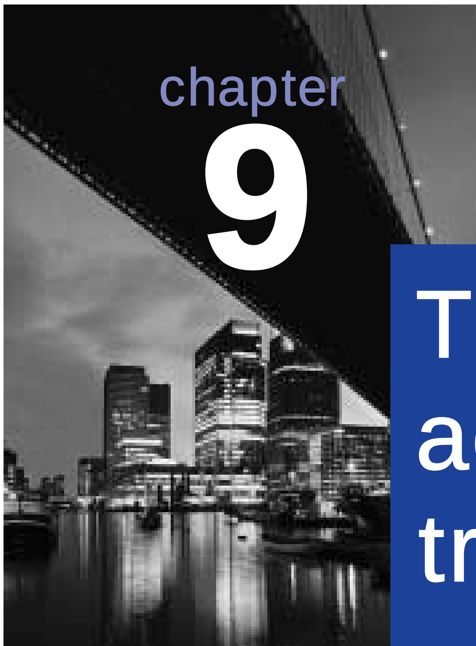
part 3

PREPARING FINAL ACCOUNTS



chapter 9

The final accounts of sole traders

Learning objectives

After reading this chapter you should be able to:

1. explain the meaning of the key terms and concepts listed at the end of the chapter;
2. explain the purpose and structure of profit and loss accounts, including the subtotals for gross profit and net profit;
3. explain the purpose and structure of balance sheets, including the subtotals for net current assets, total assets less current liabilities and net assets;
4. describe the nature of administrative expenses, selling and distribution expenses, fixed assets, current assets, current liabilities long-term liabilities and capital;
5. explain the relevance of stock and the cost of sales in the determination of the gross profit;
6. prepare a simple trading and profit and loss account and balance sheet from a trial balance using either an account/horizontal format or a vertical format;
7. make all the necessary ledger account and journal entries relating to the preparation of trading and profit and loss accounts.

Introduction

Final accounts consist of a profit and loss account and balance sheet. These are prepared at the end of the business's accounting year after the trial balance has been completed. Some businesses also produce final accounts half yearly, quarterly or even monthly. The purpose, structure and preparation of the profit and loss account and balance sheet are discussed below.

The purpose and structure of profit and loss accounts

The profit and loss account provides a summary of the results of a business's trading activities during a given accounting year. It shows the profit or loss for the year. The purpose of a profit and loss account is to enable users of accounts, such as the owner, to evaluate the financial performance of a business for a given accounting year. It may be used to determine the amount of taxation on the profit.

Chapter 2 explained that profit can be defined as the amount which could be taken out of a business as drawings in the case of a sole trader or partnership, or is available for distribution as dividends to shareholders in the case of a company, after maintaining the value of the capital of a business. Profit is not the same as an increase in the amount of money the business possesses. It is the result of applying certain accounting principles to the transactions of the business. These will be described in detail in the next chapter.

The basic format of a profit and loss account is as follows:

ABC
Profit and loss account for the year ended ...

	£	£
Sales		X
Less: cost of sales		X
Gross profit		X
Less: other costs and expenses:		
Selling and distribution costs	X	
Administrative expenses	X	
Interest payable on loans	X	
		X
Net profit		X

In the accounts of sole traders and partnerships the actual composition of each of the above groupings of costs would be shown. Selling and distribution costs include advertising expenditure, the wages of delivery-van drivers, motor expenses including petrol and repairs, etc. Administrative expenses usually comprise the salaries of office staff, rent and rates, light and heat, printing and stationery, telephone and postage, etc. The published final accounts of companies contain a classification of costs similar to that shown above.

The purpose and structure of balance sheets

The balance sheet is a list of the assets and liabilities, and capital, of a business at the end of a given accounting year. It therefore provides information about the resources and debts of the reporting entity. This enables users of accounts to evaluate its financial position, in particular whether the business is likely to be unable to pay its debts. The balance sheet is like a photograph of the financial state of affairs of a business at a specific point in time.

Balance sheets contain five groups of items, as follows.

