# The ABCs for a sole proprietor

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# Sole proprietor and accounting

## SOLE PROPRIETORS ARE ACCOUNTING ENTITIES

Sole proprietors are accounting entities and they are required to organise their accounting in the cases and pursuant to the procedure provided for in the **Accounting Act**.

A sole proprietor may apply either a cash based or an accrual based accounting principle in its business accounting. When choosing the accounting principle, attention should be given to the fact that **in the taxation of business income, the cash basis principle is used** (**Income Tax Act § 36 (1) and (3)**). It means that if a sole proprietor keeps accounts on accrual basis, the business income will be adjusted to cash basis for completing Form E of the tax return .

The requirements for accounting are provided for in the Accounting Act and in the guidelines of the Accounting Standards Board.

## THINGS TO BE FOLLOWED IN A SOLE PROPRIETOR'S ACCOUNTING

**Accounting entities are obliged to:**

- organise their accounts in accordance with the principles generally accepted in Estonia and the international financial reporting standards to ensure the provision of up-to-date, relevant, objective and comparable information concerning the financial position, financial performance and cash flows of the accounting entity;
- document all their business transactions;
- record all their business transactions in accounting ledgers and journals on the basis of source documents or corresponding summary documents;
- preserve accounting documents.

**Sole proprietors keeping accounts on cash basis** have to follow sections 1 to 3, 4 (except clause 4)), 5, 6 (except subsection (3)), 7, 9, 10 and 12 of the **Accounting Act**, and and other requirements from the Estonian financial reporting standard, which regulate the accounting on cash basis.

**Sole proprietors keeping accounts on accrual basis** have to follow the entire Accounting Act.

# Cash based and accrual based accounting

In the case of the cash based accounting, income and expenses are recorded in chronological order from the beginning of the year, taking into account when the money is actually paid or received. The entries of the income and expenses are made in the accounting journals and ledgers when the money is received in the pay-office or into the bank account and when the money is paid out from the pay-office or from the bank account.

**Example**
An operator gave goods to the buyer and submitted an invoice in the amount of 639.12 euros in October 2019. The money for the goods transferred in the amount of 639.12 euros was received by the operator in January 2020. The amount 639.12 euros is deemed to be the operator's income of the year 2020.

In the case of accrual based accounting, business transactions are recorded when they occur, regardless of when the money is received or paid for the transactions.

**Example**
An operator gave goods to the buyer and submitted an invoice in the amount of 639.12 euros in October 2019. The money in the amount of 639.12 euros was received in the bank account of the operator in January 2020. The amount of 639.12 euros is recorded in the operator's accounting as the income of the year 2019. However, 639.12 euros is recorded in the accounting for taxation purposes as the income of the year 2020 on Form E of the income tax return.

Sole proprietors are both accounting entities and taxable persons. If a sole proprietor applies accrual based accounting, then he/she has to keep supplementary records on circumstances that are important for taxation purposes, it means to keep accounting for taxation purposes. Accounting for taxation purposes is essentially a cash based accounting. Thus, a sole proprietor applying accrual based accounting is obliged to keep cash based accounting for taxation purposes in addition.

# Accounting journals and ledgers, source documents

### ACCOUNTING JOURNALS AND LEDGERS (DAYBOOKS)

Sole proprietors show all their transactions related to business activities in the accounting journals and ledgers (**§ 9 and 10 of the Accounting Act**), whereas each entry made on any transaction must contain the following information:

- the date of the business transaction
- reference to the source document constituting the basis for the entry

- the corresponding amounts
- a short explanation of the business transaction
- the name and number of the source document (summary document).

A daybook is the cash based accounting journal/ledger.

### ACCOUNTING SOURCE DOCUMENTS

All accounting entries in the daybook (daily journal) must be supported by source documents certifying the corresponding business transactions **(§ 7 of the Accounting Act**) or by summary documents prepared on the basis of source documents. The requirements for source documents have been set out in § 7 of the Accounting Act, according to which a source document must contain the following information:

- document name and number;
- date of preparation;
- economic content of a transaction;
- figures of a transaction (quantity, price and amount);
- information enabling to identify the parties to the transaction;
- a sequential number of the corresponding accounting entry.

Accounting source documents, accounting ledgers, journals, contracts and other documents must be preserved **seven years** as of the end of the financial year when a business transaction was recorded in the accounting journals and ledgers on the basis of the source document (**§ 12 of the Accounting Act**, see also **§ 58 of the Taxation Act**).

Source documents may be converted into another format or carried to another data medium (for example, a computer), if the information of source documents concerning transactions are not changed in the course of the conversion.

If a sole proprietor is a person liable to value added tax, then the Value-Added Tax Act shall establish its own requirements (see **§ 37 of the Value Added Tax Act**).

## FORMATION OF A DAYBOOK (DAILY JOURNAL)

A daybook has no fixed form and operators may choose a suitable form themselves and develop it pursuant to the Accounting Act.

Sole proprietors may:

- draw up a daybook itself whether on paper or on a computer;
  Upon drawing up a daybook, the structure of a business income tax return (**Form E**) can be taken into account dividing the part of income and expenses according to rows in the tax return, which makes the subsequent completion of the tax return simpler. If not all items listed among the income and expenses in the tax return are present, there is no need to enter these in the daybook either.

- use accounting programs that are sold by companies dealing with accounting software.

On the basis of the daybook, sole proprietors have to fill in a business income tax return (**Form E**), where thet enter business income and expenses. Business income tax returns must be submitted to the Tax and Customs Board not later than by 30 April of the year following the year of the business activities.

On the production and sale of agricultural products, the sale of timber and on the income and expenses concerning other business activities, separate accounts must be kept.

Upon filling in Form E, the income and expenses are indicated together with value added tax.