- **FINANCIAL STATEMENTS**

These are prepared at the end of a given trading period to determine the profit and losses of the business, and also to show the financial position of the business at a given time.

They includes; trading account, profit and loss account, trading profit and loss account and the balance sheet.

They are also referred to as the final statements.

The trading period is the duration through which the trading activities are carried out in the business before it decides to determines it performances in terms of profit or loss. It may be one week, month, six months or even a year depending on what the owner wants.

Most of the business use one year as their trading period. It is also referred to as the accounting period.

At the end of the accounting period, the following takes place;

- All the accounts are balanced off
- A trial balance is extracted
- Profit or loss is determined
- The balance sheet is prepared

Determining the profit or loss of a business

When a business sells its stock above the buying price/cost of acquiring the stock, it makes a profit, while if it sells below it makes a loss. The profit realized when the business sell it stock beyond the cost is what is referred to as the gross profit, while if it is a loss then it is referred to as a gross loss.

It is referred to as the gross profit /loss because it has not been used to cater for the expenses that may have been incurred in selling that stock, such as the salary of the salesman, rent for the premises, water bills, etc. it therefore implies that the businessman cannot take the whole gross profit for its personal use but must first deduct the total cost of all other expenses that may have been incurred.

The profit realized after the cost of all the expenses incurred has been deducted is what becomes the real profit for the owner of the business, and is referred to as Net profit. The net profit can be determined through calculation or preparation of profit and loss account.

In calculating the gross profit, the following adjustments are put in place

- Return inwards/Sales return: - these are goods that had been sold to the customers, but they have returned them to the business for one reason or the other. It therefore reduces the value of sales, and is therefore subtracted from sales to obtain the net sales

  Therefore Net sales = Sales – Return inwards

- Return outwards/purchases return: - these are goods that had been bought from the suppliers to the business and have been returned to them for one reason or the other. It reduces the purchases and is therefore subtracted from the purchases to obtain the net purchases.

- Drawings: - this refers to goods that the owner of the business has taken from the business for his own use. It reduces the value of purchases, and is therefore subtracted from purchases when determining the net purchases. It is different from the other drawing in that it is purely goods and not money
- Carriage inwards/Carriage on purchases: - this is the cost incurred by the suppliers in transporting the goods from his premises to the customers business. It is treated as part of the purchases, and therefore increases the value of purchases. It is added to purchases to determine the actual value of purchases/Net purchases.

  Therefore Net Purchases = Purchases + Carriage inwards – Return Outwards - Drawings

- Carriage outwards/Carriage on sales: - this is the cost that the business has incurred in transporting goods from its premises to the customers premises. The cost reduces the business profit that would have been realized as a result of the sale, and is therefore treated as an expense and is subtracted from the gross profit, before determining the net profit.
- Opening stock is the stock of goods at the beginning of the trading period, while the closing stock is the stock of the goods at the end of the trading period

  Gross profit is therefore calculated as follows;

  Gross Profit = Sales – Return inwards – (Opening stock + Purchases + carriage inwards – Return outwards – Closing stock)

  Or

  Gross profit = Net sales – Cost of Goods Sold (COGS)

  COGS = Opening Stock + Net Purchases – Closing stock

  Net Profit = Gross profit – Total expenses

Trading Account

This is prepared by the business to determine the gross profit/loss during that trading period
It takes the following format;

Name of the business
Trading Account
Dr For the period (date) Cr

	Shs	Shs		Shs	Shs
Opening stock		xxxxxx	Sales	xxxxxx	
add Purchases	xxxxx		Less Return inwards	xxx	
add Carriage inwards	xxx		Net sales		xxxxxx
less Return Outwards	xxx				

less Drawings	xx	xxxxx		
Goods available for sale		xxxxxx		
Less Closing Stock		xxx		
Cost Of Goods Sold (COGS)		xxxxxx		
Gross profit c/d		xxxx		
		xxxxxx		xxxxxx
			Gross profit b/d	xxxx

The trading account is completed by the time the gross profit b/d is determined

For example

The following balances were obtained from the books of Ramera Traders for the year ending may 31st 2010

Sales	670 000
Purchases	380 000
Return inwards	40 000
Carriage outwards	18 000
Return outwards	20 000
Carriage inwards	10 000

Additional information;

