

E5 and A2 - Compare and Contrast a set of Final Accounts for a Sole Trader and a Non-Profit Organisation

▲ **sole trader**, otherwise known as a sole proprietor exists where as a single person owns and runs a business. This is a very common form or organisation in the UK. Sole traders have grown substantially over the years. There are several reasons for this trend including more opportunities for firms on consultancy basis and government support for self-employed. Most sole traders work on their own. This need not be the case though, there is no theoretical reason why a sole trader couldn't employ a hundred staff and own up to nine factories, and however, in practice this is unlikely that a single person could raise that amount of capital needed for an organisation as big as that.

▲ **sole trader** holds full responsibility for the financial control over his or her business, for meeting capital requirements and running costs, and her full personal liability in the case of debt. He or she does not have the protection of **Limited liability** like a **limited company**. Sole traders are easy to set up, the sole trader has:

- Responsibility for providing capital either as savings or loans
- Direct personal involvement
- Unlimited liability
- Independence to run the business, however, they see fit
- Entitlement to all profits but responsible for all debts

▲ **non-profit organisation** collects remaining profits from trading activities. Their main objective would not be to make a profit but just to cover costs and break even. To gain capital they therefore have to remain on different forms of outlet, such as grants from local and general government as well as other public bodies. Donations are also accepted as well as support financially from other companies.

Businesses and **non-profit organisations** differ their aims and accounting terminology, as well as their finances. Below is a table to show primary objectives, main accounting statements, financial sources and financial performance for **sole traders** and **non-profit organisations**:

	Sole Trader	Non-profit organisation
Main Objective	Make a profit	Provide facilities and services to members
Main Accounting Statements	<ul style="list-style-type: none"> ➤ Trading, Profit and Loss Account ➤ Balance sheet 	Income and Expenditure Account
Main Sources	<ul style="list-style-type: none"> ➤ Own Savings ➤ Redundancy Pay ➤ Inheritances ➤ Loans (small sums) 	<ul style="list-style-type: none"> ➤ Surplus from trading activities ➤ Grants from local and central government and other public bodies ➤ Donations from charities ➤ Support from other companies
Main Performance	Profit	More money going in then coming out
	Loss	More money going out then coming in

The main and fundamental difference between both sets of accounts is that a **sole trader's** accounts are recorded in **double entry** format where most **non-profit organisations** are recorded by **single entry**. Most **non-profit organisations** therefore keep a cash book which is a simple version to those used by a **sole trader** and many other businesses. In this particular cash book it records receipts paid into the bank and payments made from the bank, together with cash receipts and payments. At this stage it must be noted that cash books form part of double entry system used by **sole traders**. This ensures that both businesses can keep track of its available finance, cash and bank transactions are entered immediately. The cash book is ruled off and balanced at the end of the financial year.

A **non-profit organisation's** cash book is presented to members in the form of receipts and payments accounts. This is unlike a **sole trader**. This is mainly because there are accounting problems in using a receipts and payments account:

1. **Accruals and Payments cannot be made:** This is unlike a **sole trader's** set of accounts as accruals and prepayments have to be allowed for in the Less Expenses on the trading, profit and loss account.

2. **The distinction between capital and revenue expenditure cannot be made:** Capital expenditure is like fixed assets whereas; revenue expenditure is like day to day purchases, like rents and rates. A **non-profit organisation** single entry system is unable to distinguish between one and the other due to its layout, which is unlike the double entry system of a **sole trader**.

Receipt and Payment accounts may be suitable for smaller non-profit making businesses which deal with small amounts of money infrequently, but it is essential for larger clubs to produce final accounts in the form of:

- **Income and Expenditure**
- **Balance Sheet**

Income and Expenditure Account:

The Income and Expenditure Account of a **non-profit organisation** lists the income and deducts the expenditure using a layout similar to a profit and loss account of a **sole trader**. The account will show:

- More money coming in than coming out
- More money going out than coming in

The Income and Expenditure account is prepared from the receipts and payments account taking note of:

- **Accruals**
- **Prepayments**
- **Depreciation of Fixed Assets**

One of the main types of income for a **non-profit organisation** is member's subscriptions. Some members will prepay subscriptions for the next financial year, while others will be late in paying, or never pay at all, ceasing to all members. Unless the organisation has a different policy, the treasurer will calculate the subscriptions that should have been received, as it is seen as a form of revenue. This is done under the subscription account and will become Income and Expenditure. A **non-profit organisation** will then have to add the subscriptions written off in **less expenses**, in the Income and Expenditure account. It is like self cancelling, they add it up in the subscription account so they have to take it away in the income and expenditure account to balance the accounts. A **sole trader's** account will not have a subscription account as it is not necessary as they do not have members like a Golf Club would, it would just have 'bad debts written off' in the trading, profit and loss account. This would be one fixed total.

