

LAWPACK

The quick guide to

Working from Home

Practical advice for
starting a home-based
job or business



Hugh Williams

This is an excerpt from Lawpack's book *Working From Home*.

To find out more about starting a home-based job or business, [click here](#).

1st edition 2005
Reprinted 2006
Reprinted 2007
2nd edition 2008
Reprinted 2008

© 2008 Lawpack Publishing Limited

Lawpack Publishing Limited
76–89 Alscot Road
London SE1 3AW

www.lawpack.co.uk

All rights reserved
Printed in Great Britain
ISBN: 978-1-905261-74-1

The law is stated as at 1 June 2008

Valid in England & Wales and Scotland

This Lawpack Guide may not be reproduced in whole or in part in any form without written permission from the publisher.

Exclusion of Liability and Disclaimer

While every effort has been made to ensure that this Lawpack Guide provides accurate and expert guidance, it is impossible to predict all the circumstances in which it may be used. Accordingly, neither the publisher, author, retailer nor any other suppliers shall be liable to any person or entity with respect to any loss or damage caused or alleged to be caused by the information contained in or omitted from this Lawpack Guide.

For convenience (and for no other reason), 'him', 'he' and 'his' have been used throughout and should be read to include 'her', 'she' and 'her'.

Parts of this book have been reproduced from *Self-Employment Kit*, *Tax Answers at a Glance* and *Running Your Own Business Made Easy* all published by Lawpack.

Contents

	Introduction	ix
1	Starting off	1
2	Tax and accounting	21
3	Rules and regulations	49
4	You and your customers	59
5	The employed at home	71
	Appendices	
1	Tax rates and allowances	78
2	Some popular ways of earning money from home	82
3	Minimum wage rates	83
4	Sample full business plan	84
5	Sample agreement when one spouse agrees to work for the other	86
6	Matters that should be included in an employment contract	87
7	Specimen layout for a set of accounts and how to present your figures to the taxman	88
8	'Heads of agreement' for a partnership agreement between husband and wife	89
9	Health and safety – the elementary steps that should be taken by an employer when an employee works from home	90
	Index	91

Chapter 2

Tax and accounting



Part-time working from home

If what you are going to be doing is simply making some sundry earnings on top of what you do already, then, perhaps, most of the contents of this book will not apply to you. However, you will need to check through the action points and in particular:

- tell HM Revenue & Customs (HMRC and formerly the Inland Revenue) what you are up to (see page 33);
- send it accounts by filling in the appropriate boxes on your tax return in line with the prescribed layout – see Appendix 7.



Action point

Have you informed HMRC of the existence of your business?

Self-employed or employed?

Before we get going, you need to sort out a very important question first of all: are you sure that you are self-employed? You must get this sorted out at the outset, particularly for your employer (if that is what he is) because he could be landed with a huge tax bill if he gets it wrong. If in doubt, get professional advice and, if still in doubt, ask for a ruling from your tax office.

HMRC is keen to classify self-employed people as employees because of the greater National Insurance contribution (both the employer and the employee pay it) and higher Income Tax payable. Employees don't have many expenses they can claim against tax (see page 73) and both they and their employers pay National Insurance on their wages, etc. On the other hand, not only do the self-employed have a much greater range of allowable expenses (see page 37) as they can claim against their profits, but their total National Insurance contributions tend to be much lower.



'Employed' or 'self-employed', it's pretty black-and-white isn't it?

No, there are grey areas. Go through the questionnaire; if in doubt, get legal advice.

Answering the following questions should help you judge whether you are self-employed or not. **Note:** There are separate and new rules for workers in the construction industry; the following questions are not appropriate for such workers.

1. Is there a contract of service, i.e. a contract of employment?
 - ✘ A 'no' answer indicates self-employment.
2. Is there a contract for services, i.e. a notice supplied by the person carrying out the work (A), indicating the nature of goods or services he will provide to B (this need not be written)?
 - ✓ A 'yes' answer indicates self-employment.
3. Is the person who does the work in business on his own account?
 - ✓ A 'yes' answer indicates self-employment.