1 Fixed assets

These are items not specifically bought for resale but to be used in the production or distribution of those goods normally sold by the business. Fixed assets are durable goods that usually last for several years, and are normally kept by a business for more than one accounting year. Examples of fixed assets include land and buildings, plant and machinery, motor vehicles, office equipment, furniture, fixtures and fittings.

2 Current assets

These are items that are normally kept by a business for less than one accounting year. Indeed, the composition of each type of current asset is usually continually changing. Examples include stocks, trade debtors, short-term investments, money in a bank cheque account and cash.

3 Current liabilities

These are debts owed by a business that are payable within one year (often considerably less) of the date of the balance sheet. Examples include trade creditors and bank overdrafts.

4 Long-term liabilities

These are debts owed by a business that are not due until after one year (often much longer) from the date of the balance sheet. Examples include loans and mortgages.

5 Capital

This refers to the amount of money invested in the business by the owner(s).

The structure of a balance sheet is shown in the diagram below. Note that the items shown in colour are subtotals or totals which should be shown on the balance sheet:

ABC
Balance sheet as at ...

Fixed assets
+
$$\left\{\begin{array}{c}\text{Current assets} \\ -\ \text{Current liabilities} \\ =\ \text{Net current assets}\end{array}\right\}$$
=
Total assets less current liabilities
–
Long-term liabilities
=
Net assets
=
Capital

Learning Activity 9.1

Prepare a balance sheet listing your assets and liabilities, or those of your family. Use an appropriate method of classifying the assets and liabilities and show the relevant totals and subtotals.

The gross profit: stock and the cost of sales

The first stage in the determination of the profit for the year involves calculating the gross profit. It is usually carried out in the profit and loss account. However, this part of the profit and loss account is sometimes presented as a separate account referred to as the trading account.

The gross profit for a given period is computed by subtracting the cost of goods sold/cost of sales from the sales revenue. It is important to appreciate that the cost of goods sold is not usually the same as the amount of purchases. This is because most businesses will have purchased goods that are unsold at the end of the accounting period. This is referred to as stock or inventory.

A manufacturing business will have a number of different types of stocks. However, for simplicity the following exposition is confined to non-manufacturing businesses whose stock consists of goods purchased for resale that have not undergone any further processing by the entity.

The cost of sales is determined by taking the cost of goods in stock at the start of the period, adding to this the cost of goods purchased during the period, and subtracting the cost of goods unsold at the end of the period. The cost of sales is then deducted from the sales revenue to give the gross profit. This is illustrated in Example 9.1.

Example 9.1

S. Mann, whose accounting year ends on 30 April, buys and sells one type of product. On 1 May 20X8 there were 50 units in stock which had cost £100 each. During the subsequent accounting year he purchased a further 500 units at a cost of £100 each and sold 450 units at a price of £150 each. There were 100 units which cost £100 each that had not been sold at 30 April 20X9. You are required to compute the gross profit for the year.

S. Mann
Trading account for the year ended 30 April 20X9

Units		£	£
450	Sales revenue		67,500
	Less: Cost of goods sold:		
50	Stock of goods at 1 May 20X8	5,000	
500	*Add*: Goods purchased during the year	50,000	
550	Cost of goods available for sale	55,000	
100	*Less*: Stock of goods at 30 April 20X9	10,000	
450	Cost of sales		45,000
	Gross profit for the year		22,500

Note

1 The number of units is not usually shown in a trading account. They have been included in the above to demonstrate that the cost of sales relates to the number of units that were sold.

