NOT an item of current assets
A. Creditors
B. Debtors
C. Pre-payment

D. Stock of good

Project

Suppose your own family had about N850,000 as capital to go into business, which type of business would you recommend for your family? How many of you in the family would be involved? In each case, state your reasons.