4. If the person is in business on his own account, has evidence been provided that this is indeed the case (e.g. copy accounts, the payment of Class 2 National Insurance contributions)?
 A 'yes' answer indicates self-employment.
5. Are the hours worked decided by the person doing the work?
 A 'yes' answer indicates self-employment.
6. Are the days worked decided by the person doing the work?
 A 'yes' answer indicates self-employment.
7. Does the person doing the work decide when to take his own holidays?
 A 'yes' answer indicates self-employment.
8. Does the business proprietor supervise the work?
 A 'no' answer indicates self-employment.
9. Is the person part-and-parcel of the business?
 A 'no' answer indicates self-employment.
10. Does the person supply tools and/or materials when he carries out the work?
 A 'yes' answer indicates self-employment.
11. Does the person doing the work give the business an invoice for the work done?
 A 'yes' answer indicates self-employment.
12. Does the business calculate how much to pay the person doing the work and give a payslip?

✘ A 'no' answer indicates self-employment.

13. Is self-employment the intention of both parties?

✓ A 'yes' answer indicates self-employment.

14. Is the person bound by the customer care 'credo' (i.e. philosophy) of the business?

✘ A 'no' answer indicates self-employment.

15. Is the person carrying out the work required to wear a uniform or dress tidily at the dictat of the business?

✘ A 'no' answer indicates self-employment.

16. Is the person carrying out the work provided with a car or transport by the business?

✘ A 'no' answer indicates self-employment.

17. In the event of sickness, does the business continue to pay the person while not at work?

✘ A 'no' answer indicates self-employment.

18. Is the person carrying out the work at liberty to work for other businesses?

✓ A 'yes' answer indicates self-employment.

19. Is the person carrying out the work required to work in order to perform a specific task?

✓ A 'yes' answer indicates self-employment.

20. Does the business, on asking this person to carry out work for it, assume any responsibility or liability characteristic of an employment, such as employment protection, employees' liability, pension entitlements, etc.?

✘ A 'no' answer indicates self-employment.

- 21.** Is the person who does the work paid an agreed price per job?
- ✓ A 'yes' answer indicates self-employment (i.e. he is not paid for the hours he works but for the work carried out).
- 22.** Is the work carried out regularly?
- ✗ A 'no' answer indicates self-employment.
- 23.** Does the individual work for other people?
- ✓ A 'yes' answer indicates self-employment.
- 24.** Does the person carrying out the work advertise?
- ✓ A 'yes' answer indicates self-employment.
- 25.** Does the person carrying out the work have headed stationery?
- ✓ A 'yes' answer indicates self-employment.
- 26.** Can the person send a substitute? If so, has this ever happened?
- ✓ A 'yes' answer indicates self-employment.
- 27.** Does the person have to rectify faulty workmanship in his own time and at his own expense?
- ✓ A 'yes' answer indicates self-employment.

Once you have addressed these questions, you should now begin to know whether you are self-employed. However, if HMRC disagrees, a definite answer can only be given by the courts.

Value Added Tax

Value Added Tax (VAT) is a tax with its own set of complicated rules and I cannot hope to give you a detailed introduction in a

book of this size. However, the basics you need to know are that, unless you run a business with a turnover of more than £67,000 (2008/09 figure) and the product or service attracts VAT (and most of them do), you probably don't need to register for VAT. Most people working from home are not registered because they don't have to be registered. But if you would like to register voluntarily (to claim VAT back on your expenses, etc.), you should contact the nearest VAT office for the registration forms.



When must I start adding VAT onto my invoices?

For most businesses, when your turnover exceeds £67,000 a year (2008/09 figure).

If you register for VAT, you will gain from one immediate benefit and possibly suffer from one immediate disadvantage. In addition to this disadvantage, you must also realise that being registered for VAT involves certain legal responsibilities.

So, before an explanation of the pros and cons of voluntary registration, you have to ask yourself the following question: 'Am I prepared to take on the responsibility of writing up my accounting records in accordance with certain legal standards, and doing so every quarter?'. If you are the sort of person who finds administration, filing and bookwork a chore, you probably should not voluntarily register for VAT as it will become an extra problem for you.

However, you could avoid this extra problem by employing an accountant to prepare the VAT returns, but this will cost extra money.

