5 Sole trader final accounts

this chapter covers . . .

In the previous chapter we looked at how the extended trial balance (ETB) format is a first step towards preparing year-end final accounts. In this chapter we take the ETB further to develop final accounts in the conventional format – or proper form – used by accountants.

***Maintaining Financial Records and Preparing Accounts** focuses on preparing the final accounts of sole traders and partnerships. In this chapter we look at sole traders as a type of business organisation and see the proper form in which the final accounts of a sole trader are presented. Partnership final accounts are considered later in the book (Chapters 14 and 15). Limited companies – a larger type of business organisation – are covered at Level 4 of NVQ Accounting (see Osborne Books' **Limited Company Accounts**).*

NVQ PERFORMANCE CRITERIA COVERED

unit 5: MAINTAINING FINANCIAL RECORDS AND PREPARING ACCOUNTS

element 5.3

preparing the final accounts of sole traders and partnerships

A *prepare final accounts of sole traders in proper form, from the trial balance*

C *observe the organisation's policies, regulations, procedures and timescales in relation to preparing final accounts of sole traders and partnerships*

D *identify and resolve or refer to the appropriate person discrepancies, unusual features or queries*

SOLE TRADERS

Sole traders are people in business on their own: they run shops, factories, farms, garages, local franchises, etc. The businesses are generally small because the owner usually has a limited amount of capital. Profits are often small and, after the owner has taken out drawings, are usually ploughed back into the business.

People set up as sole traders for various reasons:

- the owner has independence and can run the business, often without the need to consult others
- in a small business with few, if any, employees, personal service and supervision by the owner are available at all times
- the business is easy to establish legally – either using the owner's name, or a trading name such as 'The Fashion Shop' or 'Wyvern Plumbers'

The disadvantages of a sole-trader business are:

- the owner has unlimited liability for the debts of the business – this means that if the sole trader should become insolvent, the owner's personal assets may be used to pay creditors
- expansion is limited because it can only be achieved by the owner ploughing back profits, or by borrowing from a lender such as a bank
- the owner usually has to work long hours and it may be difficult to find time to take holidays; if the owner should become ill the work of the business will either slow down or stop altogether

FINAL ACCOUNTS AND THE TRIAL BALANCE

final accounts

The final accounts of a sole trader comprise:

- trading and profit and loss account
- balance sheet

These final accounts can be produced more often than once a year in order to give information to the sole trader on how the business is progressing. However, it is customary to produce annual accounts for the benefit of the Inland Revenue, bank manager and other interested parties. In this way the profit and loss account covers an accounting period of a financial year (which can end at any date – it doesn't have to be the calendar year), and the balance sheet shows the state of the business at the end of the accounting period.

trial balance

The starting point for preparing final accounts is the trial balance prepared by the book-keeper: all the figures recorded on the trial balance are used in the final accounts. The book-keeper's two-column trial balance is often developed into an extended trial balance – as we saw in the last chapter.

The extended trial balance gives an understanding of the principles of final accounts and is often used by accountancy firms as a first step towards preparing year end accounts for their clients. The way in which accountants present final accounts is often described as being in the conventional format, or in proper form.

Shortly we will use the extended trial balance of Tara Smith (seen in the previous chapter on page 55) in a Case Study to prepare her sole trader final accounts in proper form, using the conventional format.

TRADING AND PROFIT AND LOSS ACCOUNT

income minus **expenses** equals **net profit (or loss)**

The trading and profit and loss account shows the income a business has received over a given period for goods sold or services provided (together with any small amounts of other income, eg rent received). It also sets out the expenses incurred – the cost of the product, and the overheads (eg wages, administration expenses, rent, and so on). The difference between income and expenses is the *net profit* of the business. If expenses are greater than income, then a loss has been made. The net profit (or loss) belongs to the owner of the business. For a business that trades in goods, a figure for *gross profit* shows the profit made before overheads are deducted.

Note that where an extended trial balance is being used, profit can be checked against the figure shown in the ETB's profit and loss account columns.

