Throwing the Light on Accounts

Do you understand them?

Expert knowledge means success

Contents

Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

The accounts of a business are often a mystery to its owners. For some people, the very thought of looking at a set of numbers written down on a sheet of paper can provide a very uncomfortable experience. But it doesn't have to be that way. Accounts won't bite you. In fact, if you understand them, they can be very helpful to you in running your business or organisation. So, let's get down to the nuts and bolts of accounts and de-mystify them.

This publication explains the two usual elements of accounts.

1. The *Balance Sheet*
2. The *Profit and Loss Account*

The Balance Sheet

A *Balance Sheet* is a financial 'snapshot' which summarises the assets and liabilities of a business at a specific point in time. All businesses have to prepare a *Balance Sheet* at least once each year, as part of their annual accounts, but it can be prepared at any time.

The *Balance Sheet* shows:

- How much capital is employed in the business;
- How quickly assets can be turned into cash;
- How solvent the business is; and
- How the business is financed.

In reading a *Balance Sheet*, it's important to remember (at least from the accounting point of view) that the owner of the business and the business are separate entities.

For example, if you invest £20,000 to start your own business, the business "owes" you £20,000. In other words, the assets (let's say £20,000 in the bank) are exactly matched by the liabilities. This must always be the case - otherwise the *Balance Sheet* won't balance.

It is also important to remember what a *Balance Sheet* is not:

- It doesn't show the profitability of a business - this is shown in the Profit and Loss Account;
- It doesn't show the value of a business - this depends on factors such as profitability and the current value (as opposed to cost) of assets.

There are a number of different ways of setting out a *Balance Sheet*. Many years ago, a *Balance Sheet* was set out horizontally, with the liabilities on the left and the assets on the right. In this case, the liabilities include the money invested in the business by the owners. In other words, the total liabilities (due to the owners and external creditors) are equal to the total capital employed (money invested in assets such as stock (inventory), receivables, cars, equipment and so on).

For the non-accountant this was not always easy to read or to interpret quickly. Today, it's usual for a *Balance Sheet* to be laid out in a vertical format, as shown in the example.

Balance Sheet
as at 31 December 2007

FIXED ASSETS	**£**	**£**
Cars		31,500
Plant and Machinery		82,400
Computers and Office Equipment		18,100

		132,000
CURRENT ASSETS		
Stock (Inventory)	52,450	
Receivables (Debtors)	89,650	
Bank Balance	16,900	

	159,000	
CURRENT LIABILITIES		
Trade/Other Payables (Creditors)		
- falling due within 12 months	55,200	
Bank Loan	30,000	
Accrued Expenses	20,000	
Taxes	30,800	

	136,000	
NET CURRENT ASSETS		23,000

		155,000
Payables due after more than 12 months		20,000
NET ASSETS		**135,000**
Financed by:		
OWNER'S CAPITAL INVESTED		50,000
PROFITS EARNED TO DATE (RESERVES)		85,000
TOTAL CAPITAL INVESTED		**135,000**

Key Terms

- **Fixed Assets** (shown at £132,000) - Fixed assets are generally assets with a life longer than one year, such as equipment and buildings. These are also known as tangible assets because they physically exist. There is also a class of fixed assets known as intangible assets;

  Goodwill, for example, is an intangible asset. If you buy a business for more than its net worth, the difference is shown on the balance sheet as goodwill. This is a representation of your expectation of future earning power. Since you can never be sure of recouping goodwill if you wish to sell, it is good practice to write off (depreciate) goodwill as quickly as possible;