- During the year the owner took goods worth sh 5 000 for his family use
- The stock as at 1st June 2009 was shs 60 000, while the stock as at 31st May 2011 was shs 70 000

Required; Prepare Ramera Traders trading account for the period ending 31st May 2010

Ramera Traders

Trading Account

Dr For the period ending 31/5/2010 Cr

	Shs	Shs		Shs	Shs
Opening stock		60 000	Sales	670 000	
add Purchases	380 000		Less Return inwards	40 000	
add Carriage inwards	10 000		Net sales		630 000
less Return Outwards	20 000				
less Drawings	5 000	365 000			
Goods available for sale		425 000			
Less Closing Stock		70 000			
Cost Of Goods Sold (COGS)		355 000			
Gross profit c/d		275 000			
		630 000			630 000
			Gross profit b/d		275 000

Carriage outwards is not an item of Trading account, but profit and loss account as an expense.

Importance of Trading account

i. It is used to determine the gross profit/loss for a given trading period for appropriate decision making by the management.
ii. It is used in determining the cost of goods that was sold during that particular accounting period.
iii. It is used to reveal the volume of turnover i.e net sales
iv. May be used to compare the performance of the business in the current accounting period and the previous periods. It can also compare its performance with other similar businesses
v. It facilitates the preparation of profit and loss account, since the gross profit is carried forward to the profit and loss account.

Profit and Loss account

In preparation of this account, the gross profit is brought down on the credit sides, with all other revenues/income of the business being credited and the expenses together with the net profit being debited. *Net profit = Total Revenues (including Gross Profit) – Total expenses*

Name of the business

Profit and Loss Account

Dr	For the period (date)		Cr
	Shs		Shs
Expenses		Gross profit b/d	xxxxxx
Insurance	xxx	Discount received	xxx
Electricity	xxx	Rent income	xxx
Water bills	xxx	Commission received	xxx
Carriage Outwards	xxx	Any other income received	xxx
General expenses	xxx		
Provision for Depreciation	xxxx		
Discount allowed	xxx		
Commission allowed	xxxx		
Rent paid	xxxx		
Any other expense	xxxx		
Net profit c/d	xxxx		
	xxxxxx		xxxxxx
		Net profit b/d	xxxx

The profit and loss account is complete when net profit b/d is obtained. In the trial balance, the revenues/incomes are always credited, while the expenses are debited, and the same treatment is found in the profit and loss account. (Any item that is taken to the profit and loss account with a balance appearing in the Debit (Dr) side of a trial balance is treated as an expenses, while those appearing in the credit side is revenue e.g. discount balance appearing in the Dr side is Discount allowed, while the one on Cr side is Discount received)

For example

The following information relates to Akinyi's Traders for the period ending March 28th 2010. Use it to prepare profit and loss account.

Gross profit		100 000
Salaries and wages		20 000
Opening stock	150 000	
Rent income		10 000
Discount received		12 000
Commission allowed	15 000	
Repairs		10 000
Discount allowed		8 000
Commission received	16 000	
Carriage outwards		4 000
Provision for depreciation		6 000
Power and lighting		10 000

Akinyi Traders

Profit and Loss Account

For the period ending 28th March 2010

Dr	Shs		Cr Shs
Expenses		Gross profit b/d	100 000
Power and lighting	10 000	Discount received	12 000
Carriage Outwards	4 000	Rent income	10 000
Salaries and wages	20 000	Commission received	16 000
Provision for Depreciation	6 000		
Discount allowed	8 000		
Commission allowed	15 000		
Repairs	10 000		
Net profit c/d	65 000		
	138 000		138 000
		Net profit b/d	65 000

Incase the expenses are more than the income, then the business shall have made a net loss, and the loss will be credited.

Net profit/loss can also be found through calculation as follows;

Net profit/loss = Gross profit + Total other revenues – Total expenses

For the above example;

Total other revenues = 12 000 + 10 000 + 16 000

= 38 000

Total expenses = 10 000 + 4 000 + 20 000 + 6 000 + 8 000 + 15 000 + 10 000

= 73 000

Therefore; Net profit = Gross profit + Total other revenues – Total expenses

= 100 000 + 38 000 – 73 000

= 65 000

Importance of profit and loss account

- ✓ It shows the revenue earned, and all the expenses incurred during the accounting period
- ✓ It used to determine the net profit/net loss of a given trading period
- ✓ It is a requirement by the government for the purpose of taxation
- ✓ May be used by the employees to gauge the strength of the business, in terms of its ability to pay them well
- ✓ It is vital for the prospective investor in the business, in terms of determining the viability of the business
- ✓ The creditors or loaners may use it to asses the business ability to pay back their debts
- ✓ It is used by the management to make a decision on the future of their business.