The preparation of final accounts

The trading account

The trading account is an account in the ledger and is thus a part of the double-entry system. It is used to ascertain the gross profit and is prepared by transferring the balances on the sales, purchases and returns accounts to the trading account. In addition, certain entries are required in respect of stock. These are as follows:

1 Stock at the start of the period:
Debit trading account
Credit stock account

2 Stock at the end of the period:
Debit stock account
Credit trading account

Note that the stock at the start of the period will be the stock at the end of the previous period. The ledger entries in respect of stocks are illustrated below using the data in Example 9.1. Prior to the preparation of the trading account the ledger will appear as follows:

Sales

			20X9		
			30 Apr	balance b/d	67,500

Purchases

20X9					
30 Apr	Balance b/d	50,000			

Stock

20X8					
30 Apr	Balance b/d	5,000			

The trading account will then be prepared as follows:

Sales

20X9			20X9		
30 Apr	Trading a/c	67,500	30 Apr	Balance b/d	67,500

Purchases

20X9			20X9		
30 Apr	Balance b/d	50,000	30 Apr	Trading a/c	50,000

Stock

20X8			20X9		
30 Apr	Balance b/d	5,000	30 Apr	Trading a/c	5,000
20X9					
30 Apr	Trading a/c	10,000			

S. Mann
Trading account for year ending 30 April 20X9

	£		£
Stock at 1 May 20X8	5,000	Sales	67,500
Purchases	50,000	Stock at 30 April 20X9	10,000
Gross profit c/d	22,500		
	77,500		77,500
		Gross profit b/d	22,500

Notes

1. The gross profit is the difference between the two sides of the trading account and must be brought down to the opposite side of the account.
2. No date columns are shown in the trading account since the date appears as part of the heading of the account.
3. When the trading account is prepared in account form the stock at the end of the year may be shown as either a credit entry or deducted on the debit side as shown below, This has the advantage of showing the cost of sales.

S. Mann
Trading account for the year ended 30 April 20X9

Opening stock	5,000	Sales	67,500
Add: Purchases	50,000		
	55,000		
Less: Closing stock	10,000		
Cost of sales	45,000		
Gross profit c/d	22,500		
	67,500		67,500
		Gross profit b/d	22,500

4. The trading account is an account in the ledger and thus part of the double-entry system. However, when it is prepared for submission to the management, the owner(s) of a business or the Inland Revenue, it is often presented vertically as shown at the start of Example 9.1.
5. No entries other than those shown above (and the correction of errors) should be made in a stock account. It is not a continuous record of the value of stock.
6. The debit balance in the stock account on 30 April 20X8 was the result of an entry identical to that on 30 April 20X9.
7. The stock shown in a trial balance will always be that at the end of the previous year (and thus the opening stock of the year to which the trial balance relates).

The profit and loss account

The profit and loss account is an account in the ledger and thus a part of the double-entry system. It is used to ascertain the net profit (or loss) for the year and is prepared in the same way as the trading account. That is, the balances on the income and expense accounts in the ledger are transferred to the profit and loss account by means of a double entry.

The balance sheet

The balance sheet is a list of the balances remaining in the ledger after the trading and profit and loss accounts have been prepared. In effect it is like a trial balance except that the balance sheet is presented using a different format. Note that the balances are not transferred to the balance sheet by means of a double entry.

In practice, and in examinations, it is usual to prepare final accounts from the information given in the trial balance. However, it is important to appreciate that the ledger entries described above also have to be done, although students are not normally expected to show them in their answer to examination questions.

An illustration of the preparation of final accounts, including the required ledger entries, is shown in Example 9.2.

Example 9.2

The following is the trial balance of A. Dillon at 31 March 20X0.

	Debit	*Credit*
	£	£
Capital		42,140
Drawings	13,600	
Loan from S. Rodd		10,000
Bank	5,800	
Cash	460	
Sales		88,400
Purchases	46,300	
Sales returns	5,700	
Purchases returns		3,100
Stock at 1 Apr 19X9	8,500	
Carriage inwards	2,400	
Carriage outwards	1,600	
Trade debtors	15,300	
Trade creditors		7,200
Motor vehicles	23,100	
Fixtures and fittings	12,400	
Wages and salaries	6,800	
Rent	4,100	
Light and heat	3,200	
Telephone and postage	1,700	
Discount allowed	830	
Discount received		950
	151,790	151,790

The stock at 31 March 20X0 was valued at £9,800. The loan from S. Rodd is repayable on 1 January 20X4.