  The cost of tangible fixed assets is also depreciated (the cost spread/written off) over the expected lives of the assets - it's quite common to see the original cost of tangible assets and their accumulated depreciation on a balance sheet;
- **Current Assets and Current Liabilities** - Current assets (£159,000) and current liabilities (£136,000) usually have a life of less than one year. Current assets include stock, work in progress, debtors, cash at bank etc;
- **Receivables or Debtors** (£89,650) represent the amount of money owed to you by customers. Current liabilities (£136,000) include overdrafts, loans due within one year, money owed under hire purchase agreements, any amounts owed in VAT or tax, etc;
- **Payables or Creditors** (£55,200) represent the amount of money owed by you to suppliers and others. "Net current assets" (£23,000) is simply the difference between current assets (£159,000) and current liabilities (£136,000). This should be positive otherwise you might not be able to meet your debts as they fall due. If so, then you may be insolvent;
- **Net Assets** - The example shows the creditors falling due after more than one year (£20,000) deducted to give the net assets. These creditors will probably include Bank Loan instalments and Hire Purchase payments due in more than 12 months. Deducting this figure from the other assets less the liabilities (£155,000) gives the net assets (£135,000) of the business;
- **Capital Employed** - Some accountants include long-term loans with the capital and reserves. Adding the two together would give the capital employed;
- **Net Worth or Total Capital Invested** - The net assets (£135,000) should be equal to the total capital and reserves (£135,000), that is, the net worth. This comprises the money introduced by the shareholders or owners and the reserves. Normally, the reserves are simply the retained profits. The capital and reserves is sometimes known as the 'equity' of the business.

Useful Tips

1. If you require assistance to draw up your *Balance Sheet* you should use an accountant.
2. All of the information required to write up a basic *Balance Sheet* can be obtained from a trial balance - this is a summary of your accounting books and records.

Understanding Profit and Loss Accounts

A *Profit and Loss Accounts* (often called a "P&L") shows what happened in a business, in terms of income, sales and expenditure, during a specific period.

All businesses have to prepare a *Profit and Loss Account* at least once each year, as part of the annual accounts. In that case the *Profit and Loss Account* covers a year's activities. However, they can be prepared for a period of any length.

The *Profit and Loss Account* shows:

- The turnover or sales for the period;
- The expenditure for the period;
- How much profit there was made; and
- How the profit is to be divided between the owners.

A *Profit and Loss Account* is generally set out in the way illustrated in the example.

Key Terms

- **Sales (or Turnover)** - The Sales figure shows the actual sales for the period, excluding VAT. It doesn't reflect the cash received from customers since some payments may still be outstanding. A basic principle in accounting is to match costs against the revenues generated by those costs, so it's important that the Sales figure is correctly calculated. It should be the sum of all invoices issued during the period;

- **Direct Costs** - The Direct Costs, that is, those costs directly attributable to the Sales, reflect raw materials and sub-contract costs in the product or service actually sold during the period. In some businesses, employee costs can also be directly attributed to the product sold. Some stock purchased during the period may not be used (consumed) - this will be shown on the Balance Sheet as an asset and is not charged to the Profit and Loss Account. Conversely, raw materials may have been consumed which were bought in a previous period. The cost of those materials will be included in the Direct Costs. Materials purchased but not consumed will be shown in the stock figure on the balance sheet. You need to watch out for purchases of materials or sub-contract work which have gone into sales made during the period, but for which you have not been billed.

  Ideally, you will not prepare the accounts until all bills have been received. However, when producing management accounts you may need to make an estimate of these costs to give a profit figure which is as accurate as possible;
- **Profit** - The direct costs are deducted from the sales figure to give Gross Profit. This allows you to calculate your Gross Profit margin. The overheads are deducted from the Gross Profit to give the Net Profit. Keep an eye on both your Gross Profit margin and your Net Profit margin (50% and 20% in the example). Dramatic reductions in either could be a sign of trouble;
- **Depreciation** - One element in the Profit and Loss Account doesn't involve a movement of cash at all. This is called Depreciation (or, in the case of intangible assets such as patents, goodwill etc, it's called "Amortisation"). Depreciation is charged (calculated) to cover the wear and tear of Fixed Assets. The amount charged therefore is an allocation or spreading of the cost of Fixed Assets over their useful life. This is often charged at the rate of 25% of capital cost per year. If Depreciation is high relative to payroll costs, you have a "capital-intensive" business; if the payroll costs are high relative to depreciation, you have a "labour-intensive" business;
- **Appropriation Account** - It is usual at the bottom of a Profit and Loss Account to show an 'appropriation account', that is, an explanation of how the profit is divided. Profit can be divided in just three ways: to the shareholders or owners (as money available for dividends or drawings); to the government as tax; or, it might be retained in the business (to use as working capital or to buy equipment or other assets).