Trading, Profit and Loss Account of a Sole Trader:

	£	£	£
Sales			228850
Sales Returns			<u>2450</u>
Net Sales			226400
Opening Stock		16900	
Purchases	133700		
Purchase Returns	<u>1840</u>		
		<u>131860</u>	
		148760	
Less Closing Stock		<u>17800</u>	
Cost of Sales			<u>130960</u>
Gross Profit			95440
Less Expenses:			
Sundry Expenses		5760	
Salaries		36700	
Rates and Insurance	2640		
Less Prepayment	<u>580</u>		
		2060	
Electricity	3480		
Plus Accruals	<u>460</u>		
		3940	
Less Allowance for Depreciation:			
Fixture and Fittings		2200	
Delivery Van		2280	
Bad Debts Written Off		1400	
Provision for Bad Debt		<u>1074</u>	
			<u>56014</u>
Net Profit			39426

This is designed for **sole trader's** to provide financial information based on the performance of a business over an accounting period. Unlike a **non-profit organisation** where it shows a ~~sales~~ or ~~cost~~ of income and expenditure it shows **Gross Profit** and **Net Profit**. The Gross Profit measures the success of the business' trading activities, where the net profit measures the overall success of the business during the period. Similar to a **sole trader** the capital expenditure of a **non-profit organisation** is not recorded in the income and expenditure account, although the depreciation will, just as the provision for depreciation of fixed assets as on a **sole trader's** trading, profit and loss account. From comparing these accounts they differ a lot, that it obvious that the companies have different objectives and financial targets to meet.

Much of the primary objectives of a **non-profit organisation** are to provide a service and facilities to members, many organisations still carry out activities with the intention to make a profit. These activities can either be:

- ▲ bar for the use of members
- Provision of catering facilities for members
- The purchase of goods to sell to members on favourable terms

The treasurer of the **non-profit organisation** account prepares accounts to cater such activities, to show either the profit or the loss. The layout of this account is exactly the same as that for a trading account of the **sole trader** with:

- Opening stock
- Closing stock
- Purchases
- Sales

If any direct costs associated with the trade such as bar wages, such as bar wages will be included in the profit or loss on trading activities, it is then taken to the income and expenditure account. This is very similar to that of a **sole trader**, except it is much smaller as a **non-profit organisation** does not operate on a large scale and therefore has fewer expenses. For example:

Seer Green Golf Club Trading Account for year ending 31.3.04

	£	£
Bar Takings		49670
Opening Stock	4930	
Purchases	35052	
	<u>39982</u>	
Less Closing Stock	<u>5230</u>	
Cost of Goods		<u>34752</u>
Gross Profit		14918
Less Expenses:		
Bar Steward		
Wages		<u>11880</u>
Net		
Loss		<u><u>-3038</u></u>

It must be noted that:

- The profit on the bar has been calculated separately. This is usual for a **non-profit organisation's** accounts to show this separately, as their main objective is to provide a service. This is unlike a **sole**

trader whose accounts clearly state all of the business's trading activities as it is required by law.

- ▲ surplus of income over expenditure is equivalent of a **sole trader** of making a net profit, but in the example above a deficit of expenditure over income is the equivalent of Net Loss. Like a **sole trader** the surplus, of a **non-profit organisation**, is added to the accumulated fund, which is equivalent of the **sole trader's** capital, which are both situated in the balance sheet.

Balance sheet:

The balance sheet of a **non-profit organisation** is presented in a very similar way to that of a **sole trader**. The major difference is that, a **sole trader** will have **Capital** in the 'Financed by' section where a **non-profit organisation** will have an **accumulated fund**. This is because the **Capital** in a **sole trader** is largely retained from the return of sales, the more sales, the higher the profits, whereas the **accumulated fund** in a **non-profit organisation** is retained from financial contributions such as donations and it states the amount the club was worth in the previous year. You can calculate the accumulated fund as:

$$\text{Net Assets} = \text{Accumulated Fund}$$

Seer Green Golf Club Balance Sheet as at 31.3.04

Fixed Assets

	Cost	Depreciation	Net
Freehold property	1250000	0	1250000
Club house	440000	264000	176000
Equipment	98000	73500	24500
	<u>1788000</u>	<u>337500</u>	<u>1450500</u>