If you are unsure about the answer to this question, it should be emphasised that there are many thousands of VAT-registered traders and, when you consider that many are small business people with no training in book-keeping, it should become apparent that keeping proper VAT records is not an insuperable

task. If you are prepared to learn the simple VAT accounting rules and stick to them, you should certainly consider registering for VAT.



Action point

If you have decided to register for VAT, or if you are going to have to register, have you done so?

If your turnover is to be above the annual VAT threshold from the start (£67,000 is the 2008/09 figure), then you have no choice in the matter. Registration is compulsory in your case. If your turnover (sales) has exceeded the threshold, for whatever reason, and you have failed to register, this could have expensive consequences and you are firmly advised to seek professional advice as soon as possible.

What is the benefit of registering? It is, as we say, so that you can reclaim VAT on most business purchases. If you are not registered, then no reclaim can be made.

What is the possible disadvantage? The possible disadvantage is that you have to add VAT to all your VATable sales. This means that all such sales are automatically more expensive than they would be if you were not registered. This may put you at a disadvantage against your competitors if they are not registered for VAT. However, if your customers themselves are registered for VAT (i.e. if you are dealing with other businesses rather than the public), the chances are that they will in turn be able to reclaim any VAT that you charge and so this would not disadvantage your business.

If you feel that you are prepared to treat VAT registration with the due respect that it requires, and that your sales will not suffer unduly as a result, then you should consider registering.

The changes you will need to make in the day-to-day running of your business are as follows:

1. For sales, you will need to issue VAT invoices and you will have to record the amount of VAT you charge (called 'output tax').
2. For purchases, you will have to keep a VAT invoice for all your purchases in order to be able to reclaim VAT and you will have to record the amount of VAT you have paid (called 'input tax').

Two final points on this introduction to VAT:

1. If your business is one that will attract a regular refund of VAT, you will be offered the chance of receiving your repayment monthly and not quarterly. Unless the sums are considerable (i.e. more than £500 a month), you are advised to resist monthly VAT returns because attending to them monthly rather than quarterly can become a nuisance.
2. You may apply to fill in just one annual VAT return and pay your VAT over nine months with a balancing payment at the end.

How to register for VAT

Telephone your nearest VAT office (under 'HM Revenue & Customs' in the telephone book) to arrange for a VAT registration application form to be sent to you and to be registered for 'Cash Accounting', so that you only have to complete one VAT return a year.

National Insurance

Along with Income Tax, if you are going self-employed, you will almost certainly have to register for National Insurance.

What this means is that, unless your profits are going to be below the prescribed limit (this figure, which is changed every year by the Chancellor of the Exchequer, is included in Appendix 1), you will have to pay Class 2 contributions. If your profits are to

be above a further threshold (again see Appendix 1 for this figure), you will have to pay Class 4 contributions as well.



How do I register for self-employed National Insurance contributions?

Contact your local NI office, listed in the phone book under 'HM Revenue & Customs'.

Class 2 contributions can be collected each month by direct debit, and you probably have attended to this obligation already when you filled in the forms (mentioned on page 34) to advise HMRC that you are now self-employed.

Class 4 contributions, if you have to pay them, will be collected along with your Income Tax liabilities and, apart from the pain of parting with the money, is a simple matter of ensuring that your self-assessment tax return is filled in correctly (see page 35 for more information).



Action point

When registering your business with the taxman and the NI office, if your profits are going to be below the Class 2 threshold (see Appendix), have you claimed exception – so that you do not have to pay them?

But we do need to return to Class 2 again. If your profits are going to be below the Class 2 threshold, you still need to inform the National Insurance authorities that you are self-employed, but, at the same time, you should claim exception from paying these particular contributions simply because your profits are below the threshold. It does seem a bit unnecessary registering to pay and then registering not to pay, but this is how it works.

You can apply for exception by applying for a 'certificate of low earnings exception'. You must apply for this as soon as possible

because they can only be backdated for up to 13 weeks before the date of application. If you do apply for exception, you may lose entitlement to other benefits, so do take advice.

If you are self-employed in your spare time as an extra to your permanent job, unless you qualify for exception, you must also pay Class 2 contributions, even if you are also paying National Insurance as an employee. However, if your Class 1 payments exceed a certain threshold, you may be able to defer payment of your Class 2 contributions. Take advice from your local tax office.