You are required to prepare the trading and profit and loss accounts and a balance sheet.

Sales

Trading a/c	88,400	Balance b/d	88,400

Sales returns

Balance b/d	5,700	Trading a/c	5,700

Purchases

Balance b/d	46,300	Trading a/c	46,300

Purchases returns

Trading a/c	3,100	Balance b/d	3,100

Stock

Balance b/d	8,500	Trading a/c	8,500
Trading a/c	9,800		

Carriage inwards

Balance b/d	2,400	Trading a/c	2,400

Carriage outwards

Balance b/d	1,600	Profit and loss a/c	1,600

Wages and salaries

Balance b/d	6,800	Profit and loss a/c	6,800

Rent

Balance b/d	4,100	Profit and loss a/c	4,100

Light and heat

Balance b/d	3,200	Profit and loss a/c	3,200

Telephone and postage

Balance b/d	1,700	Profit and loss a/c	1,700

Discount allowed

Balance b/d	830	Profit and loss a/c	830

Discount received

Profit and loss a/c	950	Balance b/d	950

Drawings

Balance b/d	13,600	Capital	13,600

Capital

Drawings	13,600	Balance b/d	42,140
Balance c/d	49,660	Profit for year	21,120
	63,260		63,260
		Balance b/d	49,660

All other accounts contain only the balances shown in the trial balance.

A. Dillon
Trading and profit and loss accounts for the year ended 31 March 20X0

	£	£		£
Stock at 1 Apr 20X9		8,500	Sales	88,400
Purchases	46,300		*Less*: returns	5,700
Less: Returns	3,100			82,700
	43,200			
Add: Carriage inwards	2,400	45,600		
		54,100		
Less: Stock at 31 Mar 20X0		9,800		
Cost of sales		44,300		
Gross profit c/d		38,400		
		82,700		82,700
Carriage outwards		1,600	Gross profit b/d	38,400
Wages and salaries		6,800	Discount received	950
Rent		4,100		
Light and heat		3,200		
Telephone and postage		1,700		
Discount allowed		830		
Net profit c/d		21,120		
		39,350		39,350
Capital a/c		21,120	Net profit b/d	21,120

A. Dillon
Balance sheet as at 31 March 20X0

Credit	£	*Debit*	£	£
Capital		*Fixed assets*		
Balance at 1 Apr 20X9	42,140	Motor vehicles		23,100
Add: Profit for year	21,120	Fixtures and fittings		12,400
	63,260			35,500
Less: Drawings	13,600	*Current assets*		
Balance at 31 Mar 20X0	49,660	Stock	9,800	
Long-term liabilities		Debtors	15,300	
Loan from S. Rodd	10,000	Bank	5,800	
Current liabilities		Cash	460	
Creditors	7,200			31,360
	66,860			66,860

Notes

1. The gross profit is the difference between the two sides of the trading account and must be brought down to the opposite side of the profit and loss account.
2. The net profit is the difference between the two sides of the profit and loss account. This is brought down to the credit side of the profit and loss account and then transferred to the capital account by debiting the profit and loss account and crediting the capital account. The reason for this transfer is because the profit belongs to the owner and it increases the amount of capital he or she has invested in the business.
3. If the debit side of the profit and loss account exceeds the credit side this is shown as a net loss (carried down) on the credit side and debited to the capital account.
4. The balance on the drawings account at the end of the period must be transferred to the capital account.
5. Each of the transfers from the ledger accounts to the trading and profit and loss accounts should also be entered in the journal.
6. Notice that the debit balances remaining in the ledger after the profit and loss account has been prepared are shown on the right-hand side of the balance sheet and the credit balances on the left-hand side. This may seem inconsistent with the debit and credit sides of the ledger being on the left and right, respectively. However, it is a common form of presentation in accounting.
7. Like the trial balance, the total of each side of the balance sheet should be the same. That is, the total of the ledger accounts with debit balances should equal the total of the ledger accounts with credit balances. If this is not the case it indicates that an error has occurred in the preparation of the trading and profit and loss account (or the balance sheet).
8. The current assets in the balance sheet are shown in what is called their reverse order of liquidity. The latter refers to how easily assets can be turned into cash.
9. The current liabilities are sometimes shown on the balance sheet as a deduction from current assets.
10. The entries on the balance sheet in respect of capital are a summary of the capital account in the ledger.
11. Carriage inwards is added to the cost of purchases because it relates to the haulage costs of goods purchased. Carriage outwards is shown in the profit and loss account because it relates to the haulage costs of goods sold and is thus a selling and distribution expense.