BALANCE SHEET

assets minus **liabilities** equals **capital**

The balance sheet gives a 'snapshot' of the business at a particular date – the end of the financial year. A typical business balance sheet will show:

assets What the business owns:
- fixed assets, eg premises, vehicles, computers
- current assets, eg closing stock of goods for resale, debtors, bank and cash balances

liabilities What the business owes:
- current liabilities, eg creditors, overdrafts, VAT due
- long-term liabilities, eg long-term bank loans

net assets The total of fixed and current assets, less current and long-term liabilities. The net assets are financed by the owner of the business, in the form of capital. Net assets therefore equals the total of the 'financed by' section – the balance sheet 'balances'.

capital Where the money to finance the business has come from, eg the owner's investment, business profits.

Case Study

TARA SMITH: FROM ETB TO FINAL ACCOUNTS IN PROPER FORM

situation

Please refer to the extended trial balance of Tara Smith's business on page 55. We will use this ETB to prepare Tara Smith's sole trader final accounts in proper form, using the conventional format.

solution

The ETB does not present the final accounts in the proper form, as used by accountants. While accountancy firms often use the ETB as a first step, the figures have to be taken from the profit and loss account columns of the ETB and presented in vertical format – running down the page.

Tara Smith's profit and loss account is shown in proper form on page 69. Study it carefully and see how the figures can be identified on the ETB shown on page 55. Note that the profit and loss account incorporates a trading account – included because Tara's business trades in goods – which gives a figure for *gross profit*, which is the profit made before overheads are deducted.

Tara Smith's balance sheet is shown in proper form on page 71. Study it carefully and see how the figures can be identified on the ETB shown on page 55.

Notes to explain various aspects of Tara's profit and loss account and balance sheet are given on pages 68 and 70.

Trading account shows gross profit for the accounting period. **Profit and loss account** shows net profit for the accounting period. Note that 'profit and loss account' is often used as a general heading which includes both of these financial statements.

The amounts for **sales** and **purchases** include only items in which the business trades – eg a clothes shop buying clothes from the manufacturer and selling to the public. Note that items bought for use in the business, such as a new till for the shop, are not included with purchases but are shown as assets on the balance sheet.

Cost of sales represents the cost to the business of the goods which have been sold in this financial year. Cost of sales is:

	opening stock	(stock bought previously)
plus	purchases	(purchased during the year)
minus	closing stock	(stock left unsold at the end of the year)
equals	cost of sales	(cost of what has actually been sold)

Gross profit is calculated as:

sales – cost of sales = gross profit

If cost of sales is greater than sales, the business has made a gross loss.

Overheads, or expenses, are the running costs of the business – known as *revenue expenditure.* The categories of overheads or expenses used vary according to the needs of each business.

Net profit is calculated as:

gross profit – overheads = net profit

If overheads are more than gross profit, the business has made a net loss.

The net profit is the amount the business earned for the owner during the year, and is subject to taxation. The owner can draw some or all of the net profit for personal use in the form of drawings. Part of the profit might well be left in the business in order to help build up the business for the future.

TARA SMITH, TRADING AS 'THE FASHION SHOP'

TRADING AND PROFIT AND LOSS ACCOUNT

for the year ended 31 December 2004

	£	£
Sales		155,000
Opening stock	12,500	
Purchases	105,000	
	117,500	
Less Closing stock	10,500	
Cost of sales		107,000
Gross profit		48,000
Less overheads:		
Administration expenses	6,200	
Wages	23,500	
Rent paid	750	
Telephone	500	
Interest paid	4,500	
Travel expenses	550	
		36,000
Net profit		12,000

Fixed assets comprise the long-term items owned by a business which are not bought with the intention of selling them off in the near future, eg premises, machinery, motor vehicles, office equipment, shop fittings, etc.

Current assets comprise short-term assets which change regularly, eg stock of goods for resale, debtors, bank balances and cash. These items will alter as the business trades, eg stock will be sold, or more will be bought; debtors will make payment to the business, or sales on credit will be made; the cash and bank balances will alter with the flow of money paid into the bank account, or as withdrawals are made.

Current liabilities are due for repayment within twelve months of the date of the balance sheet, eg creditors, and bank overdraft (which is usually repayable on demand, unlike a bank loan which is negotiated for a particular time period).

Working capital is the excess of current assets over current liabilities, ie current assets minus current liabilities = working capital. Without adequate working capital, a business will find it difficult to continue to operate. Working capital is also often referred to as *net current assets*.