Is National Insurance payable if you are self-employed?

Yes, unless your profits are below a certain level. You need to register either way.

PAYE

Taking somebody on can be one of the early big milestones in any business. What follows can also apply to private individuals who are employing people such as cooks, nannies, gardeners, etc. and so, while most of what follows relates to the things that a business person should do, private individuals should be aware that they may well be caught by the PAYE regulations that relate to employing people.

There is no clear guidance one can give. Having said this, the only answer is that you have to obey the law, but knowing what the law is is not always easy in itself.

If you take on somebody and you are paying him more than £105 a week (2008/09 figure), no matter what his age, you have to pay National Insurance contributions and the rate is 12.8 per cent. If this is the case, then the first thing you should do is inform HMRC that you have taken somebody on and the second thing you should do is decide how you are going to handle the PAYE payment obligations.

In my view, the simplest way of meeting your obligations is to ask a professional accountant to look after the PAYE side of things for you. He will tell you how much to pay your employees net of tax and National Insurance and he will also send you the appropriate PAYE slip for making the monthly or quarterly payments to HMRC. He will also be able to help you with the Annual Return (P35) and with the benefit forms (P11Ds).

A second alternative is to buy a simple computer program and do the work in-house yourself. These are good, economically priced and well worth the investment in both software and stationery.

A third alternative is to use the manual forms which HMRC sends you. In my view, these are not easy forms to follow and are definitely a worse option than the first two suggestions above.

A fourth alternative is to go and buy a manual wages system from the local stationer. This would certainly be better than using HMRC's forms but, in this computer-centred age, I certainly recommend options 1 and 2.

If you take on someone earning less than £105 per week (2008/09 figure), there will be no National Insurance contributions to worry about. However, you may still find that you need to deduct tax from your employee's earnings. This depends on the tax code you have been directed to use, which is either shown on the Form P45 from his previous job or advised by HMRC. If you take on someone who does not have a P45 (because he wasn't working previously or has an existing job which is to continue), he will need to complete a P46 and send it to HMRC. It will then send you a notice of coding, which may well direct you to deduct tax if there are other earnings.



**I need to take someone on part-time at home.
Must I use the PAYE system?**

If he is employed by you, yes. If he remains self-employed, no. If in doubt, after completing the questionnaire on pages 22-25, take advice from HMRC.

If you are unsure as to whether the person you are taking on is going to be treated as an employee or self-employed, then apply the test shown on pages 22-25.

If this test leaves you none the wiser, perhaps the best answer to give you is to go and discuss the matter with HMRC or with a professional accountant. Make no mistake, it is a complicated business and one that is very important to get right. Employers should not turn a blind eye to their obligations.

If you take on someone casually on both an infrequent and irregular (possibly one-off) basis, HMRC is very unlikely to be concerned about the matter. There is a very well-known legal maxim 'de minimis non curat lex', which means 'the law is not concerned with trifles'. The best advice I can give you is to say 'Is this a trifle?'. If it is, and you can justify it as being so to a visiting inspector, then regard the person as being casual – a trifle. If the matter has obviously some regularity and (shall we say) meaty content – in other words not a trifle – then I suggest that you go and talk it through with HMRC or an accountant and take the action that arises from such an approach.

What is PAYE?

PAYE stands for Pay As You Earn. It represents a logical system whereby week by week or month by month an employer deducts tax and National Insurance in such a way that, at the end of the Income Tax year, the right amount of tax and National

Insurance has been deducted and handed over to the authorities. It works in the following way:

Let's say that you earn £15,000 a year and your personal tax-free allowance is £3,000. Let's also suppose that the rate of tax that you are paying is 20 per cent.

If you paid tax just once a year, you would calculate the tax as follows:

- £15,000 less your tax-free personal allowance £3,000 gives you...
- taxable pay £12,000 on which...
- tax at 20 per cent is £2,400.



Action point

Do you need to register with HMRC as an employer?