Trading, Profit and Loss Account

This is the combination of trading account and trading profit and loss account to form a single document. It ends when the net profit/loss brought down has been determined. That is;

Name of the business

Trading, Profit and Loss Account

Dr For the period (date) Cr

	Shs	Shs		Shs	Shs
Opening stock		xxxxxx	Sales	xxxxxx	
add Purchases	xxxxx		Less Return inwards	xxx	
add Carriage inwards	xxx		Net sales		xxxxxx
less Return Outwards	xxx				
less Drawings	xx	xxxxx			
Goods available for sale		xxxxxx			
Less Closing Stock		xxx			
Cost Of Goods Sold (COGS)		xxxxxx			
Gross profit c/d		xxxx			
		xxxxxx			xxxxxx
Expenses			Gross profit b/d		xxxx
Insurance		xxx	Discount received		xxx
Electricity		xxx	Rent income		xxx
Water bills		xxx	Commission received		xxx
Carriage Outwards		xxx	Any other income received		xxx

General expenses	xxx		
Provision for Depreciation	xxxx		
Discount allowed	xxx		
Commission allowed	xxxx		
Rent paid	xxxx		
Any other expense	xxxx		
Net profit c/d	xxxx		
	xxxxxx		xxxxxx
		Net profit b/d	xxxx

End Year Adjustments

The following items may require to be adjusted at the end of the trading period

- Revenues/Income
- Expenses
- Fixed assets

Adjustment on revenues

The revenue may have been paid in advance in part or whole (prepaid revenue) or may be paid later after the trading period (accrued revenue).

Prepaid revenue is subtracted from the revenue/income to be received and the difference is what is treated in the profit and loss account or trading profit and loss account as an income, while the accrued revenue is added to the revenue/income to be received and the sum is what is treated in the above accounts as the actual revenue.

Only the prepaid amount and the accrued amounts are what are then taken to the balance sheet

Adjustment on the expenses

The expenses may have been paid for in advance in part or whole (prepaid expenses) or may be paid for later after the trading period (accrued expenses).

Prepaid expenses is subtracted from the expenses to be paid for and the difference is what is treated in the profit and loss account or trading profit and loss account as an expense, while the accrued expenses is added to the expenses to be paid for and the sum is what is treated in the above accounts as the actual expenses.

Only the prepaid amount and the accrued amounts are what are then taken to the balance sheet

Adjustment on fixed assets

The fixed assets may decrease in value, due to tear and wear. This makes the value to go down over time, what is referred to as depreciation. The amount of depreciation is always estimated as a percentage of cost.

The amount that shall have depreciated is treated in the profit and loss account or T,P&L as an expense, while the value of the asset is recorded in the balance sheet, less depreciation.

For example;

1. 1997 The following Trial balance was prepared from the books of Paka Traders as at 31st December 1995. Trial balance December 31st 1995

	Dr. (shs)		Cr. (shs)
Sales			980,000
Purchases	600,000		
Returns	80,000	20 000	
Carriage in			40,000
Carriage out	3,000		
Stock (Jan 1st 1999)	120,000		
Rent	60,000		45 000
Discount	15,000		25 000
Motor vehicle	150 000		
Machinery	250 000		
Debtors	120,000		
Salaries	18,000		
Commission	7,000		12 000
Capital			178,000
Insurance	15 000		
Creditors			240,000
Cash	122 000		
	1 540 000		1 540 000

Additional information

i. Stock as at 31st December was 100,000
ii. the provision for depreciation was 10% on the cost of Motor vehicle, and 5% on the cost of Machinery

Required:

Prepare trading profit and loss account for the period ending 31st December 1999

Adjustments:

Provision for depreciation;