Long-term liabilities are where repayment is due in more than one year from the date of the balance sheet; they are often described by terms such as ‘bank loan,’ ‘long-term loan,’ or ‘mortgage.’

Net assets is the total of fixed and current assets, less current and long-term liabilities. The net assets are financed by the owner of the business, in the form of capital. Net assets therefore equals the total of the ‘financed by’ section – the balance sheet ‘balances’.

Capital is the owner’s investment, and is a liability of a business, ie it is what the business owes the owner.

TARA SMITH, TRADING AS 'THE FASHION SHOP'

BALANCE SHEET

as at 31 December 2004

	£	£	£
Fixed assets			
Premises			100,000
Shop fittings			20,000
			120,000
Current assets			
Stock (closing)		10,500	
Debtors		10,500	
Bank		5,450	
Cash		50	
		26,500	
Less Current liabilities			
Creditors	14,500		
Value Added Tax	2,000		
		16,500	
Working capital (or **Net current assets**)			10,000
			130,000
Less Long-term liabilities			
Loan from bank			50,000
NET ASSETS			80,000
FINANCED BY			
Capital			
Opening capital			75,000
Add net profit			12,000
			87,000
Less drawings			7,000
Closing capital			80,000

PREPARATION OF FINAL ACCOUNTS FROM A TRIAL BALANCE

The trial balance contains the basic figures necessary to prepare the final accounts but, as we saw in the previous chapter (pages 56-59), the figures are transferred from the double-entry accounts of the business. Nevertheless, the trial balance is a suitable summary from which to prepare the final accounts. The information needed for the preparation of each of the final accounts needs to be picked out from the trial balance in the following way:

- go through the trial balance and write against the items the final account in which each appears
- 'tick' each figure as it is used – each item from the trial balance appears in the final accounts once only
- the closing stock figure is sometimes listed in the trial balance, but is more usually shown as a note; it appears twice in the final accounts – in the trading account, and in the balance sheet (as a current asset)

If this routine is followed with the trial balance of Tara Smith, it appears as follows . . .

Trial balance of Tara Smith as at 31 December 2004

	Dr	Cr		
	£	£		
Opening stock	12,500		T	✔
Purchases	105,000		T	✔
Sales		155,000	T	✔
Administration expenses	6,200		P & L (*expense*)	✔
Wages	23,500		P & L (*expense*)	✔
Rent paid	750		P & L (*expense*)	✔
Telephone	500		P & L (*expense*)	✔
Interest paid	4,500		P & L (*expense*)	✔
Travel expenses	550		P & L (*expense*)	✔
Premises	100,000		BS (*fixed asset*)	✔
Shop fittings	20,000		BS (*fixed asset*)	✔
Debtors	10,500		BS (*current asset*)	✔
Bank	5,450		BS (*current asset*)	✔
Cash	50		BS (*current asset*)	✔
Capital		75,000	BS (*capital*)	✔
Drawings	7,000		BS (*capital*)	✔
Loan from bank		50,000	BS (*long-term liability*)	✔
Creditors		14,500	BS (*current liability*)	✔
Value Added Tax		2,000	BS (*current liability*)	✔
	296,500	296,500		
Note: closing stock was valued at £10,500			T	✔
			BS *(current asset)*	✔

Note: T = trading account; P & L = profit and loss account; BS = balance sheet

In the trial balance illustrated here, items are grouped together – for example, all the profit and loss account overheads and expenses are listed together. This has been done to help you at these early stages in the preparation of final accounts.

However, this grouping into categories will not always be the case. In particular, in Skills Tests and Examinations, you will often find that the items listed in the trial balance appear in alphabetical order. This does have the effect of, for example, putting administration expenses (a profit and loss account overhead) next to bank (which appears in the balance sheet). It is time well spent to go through the trial balance carefully and to indicate where each item appears in the final accounts.

FINAL ACCOUNTS: POINTS TO NOTE

trading account and gross profit

The final accounts that we have prepared in conventional format in this chapter include a trading account. This shows the gross profit, which is the profit of the business before overheads are deducted. However, the extended trial balance format that we have used does not easily show gross profit. Both formats show the net profit of the business.

