Accounts

Produced by Tax Training Ltd. www.taxtrainingltd.co **020 8224 5695.** **March 2018**

Purpose of accounts

Accounts are financial records. They are a collection of numerical and narrative documents which collectively summarise the financial state of an entity.

They are prepared for an **entity.** This may be a commercial business such as a limited company or partnership. They can be a non-commercial entity such as a school or charity. They can be an individual. They can be just the trade of an individual, or of part of a company. They can be for groups, such as groups of companies, or individuals, or even of the entire nation.

The principles of accounts are largely the same, regardless of the size or nature of the entity, and regardless of whether it is commercial.

Calculation of tax starts with the accounts as published. These are then adjusted in accordance with tax law to produce the taxable profit.

Accounts must be prepared in accordance with published **accounting standards.** This is required for accounts of all types of entity, regardless of size, form or whether they are commercial.

Contents of accounts

Accounts comprise **financial statements.** These are separate documents reviewing the finances of the entity from a particular perspective.

Traditionally the two important documents in a business's set of accounts are:

- profit and loss account
- balance sheet.

The **profit and loss account** tells you how well the business has done during the period being reported. It relates to a period of time, often one year. So this statement is usually headed in the form "profit and loss account for the year ended 31 December 2017".

It should be noted that only a commercial entity produces a profit or loss. A non-commercial entity makes a surplus or a deficit.

The **balance sheet** tells you how much the entity is worth. It applies to a moment in time, usually the end of the day. It is like a snapshot. So this statement is usually headed in the form "balance sheet as at 31 December 2017".

Note that the profit and loss account relates to a period of time, whereas a balance sheet relates to a moment in time.

Every financial statement must have three pieces of information in its **heading**:

- what type of financial statement it is
- the name of the entity to which it relates
- the period or date to which it relates.

There are other forms of financial statement such as the statement of realised gains and losses, cashflow statements, notes to the accounts and various narrative reports.

The profit and loss account

There are usually at least five key lines in a profit and loss account:

- turnover
- costs
- gross profit
- expenses
- net profit.

The mathematics are simple:

- turnover – costs = gross profit
- gross profit – expenses = net profit.

Net profit is the figure that really matters.

These five items will appear in almost every profit and loss account. However, company law and accounting standards require many of these items to be broken down or additional information to be given.

For small businesses, a tax return may be submitted using **three-line accounts:** turnover, costs and profit (or loss).

Let us consider the simple example of a clothes shop.

Its **turnover** is how much it takes in sales. It does not matter how the customers pay — whether by cheque, card or cash. All takings are added for this figure. This figure is sometimes called revenue, earnings, receipts, gross receipts or just income.

If the business is registered for VAT, turnover is exclusive of VAT. So if a shirt is sold for £20 plus £4 VAT, the turnover is £20 even though the customer paid £24. The other £4 is simply collected by the shop on behalf of the government.

Accounting standards require turnover to be split between **continuing activities** and **discontinued activities.**

There are some businesses where turnover is difficult to determine. Examples include banking, insurance and gambling. Such businesses have special accounting provisions to deal with this.

Costs are how much the shop paid for the goods it has sold. This figure is sometimes called direct costs or cost of sales.

If the business is registered for VAT, costs are exclusive of VAT. So if a VAT-registered trader spends £120 on stationery, the cost for accounts is £100 as the other £20 represents VAT which the trader may claim back as input tax. If the trader is not registered for VAT, the cost of the stationery is £120.

The same principle applies if a VAT-registered trader buys an item where VAT may not be claimed back, such as a company car. If such a trader bought a care for £20,000 plus £4,000 VAT, the cost for the accounts is £24,000 as VAT law does not allow input tax to be claimed for cars.

Gross profit is simply turnover minus costs. In the accounts, this is expressed as an amount of money. It can also be expressed as a ratio to turnover. In the example above, the gross profit ratio is 50%.

Expenses or overheads are the other amounts a shop must pay. This will include advertising, wages, cleaning, electricity, rates, repairs, maintenance and the suchlike. Expenses are all charges to a business that are not costs.

A common reason for new and small businesses to fail is that they do not keep expenses under control.

The expenses may be listed separately under headings appropriate to the business. Typical headings may include:

- advertising and marketing
- audit and accounting
- bad debts
- bank charges
- depreciation
- heat, light and power
- hire fees and leases
- insurance

- interest on business loans
- legal expenses
- premises costs
- rent and rates
- repairs and renewals
- sundry
- travel and subsistence
- wages and salaries

Net profit is the gross profit minus expenses. Alternatively it is turnover minus costs and expenses. It is possible for a business to make a gross profit but a net loss.

Net profit is the figure that really matters. If a business does not make a net profit, it should not be in business.