When the trading and profit and loss account and balance sheet are presented to the owner(s) of a business and the Inland Revenue it is common to use a vertical format. This is illustrated next using the data in Example 9.2.

A. Dillon
Trading and profit and loss accounts for the year ending 31 March 20X0

	£	£	£
Sales			88,400
Less: Returns			5,700
			82,700
Less: Cost of sales:			
Stock at 1 Apr 20X9		8,500	
Add: Purchases	46,300		
Less: Returns	3,100		

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	43,200	
Add: Carriage inwards	2,400	
	54,100	
Less: Stock at 31 Mar 20X0	9,800	
		44,300
Gross profit		38,400
Add: Discount received		950
		39,350
Less: Expenditure:		
Carriage outwards	1,600	
Wages and salaries	6,800	
Rent	4,100	
Light and heat	3,200	
Telephone and postage	1,700	
Discount allowed	830	18,230
Net profit for the year		21,120

Balance sheet as at 31 March 20X0

	£	£
Fixed assets		
Motor vehicles		23,100
Fixtures and fittings		12,400
		35,500
Current assets		
Stock	9,800	
Debtors	15,300	
Bank	5,800	
Cash	460	
	31,360	
Less: Current liabilities		
Creditors	7,200	
Net current assets		24,160
Total assets less current liabilities		59,660
Less: Long-term liabilities		
Loan from S. Rodd		10,000
Net assets		49,660
Capital		
Balance at 1 Apr 20X9		42,140
Add: Profit for year		21,120
		63,260
Less: Drawings		13,600
Balance at 31 Mar 20X0		49,660

Summary

Final accounts comprise a trading and profit and loss account, and balance sheet. These are prepared at the end of the accounting year after the trial balance has been completed. The trading and profit and loss accounts provide a summary of the results of a business's trading activities during a given accounting year. They show the gross and net profit or loss for the year, and enable users to evaluate the performance of the enterprise. The balance sheet is a list of the assets and liabilities (and capital) of a business at the end of a given accounting year. It enables users to evaluate the financial position of the enterprise, including whether it is likely to be able to pay its debts. In the balance sheet assets are classified as either fixed or current, and liabilities as either current or long term. The balance sheet also contains several useful subtotals comprising net current assets, total assets less current liabilities, and net assets.

The gross profit is the difference between the sales revenue and the cost of sales. The cost of sales is the amount of purchases as adjusted for the opening and closing stocks. The stock at the end of an accounting year has to be entered in the ledger by debiting a stock account and crediting the trading account. The trading and profit and loss accounts are then prepared by transferring the balances on the nominal accounts in the ledger to these accounts.

The balance sheet is a list of the balances remaining in the ledger after the trading and profit and loss accounts have been prepared. It is extracted in essentially the same way as a trial balance, but presented using a more formal layout to show the two groups of both assets and liabilities, and pertinent subtotals.

Key terms and concepts

Balance sheet (90)
capital (91)
cost of sales (92)
current assets (91)
current liabilities (91)
final accounts (90)
fixed assets (91)
gross profit (92)
inventory (92)
long-term liabilities (91)
loss (95)
net assets (91)
net current assets (91)
net profit (95)
profit (90)
profit and loss account (90)
stock (92)
total assets less current liabilities (91)
trading account (93)

Review questions

9.1 **a** Explain the purposes of a profit and loss account and a balance sheet.
b Describe the structure of each.

