Section 3: Understanding Your Accounts

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Disclaimer

This guide is designed to alert you to some of the major issues you should be considering. It is not a replacement for professional advice tailored to your precise needs and circumstances.

You should always seek the advice of a suitably qualified professional before acting on any of the advice.

And if you would like to speak to us about any of the issues covered in this guide, please feel free to give us a call or drop us an email.

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3 Introduction

You may not think that understanding your accounts is anything to do with you but unfortunately you're wrong!!

As this is your business, it is vital you have a good understanding of what is going on in it.

You're probably more than happy with the operational side of the business but you also need to understand the finances and how your accounts are put together.

And don't assume it is all your accountant's responsibility – you're responsible too!

In fact, as it's your name on the accounts and tax return, it's very important that you understand the numbers as the taxman will be asking you first **not** your accountant!

3.1 Terminology

3.1.1 Year end

Your accounts year end is your business year end. This is normally different from the tax year end (5 April) even if you are a sole trader. You may also hear this referred to as your financial year end.

3.1.1.1 Limited company:

If you are a limited company, then your year end will be whatever is registered at Companies House this is often the end of the month after you incorporate. So for example if you incorporate on 18 August your year end will be 31 August.

So for example if you incorporate on 18 August 2014, then you will make up accounts for the period 18 August 2004 to 31 August 2015.

You will then continue making up accounts every year until you cease trading.

3.1.1.2 Sole trader:

If you are a sole trader, then you can choose whatever business year end and whatever length you like (as much as twenty three months in some cases). In your first year of trading you will need to choose carefully as there can be some significant advantages to when you pay your tax if you choose the right year end.

3.1.2 Changing your year end

Subject to certain conditions, you can elect to change your business year end whether you are a limited company, sole trader or partnership.

3.1.2.1 Limited company:

You can change your year end and shorten your year as many times as you like – for example you could decide to change your year end from 31 August to 31 July and then make up accounts for eleven months to 31 July rather than twelve months to 31 August.

You can also lengthen your year as long as the accounting period is no longer than eighteen months. Although as you can only lengthen your accounting period once every five years you need to think carefully about this!!

If you decide to change your companies year end, you will also need to notify Companies House using Form AA01 and this must be submitted before your company accounts are due for submission – which is nine months after the year end for private companies.

3.1.2.2 Sole trader:

If you're an existing business that has traded for many years it is still possible to change your year end. However, as with a limited company your accounting period cannot be in excess of eighteen months and you can only change your accounting year end once every five years (whether you are lengthening or shortening it) unless there are valid commercial reasons for doing so.

3.1.3 Accounting period

An accounting period is merely a period of time which you use to measure something in your business. So it might be a week, a month or a year.

Generally people refer to an accounting period as meaning your annual accounts - although as we have seen above this may or may not equate to twelve months!!

3.1.4 Costs and Sales

There are many different ways of referring to sales – a few that you may see are revenue, income and turnover.

Also, costs may also be called direct costs, cost of sales, overheads or indirect costs.

3.1.5 Financial Statements

Financial statements is another name for your accounts.

The basic elements of your accounts are your profit and loss account and your balance sheet. If you are a limited company then you will have to comply with the Companies Act and prepare accounts which have a lot more information in them and comply with a certain format.

3.1.6 Management accounts

Financial statements or accounts are normally produced at the end of your financial year and may not be produced until several months afterwards.

Many businesses require information on a timelier basis and so will produce management accounts. They are what they say on the tin – accounts for management.

How complicated or involved your management accounts are really depends on your business. It may be that you will just produce a simple profit and loss account and balance sheet once a quarter. Or you may need to make adjustments such as accruals, prepayments or depreciation each month (see below for an explanation as to what these are) before producing your accounts.

As well as profit and loss and balance sheet, businesses may also produce cash flow forecasts and commentary on the numbers. They may also look in detail at debtors and creditors and other critical figures in their business.

The information is normally collated into a reporting pack which is known as the management accounts pack.

3.1.7 Key performance indicators

The key performance indicators (KPIs) are the numbers in a business which really let the business owner know what is going on and how the business is performing.

These should be a mixture of financial (eg profit margins, turnover), customer (eg average spend, top 20), employees (eg staff turnover, sales per employee) and process (eg time taken to fulfil order, error rate).

The KPIs for your business may change over time as different areas may require focus at different times.

The important thing is to be looking at these and reviewing this regularly.

3.2 Profit and loss account

The profit and loss (p&l) account summarises the sales and costs of a business.