The way PAYE works is to collect that £2,400 on a monthly basis (£200 per month) and that works as follows:

HMRC issues tables that show the tax-free pay for each of the various PAYE codes for each week and for each month throughout the year. They also issue tax tables that tell you how much tax to deduct from somebody's pay for each of the weeks and months throughout the year. I won't go into the details here (your eyes may be glazing over already by now), but if we take the case of somebody with a tax allowance of £3,000, that would equate to a PAYE code of 300. During the year, at whatever payment date you were making a wages or salary payment you would look up the appropriate amount of free pay for somebody with a tax code of 300 at that moment. What you would find is that if you were paying somebody £15,000 a year, each month you would pay him £1,250 gross. Of this sum, £250 is tax-free pay (you would find this

in Table A of the documentation you are given by HMRC) so that you apply the tax rate of 20 per cent (using Table B) to the £1,000 taxable pay. This means that you would deduct £200 from the pay each month and send that off to HMRC. At the end of the year you would have paid over £2,400.

However, you have to remember that, in addition to doing this tax calculation, you would also have to work out the National Insurance. It is quite a palaver and this is why I recommend using a computer or getting somebody else to do it.

Income Tax

If you are going to run your own business from home, then so far as the tax authorities are concerned, you have to tell them that you are going self-employed and you have to fill in forms CWF1 and CA5601. To get these forms, simply phone or call in at your local tax office or visit www.hmrc.gov.uk. You must do this within three months of starting or they are liable to make you pay a penalty (or fine) of £100.



How do I tell HMRC that I am self-employed?

By completing and sending it forms CWF1 and CA5601, available online at www.hmrc.gov.uk/menus/otherforms.htm.

When to pay

The self-employed normally pay their tax in three annual instalments:

1. **By 31 January** – the amount is normally half of last year's tax bill.
2. **By 31 July** – the same amount as in 1.

- 3. By the next 31 January** – the amount due is calculated on the actual income returned for the tax year less the payments you have already made (as above).

Self-assessment

If you are self-employed, either as a sole trader or in a partnership, you must complete a tax return annually. A tax return is used to work out how much tax and National Insurance contributions you have to pay. Instead of paying tax on your income, you pay tax on your business profits and like a company, you can deduct your business expenses from your income to work out how much taxable profit you have made.

Usually HMRC will send you a tax return automatically in April, but if it doesn't, it is still your responsibility to ask for one. If you want HMRC to work out your tax bill, you should fill in the return and send it in by 30 September, but if you are happy to calculate the tax yourself, the final deadline is 31 January. If you don't meet this deadline, you will be fined and may also be charged additional penalties.

It is always easier to complete your tax returns if all your paperwork is in order. If you are self-employed or a sole trader, legally you must keep records of your income (and any capital gains) for at least five years and ten months after the end of the tax year.

Most traders leave this matter to their accountants. If you are not going to use the services of an accountant, I suggest that you contact the local tax office in good time for its free advice on this aspect which it will give in connection with helping you complete your tax return. You can also contact HMRC's Self-Assessment Helpline on 0845 900 0444.

Business rates and Council Tax

It is possible that, if it knows you are conducting a business from home, the local authority will assess you to business rates. This will depend on what you propose doing and what the local planning laws say.



Will I have to pay business rates working from home?

It depends on the space occupied by your business – contact your local authority for advice.

In principle, someone using part of his home as an office is unlikely to be of interest to his local authority. However, if you start manufacturing things and effectively change the use of part of your home, then, yes, it is going to come knocking.

On the other hand, if you were to tell the local authority that you no longer use a bedroom as a bedroom but as an office, you may even get a reduction in the Council Tax payable. But it may undo this saving by slapping a business rate charge on the room.

Capital Gains Tax

If a specific part of your house is set aside for business purposes, then that proportion of your profits on the sale of the house will, in theory, be taxable. However, if you do not have any rooms used exclusively for business purposes, you normally will not be liable to any Capital Gains Tax (CGT) if you sell your house.

Having said this, I have never known the taxman to claim any CGT due to the fact that a small business had been run in a private residence which was subsequently sold.

The key word in this section is 'exclusively'. If, say, you have set aside a bedroom as an office, in my view, it is likely to be still regarded as a bedroom. However, if you used a room downstairs

as an office and it had separate access for customers from the main house, it might attract interest and you should seek professional advice over the tax implications.