Note that the trading account, whilst an account in its own right, is often referred to under the general heading of profit and loss account.

balance sheet assets and the order of liquidity

In the balance sheet it is customary to list the assets – fixed assets and current assets – in an 'increasing order of liquidity'. In accounting, liquidity means nearness to cash, so the most permanent assets – ie those that are furthest away from cash – are listed first. Thus premises, which would take time to turn into cash, heads the list, with other fixed assets – such as shop fittings, machinery and vehicles – following. For current assets, the usual order is to start with stock, then debtors, bank (if not overdrawn), and cash. In this way, the assets are listed from the most fixed (usually premises) to the most liquid (cash itself).

The reason for this order is historical – nineteenth-century business owners wanted to impress upon readers of their accounts the solid assets that they owned. The top line of the balance sheet was the first to be read and that showed the value of their premises. The following lines listed their other assets. This traditional approach lives on into twenty-first century balance sheets.

adjustments to final accounts

Whilst the starting point for the preparation of final accounts is the book-keeper's two-column trial balance, if we used only the trial balance figures (which record the financial transactions that have taken place) the resultant final accounts would show an inaccurate picture of the state of the business. Adjustments are made with the aim of improving the accuracy of the final accounts in showing the profit, and the assets and liabilities of the business.

The six main adjustments to final accounts are for:

1 closing stock (already covered in this and the previous chapter)
2 accruals
3 prepayments
4 depreciation of fixed assets
5 bad debts written off
6 provision for doubtful debts

These adjustments (except for closing stock) will be covered fully in the next three chapters.

SOLE TRADER FINAL ACCOUNTS: EXAMPLE LAYOUT

An example layout for the final accounts of a sole trader is included in the Appendix (pages 338 and 339), and can also be downloaded from the website www.osbornebooks.co.uk. This format shows:

- the layout for a trading and profit and loss account
- the layout for a balance sheet

Note that when used for partnership final accounts (see Chapter 14), the layout will need to be adjusted to take note of the appropriation of profits and of the partners' capital and current accounts.

FURTHER ITEMS IN FINAL ACCOUNTS

There are a number of further book-keeping items that have to be incorporated into the trading and profit and loss account. These items include:

- carriage in
- carriage out
- sales returns
- purchases returns

- discount received
- discount allowed

carriage in

This is the expense to a buyer of the carriage (transport) costs. For example, if an item is purchased by mail order, the buyer usually has to pay the additional cost of delivery.

In the trading account, the cost of carriage in is added to the cost of purchases. The reason for doing this is so that all purchases are at a 'delivered to your door' price.

carriage out

This is where the seller pays the expense of the carriage charge. For example, an item is sold to the customer and described as 'post free'.

In the profit and loss account, the cost of carriage out incurred on sales is shown as an expense of the business.

sales returns

Sales returns (or *returns in*) is where a debtor returns goods to the business. In final accounts, the amount of sales returns is deducted from the figure for sales in trading account.

purchases returns

Purchases returns (or *returns out*) is where a business returns goods to a creditor.

In final accounts, the amount of purchases returns is deducted from the figure for purchases in trading account.

discount received

Discount received is an allowance offered by creditors on purchases invoice amounts for quick settlement, eg 2% cash discount for settlement within seven days.

In final accounts, the amount of discount received is shown in profit and loss account as income received.

discount allowed

This is an allowance offered to debtors on sales invoice amounts for quick settlement.

In final accounts, the amount of discount allowed is shown in profit and loss account as an expense.

Case Study

NATASHA MORGAN: TRADING AND PROFIT AND LOSS ACCOUNT – FURTHER ITEMS

situation

An extract from the trial balance of Natasha Morgan, sole trader, is as follows:

Trial balance (extract) as at 30 June 2004

	Dr	Cr
	£	£
Opening stock	12,350	
Sales		250,000
Purchases	156,000	
Sales returns	5,400	
Purchases returns		7,200
Carriage in	1,450	
Carriage out	3,250	
Discount received		2,500
Discount allowed	3,700	
Other expenses	78,550	

Note: closing stock was valued at £16,300

Natasha asks for your help in the preparation of the trading and profit and loss account in proper form, using the conventional format.

solution

There are a number of further items to be incorporated into the layout of the trading and profit and loss account. In particular, the calculation of cost of sales is made in the following way:

opening stock	
+	purchases
+	carriage in
–	purchases returns
–	closing stock
=	cost of sales

The trading and profit and loss account for Natasha Morgan's business is shown on the next page. Note the use of three money columns.