The p&l account will generally be split down as follows:

	£	
Sales	100	Also known as revenue, turnover, income
Less: Cost of Sales	(80)	Also known as direct costs
Gross Margin	20	Also known as gross profit
Less: Overheads		Also known as indirect costs
Rent	2	
Heat & Light	1	
Insurance etc	2	
Net profit	15	If this figure is a negative it means you have made a loss

It's important to note that if you are VAT registered, all the figures in the profit and loss account exclude VAT.

3.2.1 Gross margin

Gross margin is the amount of sales less the costs directly attributable to those sales. So, if your business is making boxes, your cost of sales would be all the costs which go in to making a box – there would be the cost of the cardboard, the salaries of the people making the boxes and the running costs of any machines used to make the boxes.

To work out the gross margin percentage, you divide the gross margin by the sales. In the above example the gross margin percentage is 20% (£20 gross margin/£100 sales).

3.2.2 Mark up

The mark up is the amount added to the direct cost to determine the selling price. In the above example the direct cost is £80 and £20 is added to get to the selling price of £100. So the mark up is 25% (£20/£80) ie the cost of the product (£80) has been 'marked up' by 25%.

3.2.3 Overheads

Overheads are those costs which you have to incur to run your business but which are directly attributable to the sales you make. So for our box making company, they need to have an office where the administrative staff sit – this is an overhead as it isn't directly contributing to the manufacture of boxes but it is a necessary cost to make sure customers are invoiced, money received and suppliers paid.

3.2.4 Cash based accounting

Some people prepare their accounts on a cash basis ie they will record sales as being any money they have received in the business from customers and costs as any money they have paid out to suppliers.

For some businesses which are mainly cash based, this will give them enough information to enable them to make accurate business decisions.

3.2.5 Accruals based accounting

Where a business needs more accurate information, it will need to use accruals based accounting.

This means that sales will be recorded as and when invoices are raised ie when your customer has the obligation to pay you – not just when he actually has paid you.

Costs will also be recorded as and when invoices are received ie when you have an obligation to pay your supplier and not just when you actually pay them.

Using this method of accounting will lead to a business having debtors (people who owe them money) and creditors (people they owe money to). These topics are covered more in the section about the balance sheet.

3.2.6 Costs - accruals and prepayments

At any point in time, a business may have expenses which they have either paid in advance of receiving the benefit or have received goods or services for which they have not been invoiced. These need adjusting in the accounts.

An example of an expense paid in advance is road fund licence.

> Let's take the example that you pay £145 road tax on your company car for twelve months in January.
>
> But your year end is actually March.
>
> This means that you have pre-paid nine months' worth of road fund licence – for the period April to December.
>
> So in your accounts, you would take out nine months' worth of the costs ie £145/12*9 = £108.75 and this would become a prepayment.

An example of an accrual is light and heat.

> You may use light and heat every day but get billed for it every quarter. So if your year end is March and you receive your January to March quarter gas bill in April, you won't post the bill in your accounts until April. But you will need to show the cost of the gas you have used in your accounts - this would be an accrual.

3.2.7 Revenue - deferred and accrued

Sometimes you may invoice customers in advance for services you have yet to do for them.

An example of this is if you invoice a customer annually in advance for a maintenance contract.

> Suppose you invoice them in January for £1,000 to cover the whole year until the end of December but your year end is March.
>
> The revenue you have earned is only three months' worth from January to March and so if you have posted the whole invoice to revenue you will need to take out nine months' worth - £1,000/12*9 = £750.
>
> This is known as deferred income ie it is deferred until your next year end.

Alternatively, you may perform some services for a customer but you may not have invoiced them as at the year end.

> Even though you haven't invoiced them yet, you have earned the revenue and so you will need to put an adjustment in your accounts so that this income is included in your current year's figures.

The whole system of calculating accruals and prepayments is known as the Matching concept, ie you are matching your sales with the costs needed to achieve them.

3.2.8 Fixed Assets and Depreciation

One of the biggest expenses incurred in a business will be the assets it buys. These are purchases which will contribute to the business for usually more than one year eg desks, PCs, machinery etc.

Given the likely size of this expenditure, it would not make sense to write this off against the profit and loss account straight away as this would cause massive losses in some years and massive profits in other years.

In accordance with the Matching concept, you need to make an adjustment to try to match the cost of your assets against the sales they are generating.

So suppose you bought a box making machine for £100k.