Machinery = $\frac{5}{100} \times 250\,000$

= 7 500

(New balance of machinery = 250 000 – 7 500 = 242 500. The 242 500 is taken to the balance as Machinery (fixed asset), while 7 500 is taken to the trading profit and loss account as expenses)

Motor vehicle = $\frac{10}{100} \times 150\,000$

= 15 000

(New balance of Motor Vehicle = 150 000 – 15 000 = 135 000. The 135 000 is taken to the balance as Motor Vehicle (fixed asset), while 15 000 is taken to the trading profit and loss account as expenses)

Paka Traders

Trading, Profit and Loss Account

Dr For the period 31/12/1995 Cr

	Shs	Shs		Shs	Shs
Opening stock		120 000	Sales	980 000	
add Purchases	600 000		Less Return inwards	80 000	
add Carriage inwards	40 000		Net sales		900 000
less Return Outwards	20 000	620 000			
Goods available for sale		740 000			
Less Closing Stock		100 000			
Cost Of Goods Sold (COGS)		640 000			
Gross profit c/d		260 000			
		900 000			900 000
Expenses			Gross profit b/d		260 000
Insurance		15 000	Discount received		25 000
Carriage Outwards		30 000	Rent income		45 000
Salaries		18 000	Commission received		12 000
Provision for Depreciation					
Motor vehicle	15 000				
Machinery	7 500	22 500			
Discount allowed		15 000			
Commission allowed		7 000			
Rent paid		60 000			
Net profit c/d		174 500			
		342 000			342 000
			Net profit b/d		174 500

The net profit/loss may be taken to the balance sheet.

The items that have been adjusted will be recorded in the balance sheet less the adjustment.

The Balance Sheet

The balance sheet will show the business financial position in relation to assets, capital and liabilities. The adjustment that can be made will be on Fixed assets and capital only. That is;

Fixed assets are recorded less their depreciation value (should there be provision for depreciation) as the actual value.

Actual value of assets = Old value – depreciation.

Capital is adjusted with the following; Net capital, Drawings and additional investment. i.e.

Closing Capital/Net capital (C.C) = Opening/initial capital (O.C) + Additional Investment (I) + Net profit (N.P) or (less Net Loss) – Drawings

CC = OC + I + NP – D

Where:

Opening Capital: - the capital at the beginning of the trading period

Closing capital: - the capital as at the end of the trading period

Additional Investment: - any amount or asset that the owner adds to the business during the trading period

Net profit: - the profit obtained from the trading activities during the period. Incase of a loss, it is subtracted

Types of Capital

The capital in the business can be classified as follows

- Capital Owned/Owner's Equity/Capital invested; - this is the capital that the owner of the business has contributed to the business. It is the Net capital/Closing capital of the business (C = A – L)
- Borrowed capital: - the resources brought into the business from the outside sources. They are the long term liabilities of the business.
- Working capital: - these are resources in the business that can be used to meet the immediate obligation of the business. It is the difference between the total current assets and total current liabilities

  Working Capital = Total Current Assets – Total Current Liabilities
- Capital employed: - these are the resources that has been put in the business for a long term. i.e.

  Capital Employed = Total Fixed assets + Working Capital

  Or

  Capital employed = Capital Invested + Long term liabilities

Name of the business

Balance Sheet

As at (date)

	Shs	shs		Shs	shs
Fixed Assets					
Land	xxxxx		Capital	xxxxx	
Buildings	xxxxx		Add Net profit	xxxx	
Motor Vahicle	xxxxx		Add additional investt	xxx	
Any other fixed assets	xxxxx	xxxxxx	Less drawings	xxx	

			Net Capital		xxxxx
Current Assets					
Stock	xxxx		Long term liabilities		
Debtors	xxxx		Long term loan	xxxx	
Bank	xxxx		Any other	xxxx	xxxx
Cash	xxxx				
Prepaid Expenses	xxxx		Current liabilities		
Accrued revenues	xxxx		Creditors	xxxx	
Any other current assets	xxxx	xxxxxx	Short term loan	xxxx	
			Accrued expenses	xxxx	
			Prepaid revenues	xxxx	
			Any other	xxxx	xxxxx
		xxxxxx			xxxxxx

For example 00A

The following information were extracted from the trial balance of Mwema traders on 31st December 2010