Current Assets

Bar stocks	5230
Subscriptions in arrears	<u>15600</u>
	20830

Less Current Liabilities

Bar creditors	3456
Bank overdraft	3200
Operating costs owing	<u>4360</u>
	<u>11016</u>
	<u>9814</u>

Net Assets

1460314

Accumulated Fund

Balance at 01.04.04	1506516
Less deficit	<u>46202</u>
	<u>1460314</u>

In the Balance sheet of a **non-profit organisation**, subscriptions in advance are recorded as a current liability, while subscriptions due but

unpaid are current assets. This method of handling subscriptions takes note of prepayments and accruals, and is the way in which a **sole trader** would handle such items in the accounts. However, in practice, a treasurer of a club may not choose to record the subscriptions due but unpaid debtors because, unlike a **sole trader**, a **non-profit organisation** will not sue for unpaid amounts. If they are subsequently paid, they can be brought into the years to come.

Balance sheets for a **sole trader** show the net profit made by the business added to the capital invested by the owner. However, it must be recognised that unlike a **non-profit organisation** the Net Profit on the balance sheet does belong to the sole owner, so it is shown as increasing the amount of capital the owner has invested in the business, whereas the **accumulated fund** is not for any one person, it is there to prove if the club has made enough profit to break even, and to show how much it is worth.

There are a number of problem areas that can trouble for a **non-profit organisation**. **Sole traders** do not have to deal with the same sort of problems. These come in the form of:

- Overdue subscriptions
- Life membership
- Entrance/joining fee
- Donations received
- Depreciation

Rules state that these fees should be handled in the club's account, if not a treasurer should see how they were handled in the previous years:

Overdue subscriptions: The practical use by **non-profit organisations** is to ignore overdue subscriptions, but unlike a **sole trader** an Adjustment Account is made for prepaid subscriptions, in a **non-profit organisation**. Adjustment Accounts allow the club to control self-balancing ledgers. It also allows them to apply accruals and prepayments like a **sole trader** would do in its Profit and Loss Account. In terms of a club and overdue subscription should be treated as an accrual where subscriptions in advance as prepayments.

Life Memberships: **Sole traders** do not offer life memberships to investors, or employees. Clubs offer it in exchange for one payment. The problem arises whether to record this payment as income for the year in which it is received, or to credit it to a reserve account, the balance of which is then transferred bit by bit over a number of years to the income and expenditure account.

Entrance Fees: This is a one-off charge made in the year joining. It gives the club income and once a person is a member, it acts as an incentive for them to remain a member. The treasurer needs to know:

- If the sum is treated as income for the year joining
- Or is it credited to an entrance fees account which is transferred to income over a number of years

Donations Received: There are two accounting treatments for donations:

- Record the amount in the income and expenditure account
- OR
- Record the amount as an addition to the accumulated fund in the balance sheet

The first method treats the donation as income for the year. The second capitalises the amount meaning it records it on the balance sheet. Which method used, solely depends on the amount of the donation. This is where the materiality concept applies. ▲ small sum of money should be capitalised as an income where a large sum of money should be capitalised, and added to the accumulated fund. Donations act as a similar way to a **sole trader's** investors. Donations for a **non-profit organisation** will not always be cash amounts; they could be a plot of land. In the case of assets other than money they have to be recorded in the same way as a **sole trader**, and that is under fixed assets on the balance sheet, these could be premises or equipment.

Depreciation: ▲ in the final accounts of a **sole trader**, fixed assets should be depreciated in a **non-profit organisation**, and both the same principals apply. Depreciation for the year is charged as an expense in the income and expenditure account. Both organisations show the asset in the balance sheet at a cost for less provision, to give the book value.

Like **sole traders**, clubs simply value their fixed assets at the end of the financial year. They fall in value subject to technological changes etc, is depreciated in the same way as a **sole trader**. It is charged as an expense on the profit and loss account and charged in the income and expenditure account for a **non-profit organisation**.

▲ **non-profit organisation** is responsible for maintaining proper accounting records like a **sole trader**.

Authority to spend: Before making payments, a treasurer of the **non-profit organisation** must ensure that he or she has authority to spend the clubs money. For one-off transactions, the minutes of a relevant

committee meeting will show that the purchase was agreed. In a **sole trader** the owner will be responsible for all purchases.

Documentary evidence: like a **sole trader** a club must ensure that there is evidence for every transaction. Payment should be made against invoices etc. In this way an audit trail is created. ▲ All documents are able to be retained for the use of an auditor who will check the accounting records after the end of each financial year.