The profit and loss account usually shows what happens to the net profit. At its simplest, net profit is split three ways:

- tax
- payments to owners
- retained profit.

Tax means income tax for sole traders and partnerships, and corporation tax for companies and other corporate bodies.

Payments to owners depends are usually **dividends** from companies. For a sole trader or partnership, money taken for personal use is usually called **drawings.** Note that dividends and drawings are *not* expenses that may be deducted from net profit. They are simply applications of what the entity does with its net profit.

Retained profit is what is left of the net profit after tax and payments to the owners. This is kept by the business for its own use, such as to fund its day-to-day operations and to expand the business.

Not all three elements will always be present. A business may make a loss, decide not to pay a dividend or drawings, or not to retain any profit.

The balance sheet

The balance sheet comprises two sets of figures, both of which come to the same figure. When these two figures are the same, the accounts are said to be balanced.

One set of figures lists the assets and liabilities of the business. The other set of figures shows how this figure is represented by the capital of the business.

Assets are:

- money (eg petty cash, bank accounts)
- things that will become money (eg debts owed by customers, prepayments)
- things worth money (eg stock, premises).

On a balance sheet, a further distinction is made between fixed assets and current assets. A **fixed asset** is one with an expected life of more than one year, such as premises, furniture, machinery and vehicles. A **current asset** is one with an expected life of less than one year, such as cash, stock and stationery.

Fixed assets are accounted for in a special way. The aim is that the cost is not taken wholly in the year of acquisition but is spread over its expected life. This is achieved by using **depreciation.**

Suppose a lathe costs £10,000 and has an expected life of ten years. It would be wrong to show the whole £10,000 as an expense in the year of acquisition, as only one tenth of the lathe would have been consumed. At the end of the year, the business still has 90% of the lathe's life left.

This is done by charging depreciation of £1,000 in the profit and loss account for each of the ten years. The balance sheet shows the value of the lathe as the cost or previous year's value minus that year's depreciation. So in year 3, for example, £1,000 would be shown in the profit and loss account as depreciation even though no money was spent that year. That £1,000 would reduce the value in the balance sheet from £8,000 in the previous year to £7,000.

The value of a fixed asset on the balance sheet is called the **net book value (NBV).** All fixed assets are depreciated except land.

A business may also have **intangible assets** such as goodwill, brand names and patents. These can similarly be written down over years, though this is usually called amortisation rather than depreciation. The principle and procedure are the same.

Current assets

Current assets are traditionally listed in order of **liquidity.** This means how easily they can be turned into money.

The most liquid of all current assets is **cash.** This includes money on the premises, such as in petty cash, floats and vending machines, plus balances in bank accounts.

The next liquid are **prepayments.** This is where you have paid for something that relates to a later period, such as part of next year's rent or next quarter's telephone line rental. This is in effect becomes cash simply by the passing of time.

Then there are **debtors.** This is money that your customers (and possibly others) owe you. When they do pay, this becomes cash.

The least liquid current asset is usually **stock** or inventory. For this to become cash, you must make a sale, which is not always certain to happen.

Stock includes **work-in-progress.** This applies where a business is involved in some kind of manufacture. For a clothes shop, it would include any partly-made garments at the date of the balance sheet. It also includes partly constructed units in a building firm. This is often overlooked by small businesses.

Liabilities

Liabilities are the opposite to assets. As you cannot have negative cash or stock, the only form of liability represents **creditors,** that is people to whom you owe money.

There are broadly three types of liability:

- current liability
- long-term liability
- accruals.

Current liability are people such as trade creditors. It represents money that you owe but have not yet paid. It also includes any unpaid rent, tax, wages or similar.

Long-term liability represents money owed but not payable for more than a year. This is usually in the form of loans or leases. Deferred tax is a form of long-term liability. It represents tax payable to HMRC in more than one year's time.

Accruals are the opposite to prepayments. The figure represents liabilities you have incurred but not yet paid for, such as telephone calls and electricity used in the period but paid in the next period. They are the opposite to prepayments.

Capital

All the assets are added, and the liabilities subtracted, to give **net assets.** This is one of the two balancing figures on the balance sheet.

The other side of the balance sheet shows how these net assets have been funded by **capital.** Note that you can say that the net assets are *funded* by capital, or conversely the capital is *represented* by net assets.

Capital comes from three main sources:

- the original contribution
- sums borrowed for the purpose

- retained profit.

The original contribution is the money provided by the original owners to get the business going. In a company, this will usually be **share capital.** in a sole trader or partnership, this is either just called capital or **proprietor's interest.**

In practice, most businesses of any kind usually have a nominal share capital, often just £2. The real initial funding is in the form of loans which can then be easily repaid.

Sums borrowed for the purpose include **preference shares, loan notes, debentures** and many other types of financial instrument.