Sales		750 000
Purchases		540 000
Sales return		24 000
Return outwards		30 000
General expenses		72 000
Commission received	24 000	
Rent expenses	2 500	
Electricity expenses		16 000
Furniture		288 000
Motor vehicle		720 000
Capital	842 500	
Bank Loan		250 000
Creditors		216 000
Cash		156 000
Debtors		244 000

Additional Information

a) Stock as at 31/12/2010 was ksh 72 000
b) Electricity prepaid was shs 4 000
c) Rent expenses accrued shs 3500
d) Depreciation was provided for as follows
   i. Motor Vehicle 15% p.a. on cost
   ii. Furniture 6% p.a. on cost

Required

(i) Prepare Trading, profit and loss account for the year

(ii) Prepare a balance sheet as at 31st December 2012

(iii) Determine the following:

a. Owner's equity
b. Borrowed capital
c. Working capital
d. Capital employed

Adjustments:

Motor Vehicle = $\frac{15}{100} \times 720\,000$

= 108 000

Therefore Motor vehicle = 612 000

Furniture = $\frac{6}{100} \times 288\,000$

= 17 280

Therefore furniture = 270 720

Mwema Traders

Trading, Profit and Loss Account

For the period 31/12/2010

Dr	Shs	Shs		Shs	Cr Shs
Purchases	540 000		Sales	750 000	
less Return Outwards	30 000	510 000	Less Return inwards	24 000	
Goods available for sale		510 000	Net sales		726 000
Less Closing Stock		72 000			
Cost Of Goods Sold (COGS)		438 000			
Gross profit c/d		288 000			
		726 000			726 000
Expenses			Gross profit b/d		288 000
General expenses		72 000	commission received		24 000
Electricity expenses	16 000				
Less Electricity prepaid	4 000	12 000			
Rent expenses	2 500				
Accrued rent exp	3 500	6 000			
Provision for Depreciation					
Motor vehicle	108 000				
Furniture	17 280	125 280			
Net profit c/d		96 720			
		312 000			312 000

			Net profit b/d		96 720

Mwema Traders
Balance Sheet
As at 31/12/2010

	Shs	shs		Shs	shs
Fixed Assets					
Motor Vehicle	612 000		Capital	842 500	
Furniture	270 720	882 720	Add Net profit	96 720	
			Net Capital		939 220
Current Assets					
Stock	72 000		Long term liabilities		
Debtors	244 000		Bank Loan		250 000
Electricity prepaid	4 000				
Bank	50 000		Current liabilities		
Cash	156 000	526 000	Creditors	216 000	
			Accrued rent	3 500	219 500
		1 408 720			1 408 720

Basic Financial Ratios

A ratio is an expression of one item in relation to the other. It is used to compare the groups of related items in the business, for the purpose of assessing the performance of the business. They include:

a) Mark-up

This is the comparison of gross profit as a percentage of cost of goods sold. i.e.

$$\text{Mark-up} = \frac{Gross\ Profit}{Cost\ of\ Goods\ Sold} \times 100$$

$$= \frac{G.P}{COGS} \times 100$$

For example: in (example OOA) above, determine the mark-up of the business.

$$\text{Mark-up} = \frac{Gross\ Profit}{Cost\ of\ Goods\ Sold} \times 100$$

Gross profit = 288 000

COGS = 438 000

$$\text{Mark-up} = \frac{288\,000}{438\,000} \times 100$$

$$= 65.75\%$$

(This implies that the Gross profit of the business is 65.75% of its cost of goods sold)

b) Margin

This is the expression of the gross profit as a percentage of net sales. That is:

$$\text{Margin} = \frac{Gross\ Profit}{net\ sales} \times 100$$

$$= \frac{G.P}{sales} \times 100$$

For example: in (example OOA) above, determine the margin of the business

$$\text{Margin} = \frac{Gross\ Profit}{net\ sales} \times 100$$

Gross profit = 288 000

Net sales = 726 000

$$= \frac{288\,000}{726\,000} \times 100$$

= 39.67%

(This implies that the gross profit of the business is 39.67% of the net sales)

Relationship between margin and mark-up

Since margin and mark-up are all the expression of Gross profit, it is possible to change one to the other.