Profit and Loss Account
Year to 31 December 2007

	£	£
SALES		600,000
Direct Costs		300,000

GROSS PROFIT (50% margin on sales)		300,000
Less: OVERHEADS		
Wages	60,000	
Office Consumables	35,000	
Rent, Rates & Insurance	55,000	
Car Running Costs	15,000	
Depreciation	15,000	
	----------	180,000
NET PROFIT (20% margin on sales)		**120,000**
Appropriated to the Partners:		
MR SMITH	60,000	
Less: drawn on account	*10,000*	
	----------	*50,000*
MRS JONES	60,000	
Less: drawn on account	*25,000*	
	----------	*35,000*
AVAILABLE FOR FUTURE DRAWINGS		**85,000**

Useful Tips

1. If you are worried about excessive overhead charges, it's useful to refer to the *Profit and Loss Account* as it gives a breakdown of each individual type of expense.
2. By drawing up a *Profit and Loss Account* it will help you to see whether corrective action is needed to maximise profit. For example, you may discover the percentage of raw materials, as a proportion of sales, is too high.
3. If you are unsure of how to draw up a *Profit and Loss Account* you could use an accountant (we'd be happy to talk to you to show you how it's done), or contact a business counsellor at your local Enterprise agency.

"Cash versus Profit"

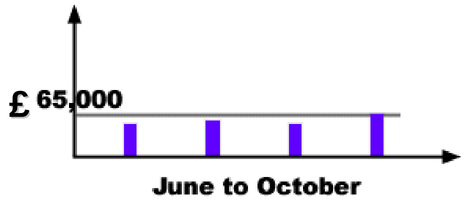
To illustrate how important it is to understand accounts and to recognise the danger signs, we've put together an example. It actually emphasises the point about cash management and how concentrating on the *Profit and Loss Account* alone can mean disaster.

Background:

A computer services company wins a major new contract. Sales go way above past levels. Thrilled, the company owners (George and Chris) watch their profits also go way up to match sales. Everything seemed great. *But what happened to their cash?*

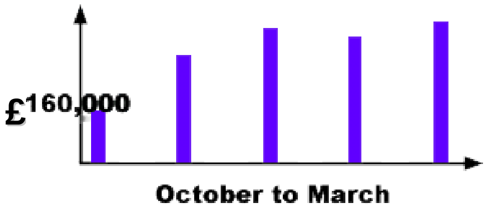
The Good Side of Things:

In this chart you see the good side of things. They had never done more than £50,000 of sales in one month. And suddenly their sales went way up with one contract. These were good times. And if you look particularly in the October and December time frame, you can see why the two partners went to the local Mercedes dealer in August and leased two new cars - they were excited to enjoy this new burst of fortunes in the company. Their way of taking advantage of it quickly and rewarding themselves was to lease the two new Mercedes.



What really happened?

George and Chris ran out of cash. They almost ran aground. And then they came to a theoretical cash negative, at about £70,000 in December. Of course, they had to go to the bank and sign over the equity in their homes. The bank wanted "belt and braces" security to cover their risk. There was a considerable amount of unhappiness about the two luxury cars that the owners discovered they didn't have the money to pay for. Instead, while they were making a profit they were going broke. Spotting the danger signs, understanding accounts and using a business plan intelligently can save you from making these same mistakes.



Recommended Reading

- 'Financial Control', David Irwin," Pitman;
- 'Managers Guide to Financial Control', David Irwin, Pitman;
- 'Planning to Succeed in Business', David Irwin, Pitman;
- 'Business Accounting', Frank Wood, Pitman;
- 'Accounts Demystified', A Rice, Pitman;
- 'Understanding and Interpreting Company Reports and Accounts', E. R. Farmer;
- 'The Financial Times Guide to Using and Interpreting Company Accounts', Wendy McKenzie.

Further Information

This guide is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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