Retained profit is all the profits the business has kept for its own use since it started trading.

A simple example

In January 2018, John opens a gift shop using £100,000 of his own money. He spends £80,000 on fittings for his shop (such as counter, shelves, till and sign), and £20,000 on stock. He believes the fittings will last for ten years. During the year, he buys another £70,000 stock. He has sales of £130,000. His stock at the end of the year is worth £30,000. His overheads for the year are £10,000 of which he takes £22,000 for himself.

From this, we can establish that at the end of the year, the business has £28,000 cash. This comprises £130,000 turnover minus £70,000 purchases, £10,000 overheads and £22,000 drawings.

These are his financial statements for his first year.

John's Gift Shop. Profit and loss account for the year ended 31 December 2018

	£	£
Turnover		**130,000**
Opening stock	20,000	
Purchases	70,000	
	90,000	
less closing stock	30,000	
Cost of sales		60,000
Gross profit		**70,000**
less: depreciation of 10% of £80,000	8,000	
overheads	10,000	
		18,000
Net profit		**52,000**
less drawings		22,000

Retained profit for the year		30,000

John's Gift Shop. Balance sheet as at 31 December 2018

Fixed assets		80,000
less depreciation		8,000
Net fixed assets		72,000
Closing stock	30,000	
Cash	28,000	
	58,000	
Net assets		130,000
Funded by:		
Proprietor's capital		100,000
Retained profit for the year		30,000
Capital		130,000

It can be seen that the balance sheet balances at £130,000. That is the figure of net assets. The value of the business is often expressed as net assets plus goodwill. Goodwill represents such matters as reputation, location, customer list, know-how and similar.

The **value** of a business is simply what someone else would be prepared to pay for it. This is a matter of negotiation. In this example, a buyer may be prepared to pay £130,000 plus goodwill equal to one year's profits of £52,000, giving a total of £182,000.

The example above is artificially simple. We have conveniently ignored tax, VAT, borrowings, debtors, creditors, deferred tax, wages, accruals, prepayments, reserves and contingencies. The idea is to produce some simple financial statements where you can see from where all the figures have been derived.

Our example shows figures in the traditional style of two columns. Modern accounts often use a single column. Where an entity has existed for at least two years, there is a second column giving comparative figures for the previous year. The current figures are often shown in bold.

If a figure is negative, or the opposite to that expected, the number is put in **brackets.** So a profit figure of (£1,000) means a loss of £1,000.

Understanding the accounts

Accounts are designed to paint a **picture.** They should not be seen as the equivalent to a scientific report accurate to several decimal places.

Much of the accounts is subjective or a matter of opinion. In our example, we assume that the fixed assets will last ten years. But is quite possible that shop fittings will last 20 years or be replaced after five years. That would mean that depreciation instead of being £8,000 a year is £4,000 (for 20 years) or £16,000 (for 5 years). In turn, that would mean that the net profit would not be £52,000 but £56,000 or £44,000 respectively.

This is why accounts are not said to be "correct" but **true and fair**. True means that the accounts reflect the records: the turnover was £130,000 for example. Fair means that the picture painted is a reasonable summary of the finances.

Probably the two most **important figures** in the accounts are net profit and net assets. Net profit shows how successfully a business is trading. Net assets indicates how much it is worth. Although we knew the numbers in our example, it was not until we had prepared the accounts that we saw that the business had net profit of £30,000 and net assets of £130,000.

Accounts can also be analysed by using **accounting ratios.** A ratio is simply one number divided by another. This can be compared with industry standards, other businesses and ratios for the same business in a previous period. In our example:

gross profit = 70,000/130,000 = 54%
net profit = 52,000/130,000 = 40%.

Other financial statements

Other financial statements commonly encountered include:

- notes to the accounts
- statement of realised gains and losses
- cashflow statement
- audit report
- narrative reports.

Notes to the accounts refer to items in the balance sheet and profit and loss account where further explanation or analysis is required. Notes allow for such further information to be given in a way that does not clutter up the main financial statements. There is usually a column in the financial statements where a number is given that cross-references to the relevant note.

Statement of realised gains and losses is a subset of the profit and loss account. It separates such gains from the trading profit of the company.

Cashflow statement is a summary of where the company has received its cash and what it has done with it. Unlike the balance sheet and profit and loss account, the cashflow statement is a statement of fact and not opinion.

Audit report is only required for larger businesses, though any entity can ask to be audited. The audit is usually undertaken by an independent accountant. Note that for companies, the audit merely states whether the accounts are true and fair, and whether they comply with the Companies Act. The audit does not say that the company is being run properly, or that it is free from fraud.

Narrative reports are written comments. The directors of a company are required to provide a report. Company law states what must be included.