BUSINESS STUDIES NOTES

FORM 2

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**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  Opening stock xxxxxx  add Purchases xxxxx  add Carriage inwards xxx  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 | Shs Shs  Sales xxxxxx  Less Return inwards xxx  Net sales 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  Opening stock 60 000  add Purchases 380 000  add Carriage inwards 10 000  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 | Shs Shs  Sales 670 000  Less Return inwards 40 000  Net sales 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***

1. It is used to determine the gross profit/loss for a given trading period for appropriate decision making by the management.
2. It is used in determining the cost of goods that was sold during that particular accounting period.
3. It is used to reveal the volume of turnover i.e net sales
4. 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
5. 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  Expenses  Insurance xxx  Electricity xxx  Water bills xxx  Carriage Outwards 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 | Shs  Gross profit b/d xxxxxx  Discount received xxx  Rent income xxx  Commission received xxx  Any other income received xxx  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

Dr For the period ending 28th March 2010 Cr

|  |  |
| --- | --- |
| Shs  Expenses  Power and lighting 10 000  Carriage Outwards 4 000  Salaries and wages 20 000  Provision for Depreciation 6 000  Discount allowed 8 000  Commission allowed 15 000  Repairs 10 000  Net profit c/d 65 000  138 000 | Shs  Gross profit b/d 100 000  Discount received 12 000  Rent income 10 000  Commission received 16 000  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  Opening stock xxxxxx  add Purchases xxxxx  add Carriage inwards xxx  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  Expenses  Insurance xxx  Electricity xxx  Water bills xxx  Carriage Outwards 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 | Shs Shs  Sales xxxxxx  Less Return inwards xxx  Net sales xxxxxx  xxxxxx  Gross profit b/d xxxx  Discount received xxx  Rent income xxx  Commission received xxx  Any other income received xxx  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

1. Stock as at 31st December was 100,000
2. 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 =

= 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 =

= 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  Opening stock 120 000  add Purchases 600 000  add Carriage inwards 40 000  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  Expenses  Insurance 15 000  Carriage Outwards 30 000  Salaries 18 000  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 | Shs Shs  Sales 980 000  Less Return inwards 80 000  Net sales 900 000  900 000  Gross profit b/d 260 000  Discount received 25 000  Rent income 45 000  Commission received 12 000  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  Fixed Assets  Land xxxxx  Buildings xxxxx  Motor Vahicle xxxxx  Any other fixed assets xxxxx xxxxxx  Current Assets  Stock xxxx  Debtors xxxx  Bank xxxx  Cash xxxx  Prepaid Expenses xxxx  Accrued revenues xxxx  Any other current assets xxxx xxxxxx  xxxxxx | Shs shs  Capital xxxxx  Add Net profit xxxx  Add additional investt xxx  Less drawings xxx  Net Capital xxxxx  Long term liabilities  Long term loan xxxx  Any other xxxx xxxx  Current liabilities  Creditors xxxx  Short term loan xxxx  Accrued expenses xxxx  Prepaid revenues xxxx  Any other xxxx xxxxx  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

1. Stock as at 31/12/2010 was ksh 72 000
2. Electricity prepaid was shs 4 000
3. Rent expenses accrued shs 3500
4. Depreciation was provided for as follows
5. Motor Vehicle 15% p.a. on cost
6. Furniture 6% p.a. on cost

Required

1. Prepare Trading, profit and loss account for the year
2. Prepare a balance sheet as at 31st December 2012
3. Determine the following:
4. Owner’s equity
5. Borrowed capital
6. Working capital
7. Capital employed

Adjustments:

Motor Vehicle =

= 108 000

Therefore Motor vehicle = 612 000

Furniture =

= 17 280

Therefore furniture = 270 720

Mwema Traders

Trading, Profit and Loss Account

Dr For the period 31/12/2010 Cr

|  |  |
| --- | --- |
| Shs Shs  Purchases 540 000  less Return Outwards 30 000 510 000  Goods available for sale 510 000  Less Closing Stock 72 000  Cost Of Goods Sold (COGS) 438 000  Gross profit c/d 288 000  726 000  Expenses  General expenses 72 000  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 | Shs Shs  Sales 750 000  Less Return inwards 24 000  Net sales 726 000  726 000  Gross profit b/d 288 000  commission received 24 000  312 000  Net profit b/d 96 720 |

Mwema Traders

Balance Sheet

As at 31/12/2010

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

1. Mark-up

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

Mark-up =

= 100

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

Mark-up =

Gross profit = 288 000

COGS = 438 000

Mark-up = 100

= 65.75%

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

1. Margin

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

Margin =

= 100

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

Margin =

Gross profit = 288 000

Net sales = 726 000

= 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:

* 1. Convert the mark-up percentage as a fraction in its simplest form

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 =

Margin fraction =

Convert the margin fraction as a percentage to obtain margin

For example: in the above example,

Mark –up = 65.75%

=

=

Margin fraction =

= x 100

= 39.67%

* Changing margin to mark-up

1. Convert the margin percentage as a fraction in its simplest form
2. 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 =

Mark-up fraction =

1. Convert the mark-up fraction as a percentage to obtain mark-up

For example: in the above example,

Margin = 39.67%

=

=

Mark-up fraction =

= x 100

= 65.75%

1. 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 =

= current assets : current liabilities

Or

Current ratio = x 100

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

Current assets = 526 000

Current liabilities = 219 500

Current ratio =

= = 1052 : 439

Or

= x 100

239.64%

1. 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) =

Average stock =

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 =

= = 36 000

Rate of stock turnover (ROST) =

=

= 12.17 Times

1. Return on capital

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

Return on capital = 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 = x 100

= x 100

= 10.33%

1. 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 =

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 =

=

= 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.