NATASHA MORGAN, SOLE TRADER
TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 30 June 2004

	£	£	£
Sales			250,000
Less Sales returns			5,400
Net sales			244,600
Opening stock		12,350	
Purchases	156,000		
Add Carriage in	1,450		
	157,450		
Less Purchases returns	7,200		
Net purchases		150,250	
		162,600	
Less Closing stock		16,300	
Cost of sales			146,300
Gross profit			98,300
Add income: Discount received			2,500
			100,800
Less overheads:			
Discount allowed		3,700	
Other expenses		78,550	
Carriage out		3,250	
			85,500
Net profit			15,300

SERVICE SECTOR BUSINESSES

The final accounts of a service sector business – such as a secretarial agency, solicitor, estate agent, doctor – do not normally include a trading account. This is because the business, instead of trading in goods, supplies services. Thus the final accounts consist of:

- profit and loss account
- balance sheet

The profit and loss account, instead of starting with gross profit from the trading account section, commences with the income from the business activity – such as ‘fees’, ‘income from clients’, ‘charges’, ‘work done’. Other items of income – such as discount received – are added, and the overheads are then listed and deducted to give the net profit, or net loss, for the accounting period. An example of a service sector profit and loss account is shown below:

JEMMA SMITH, TRADING AS 'WYVERN SECRETARIAL AGENCY'

PROFIT AND LOSS ACCOUNT

for the year ended 31 December 2004

	£	£
Income from clients		110,000
Less overheads:		
Salaries	64,000	
Heating and Lighting	2.000	
Telephone	2.000	
Rent and Rates	6,000	
Sundry Expenses	3,000	
		77,000
Net profit		33,000

The balance sheet layout of a service sector business is identical to that seen earlier (page 71); the only difference is that there is unlikely to be much, if any, stock in the current assets section.

Chapter Summary

- The extended trial balance (ETB) format is a first step towards preparing year end final accounts. From the ETB can be developed final accounts in the conventional format used by accountants.
- Sole traders are people in business on their own; generally their businesses are small because the owner usually has a limited amount of capital.
- In proper form, the final accounts of a sole trader comprise
  - profit and loss account (which may include a trading account)
  - balance sheet
- Further book-keeping items incorporated into final accounts include
  - carriage in
  - carriage out
  - sales returns
  - purchases returns
  - discount received
  - discount allowed
- There is more material to cover in connection with final accounts. The next few chapters deal with accruals and prepayments, depreciation of fixed assets, bad debts and provision for doubtful debts, and the regulatory

framework of accounting. Later in the book we will study the preparation of final accounts from incomplete records (Chapter 13), and partnership final accounts (Chapter 14).

Key Terms

conventional format	the proper form of final accounts used by accountants
sole trader	a person who is in business on his/her own
service sector business	a business which supplies services, eg secretarial agency, solicitor, estate agent
gross profit	sales minus cost of sales, ie the profit made before overheads are deducted
net profit	gross profit minus overheads, ie the profit which belongs to the owner of the business
assets	items owned by the business, split between fixed assets and current assets
liabilities	items owed by the business, split between current liabilities and long-term liabilities
capital	the owner's investment in the business

Student Activities

Conventional format: *Example layouts of the trading and profit and loss account, and balance sheet in conventional format – or proper form – are included in the Appendix (pages 338 and 339). They may be photocopied for guidance with Student Activities; alternatively, a computer spreadsheet layout can be set up.*

5.1 *Please refer back to the extended trial balance of Nick Johnson prepared in Student Activity 4.5.*

You are to prepare the final accounts of Nick Johnson for the year ended 31 December 2004 in proper form, using the conventional format.

5.2 *Please refer back to the extended trial balance of Alan Harris prepared in Student Activity 4.6.*

You are to prepare the final accounts of Alan Harris for the year ended 30 June 2004 in proper form, using the conventional format.