> You knew it was likely to last five years and be able to produce the same level of boxes each year until it died at the end of year five.
>
> A fair way of attributing the cost of that machine would be £100k/5 years = £20k to each year it was producing boxes.
>
> That charge of £20k would be known as the depreciation charge.
>
> Each year you would add another year of depreciation and 'write down' the value of the asset in your accounts.
>
> So at the end of year one you would have charged £20k depreciation and the 'written down value' of the machine would be £80k (£100k less £20k).
>
> At the end of year two, you would have charged £40k depreciation (being two years at £20k) and the 'written down value' of the machine would be £60k. By the end of year five, the machine's 'written down value' would be zero.

If you were able to sell the machine at the end of year five, then any proceeds from the sale would be a profit for you as the machine has no value in your accounts.

So if you sold it in year five for £10k you would show a £10k profit in your accounts – being the proceeds less the written down value of zero.

The 'written down value' is also known as the 'net book value'.

3.3 Balance Sheet

Whilst the profit and loss (p&l) account summarises the sales and costs of your business, the balance sheet tells you where you are at a certain point in time.

The balance sheet will generally be split down as follows:

	£	£	
Fixed Assets		100	
Current Assets:			
Trade debtors	80		
Stock	115		
Prepayments & accrued income	5		
Cash at bank and in hand	30		
		230	
Current Liabilities:			
Trade creditors	70		
Accruals & deferred income	20		
Other creditors	10		
Bank loans and overdrafts	20		
		(120)	
Total assets less current liabilities		220	
Capital and reserves			
Called up share capital		100	If you are a limited company
(Proprietor's/Partners account			If you are a sole trader/ partnership)
Profit and loss account		120	
Shareholders' (proprietor/partners' funds)		220	

3.3.1 Fixed Assets

Fixed assets are purchases which will contribute to the business's profit for more than one year for example computers, desks and chairs.

The amount shown in the balance sheet will be the cost of the asset less any depreciation to date.

3.3.2 Trade debtors

Trade debtors are customer you have sold goods or services to and who have not yet paid you. Trade debtors will be shown in the balance sheet after making provisions for any amounts which are not likely to be recovered – this is known as the bad debt provision.

3.3.3 Stock

The amount included on the balance sheet for stock is the amount of stock you have left at the year end. This stock should be valued at the lower of cost (what you paid for it) or net realisable value (what you can sell it for).

The difference between the value of any opening stock and the closing stock will be included in the profit and loss account as a cost.

3.3.4 Prepayments and accrued income

If you have any accrued income (see 3.2.7) or prepayments (see Section 3.2.6) then these will be shown here. The other side of the entry will be to increase sales (accrued income) or reduce costs (prepayments) – both of these are entries which affect the profit and loss account.

3.3.5 Cash at bank and in hand

This will be the amount showing on your bank statement less any cheques you wrote before year end which haven't yet been presented and plus any money you have paid into the bank which hasn't yet appeared on your bank statement.

This figure will also include any cash you are holding in the business.

3.3.6 Trade creditors

Trade creditors are suppliers you have bought goods or services from and have received an invoice from but who you haven't yet paid.

3.3.7 Accruals and deferred income

If you have any deferred income (see 3.2.7) or accruals (see Section 3.2.6) then these will be shown here. The other side of the entry will be to decrease sales (deferred income) or increase costs (accruals) – both of these are entries which affect the profit and loss account.

3.3.8 Other creditors

Other creditors are people you owe money to who don't usually send you an invoice e.g. VAT, PAYE and corporation tax.

3.3.9 Bank loans and overdrafts

If you have any agreed loans or are overdrawn in your bank account, then this will show here. If your loans are repayable after more than one year, then the amounts will be split down to show how much is repayable within one year and how much after one year.

3.3.10 Called up share capital

This relates purely to a limited company.

Every company has to have an authorised level of share capital – this is the total amount of share capital which it is authorised to issue.

But it doesn't have to issue the full amount. For smaller companies it is usual to set the company up to be able to issue either 100 or 1,000 £1 shares – so it's authorised share capital is either £100 or £1,000.

But the amount the director subscribes to is less than this – it may be £1, £10 or £100. This is known as the called up share capital.

The directors then need to give the company the money for the shares – this then becomes fully paid up share capital.

3.3.11 Proprietors/Partners accounts

These accounts show the amounts the proprietor (sole trader) or partners (partnership) have either put into or taken out of the business.

At the end of the year the profit and loss account will be rolled into the proprietor's account for a sole trader or split in the relevant proportion between the partners in a partnership. (How much each partner gets will normally be set out in a partnership agreement).

3.3.12 Profit and loss account

This is the total amount of profit the business has made since it began trading. If this figure is a negative then it means the business has made a loss rather than a profit.