9.2 Explain the relevance of stocks of goods for resale in the determination of the gross profit.

9.3 Explain each of the entries in the following stock account:

Stock

Trading account	4,600	Trading account	4,600
Trading account	6300		

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Exercises

An asterisk after the question number indicates that there is a suggested answer in the Appendix.

9.4* **Level I**

The following is the trial balance of R. Woods as at 30 September 20X6:

	Debit	*Credit*
	£	£
Stock 1 Oct 20X5	2,368	
Purchases	12,389	
Sales		18,922
Salaries and wages	3,862	
Rent and rates	504	
Insurance	78	
Motor expenses	664	
Printing and stationery	216	
Light and heat	166	
General expenses	314	
Premises	5,000	
Motor vehicles	1,800	
Fixtures and fittings	350	
Debtors	3,896	
Creditors		1,731
Cash at bank	482	
Drawings	1,200	
Capital		12,636
	33,289	33,289

The stock at 30 September 20X6 is valued at £2,946.

You are required to prepare a trading and profit and loss account for the year ended 30 September 20X6 and a balance sheet at that date.

9.5* **Level I**

On 31 December 20X3, the trial balance of Joytoys showed the following accounts and balances:

	Debit	*Credit*
	£	£
Bank	500	
Capital		75,000
Bank loan		22,000
Inventory	12,000	
Purchases	108,000	
Sales		167,000
Rent, rates and insurance	15,000	
Plant and machinery at cost	70,000	
Office furniture and fittings at cost	24,000	

continued

	Debit	Credit
	£	£
Discount allowed	1,600	
Bank interest	400	
Discount received		3,000
Wages and salaries	13,000	
Light and heat	9,000	
Drawings	10,000	
Returns outwards		4,000
Returns inwards	1,000	
Creditors		16,000
Debtors	22,500	
	287,000	287,000

You are given the following information:

1 The inventory at 31 December 20X3 was valued at £19,500.
2 The bank loan is repayable in 5 years' time.

You are required to prepare a trading and profit and loss account for the year ended 31 December 20X3, and a balance sheet at that date.

9.6* **Level I**

The following is the trial balance of A. Evans as at 30 June 20X2:

	Debit	Credit
	£	£
Capital		39,980
Drawings	14,760	
Loan—Solihull Bank		20,000
Leasehold premises	52,500	
Motor vehicles	13,650	
Investments	4,980	
Trade debtors	2,630	
Trade creditors		1,910
Cash	460	
Bank overdraft		3,620
Sales		81,640
Purchases	49,870	
Returns outwards		960
Returns inwards	840	
Carriage outwards	390	
Stock	5,610	
Rent and rates	1,420	
Light and heat	710	
Telephone and postage	540	
Printing and stationery	230	
Bank interest	140	
Interest received		620
	148,730	148,730

You are given the following additional information:

1 The stock at 30 June 20X2 has been valued at £4,920.
2 The bank loan is repayable on 1 June 20X5.

You are required to prepare a trading and profit and loss account for the year ended 30 June 20X2 and a balance sheet as at that date.

9.7 Level I

The following is the trial balance of J. Peters as at 30 September 20X0:

	Debit	*Credit*
	£	£
Capital		32,890
Drawings	5,200	
Loan from A. Drew		10,000
Cash	510	
Bank overdraft		1,720
Sales		45,600
Purchases	29,300	
Returns inwards	3,800	
Returns outwards		2,700
Carriage inwards	960	
Carriage outwards	820	
Trade debtors	7,390	
Trade creditors		4,620
Land and buildings	26,000	
Plant and machinery	13,500	
Listed investments	4,800	
Interest paid	1,200	
Interest received		450
Rent received		630
Stock	3,720	
Repairs to buildings	810	
Plant hire charges	360	
Bank charges	240	
	98,610	98,610

Further information:

1 The stock at 30 September 20X0 was valued at £4,580.
2 The loan from A. Drew is repayable on 1 January 20X7.

You are required to prepare a trading and profit and loss account for the year ended 30 September 20X0 and a balance sheet as at that date.