- Changing mark-up to margin

  Mark-up can be changed to margin as follows:

  a) Convert the mark-up percentage as a fraction in its simplest form

  ii) Add the value of the numerator of the fraction to the denominator to come up with the new fraction (margin fraction) that is

  If the mark-up fraction = $\frac{a}{n}$

  Margin fraction = $\frac{a}{n+a}$

  iii) Convert the margin fraction as a percentage to obtain margin

  For example: in the above example,

  Mark –up = 65.75%

  $$= \frac{65.75}{100}$$

  $$= \frac{263}{400}$$

  Margin fraction = $\frac{263}{400+263}$

  $$= \frac{263}{663} \text{ x } 100$$

  = 39.67%

- Changing margin to mark-up

  (i) Convert the margin percentage as a fraction in its simplest form

  (ii) Subtract the value of the numerator of the fraction from the denominator to come up with the new fraction (mark-up fraction) that is

  If the margin fraction = $\frac{a}{n}$

  Mark-up fraction = $\frac{a}{n-a}$

(iii)Convert the mark-up fraction as a percentage to obtain mark-up

For example: in the above example,

Margin = 39.67%

$= \frac{39.67}{100}$

$= \frac{263}{663}$

Mark-up fraction = $\frac{263}{663-263}$

$= \frac{263}{400}$ x 100

= 65.75%

c) Current ratio/working capital ratio

This is the ratio of the current assets to current liabilities. It can also be expressed as a percentage. That is:

Current ratio = $\frac{current\ assets}{current\ liabilities}$

= current assets : current liabilities

Or

Current ratio = $\frac{current\ assets}{current\ liabilities}$ x 100

For examples: in (example OOA) above, determine the current ratio;

Current assets = 526 000

Current liabilities = 219 500

Current ratio = $\frac{current\ assets}{current\ liabilities}$

$= \frac{526\ 000}{219\ 500}$ = 1052 : 439

Or

$= \frac{526\ 000}{219\ 500}$ x 100

239.64%

d) Rate of stock turnover

This is the rate at which the stock is bought or sold within a given period of time. It is obtained by;

Rate of stock turnover (ROST) = $\frac{cost\ of\ goods\ sold}{average\ stock}$

Average stock = $\frac{opening\ stock+closing\ stock}{2}$

In (example OOA) above, determine the rate of stock turnover;

The cost of goods sold = 438 000

The closing stock = 72 000

The opening stock = 0

Therefore

The average stock = $\frac{opening\ stock+closing\ stock}{2}$

$= \frac{0+72\ 000}{2} = 36\ 000$

Rate of stock turnover (ROST) = $\frac{cost\ of\ goods\ sold}{average\ stock}$

$= \frac{438\ 000}{36\ 000}$

= 12.17 Times

e) Return on capital

This is the expression of net profit as a percentage of the capital invested. That is;

Return on capital = $\frac{net\ profit}{capital\ invested}$ x 100

It can be given as a ratio or a percentage.

For example: in (example OOA) above, determine the return on capital of the business

Net Profit = 96 720

Capital invested/owner's equity = 939 220

Return on capital = $\frac{net\ profit}{capital\ invested}$ x 100

$= \frac{96720}{939220}$ x 100

= 10.33%

f) Acid test ratio/quick ratio

This shows how fast the business can convert its current assets excluding stock to settle its current liabilities. That is;

Quick ratio = $\frac{current\ aassets-closing\ stock}{current\ liabilities}$

It is given in ratio form.

For example: in above (example OOA), determine the quick ratio;

Current assets = 526 000

Stock = 72 000

Current liabilities = 219 500

Quick ratio = $\frac{current\ aassets-closing\ stock}{current\ liabilities}$

$= \frac{526\ 000-72\ 000}{219\ 500}$

= 2.07 (or 207 : 100)

Importance of Financial Ratios

- Mark up and margin helps in the following; setting the selling price, calculating profit or losses and determining the sales for a given period of time

- Working capital and acid test ratio help in showing whether the business is in a position to meet its short term obligations and checking whether the business is utilizing its resources properly. That is high working capital ratio shows that most of the resources are idle
- Return on capital shows the following;
  - The performance of the business in relation to other similar businesses
  - Comparison of the performance of the business over different periods
  - Whether the business finances have been invested or not
  - Help the potential investors on the decision on where to invest

- Rate of stock turnover also help in determining how fast or slow the stock is moving. It also helps in computing the gross profit or loss.