Inheritance Tax

Inheritance Tax (IHT), like VAT, is a tax with its own set of complicated rules. In the briefest terms, if you were to die leaving assets worth more than the 'nil-rate band' of £312,000 (2008/09 figure), the Chancellor of the Exchequer will want 40 per cent of the balance in tax. A recent change does now allow a surviving husband/wife to benefit from his/her deceased spouse's nil-rate band, but 40 per cent is still a truly shocking rate of tax; it is the starting rate and it applies to just about everything you own at the time of your death.

With many houses now worth at least this sum, the Chancellor is currently reaping more from the taxpayer from IHT than he is getting from what we give him when we buy wines and spirits. You can see how this tax is no minnow that can be ignored. In other words, while this book is concerned with working from home and not with IHT saving, you may need to take professional advice about this matter.

Having said this, and trying to stress the importance of ensuring that your estate is as well protected as it can be from the ravages of IHT, it is unlikely that, having decided to work from home, you will suffer more IHT than otherwise may be the case.

I don't think it is at all likely that IHT will have any impact on anyone working from home, but, if you have any doubts, please seek professional advice.

Business expenses

If you are self-employed and working from home, which expenses are tax-deductible? The following is a guide:

Basic costs and use of home for work

Normally allowed: Proportion of telephone, lighting, heating, cleaning, insurance. Proportion of rent and Council Tax, if you use part of the home exclusively for business – claiming ground rent and Council Tax may mean some Capital Gains Tax to pay if you sell your home, but this is unlikely. Cost of goods bought for resale and raw materials used in business. Advertising, delivery charges, heating, lighting, cleaning, rates, telephone. Replacement of small tools and special clothing. Postage, stationery, relevant books and magazines. Accountant's fees. Bank charges on business accounts. Fees to professional bodies. Security expenditure.

Not allowed: Initial cost of machinery, vehicles, equipment, permanent advertising signs – but you can claim capital allowances. Cost of buildings. Providing for anticipated expenses in the future.



How do I estimate the proportion of relevant utility bills that I can offset against tax?

Work out the area of your home taken up by your business; apply that as a percentage.

Note: You would normally ask an accountant to calculate and claim capital allowances. In principle, you are allowed to claim 25 per cent of most capital assets as a deduction against your profits, but it is quite complicated. Professional help is recommended.

Wages and salaries

Normally allowed: Wages, salaries, redundancy and leaving payments paid to employees. Pensions for past employees and their dependants. Staff training.

Not allowed: Your own wages or salary or that of any business partner. Your own drawings.

Tax and National Insurance

Normally allowed: Employer's National Insurance contributions for employees. Reasonable pay for your spouse, provided he or she is actually employed.

Not allowed: Income Tax. Capital Gains Tax. Inheritance Tax. Your own National Insurance contributions.

Entertaining

Normally allowed: Entertainment of own staff (e.g. Christmas party).

Not allowed: Any other business entertaining.

Pre-trading

Normally allowed: Revenue business expenditure (i.e. things you bought before you started to trade and are now being used in the business) incurred within five years before starting to trade.

Gifts

Normally allowed: Gifts costing up to £50 a year to each person so long as the gift advertises your business (or things it sells). Gifts (whatever their value) to employees.

Not allowed: Food, drink, tobacco or vouchers for goods given to anyone other than employees.



How do I claim tax-deductible expenses?

By completing the relevant parts of a tax return.

Travelling

Normally allowed: Hotel and travelling expenses on business trips. Travel between different places of work. Running costs of own car; whole of cost if used wholly for business; proportion if used privately too.

Not allowed: Cost of buying a car or van, but you can claim capital allowances.

If a business leases a car costing more than £12,000, part of the leasing cost is disallowed for tax purposes. The rules are complicated, but, in principle, the more expensive the car you lease, the smaller the sum that you will be allowed to claim as a tax deduction in your accounts.

Interest payments

Normally allowed: Interest on overdrafts and loans for business purposes.

Not allowed: Interest on capital paid or credited to partners.

Hire purchase

Normally allowed: Hire charge part of instalments (i.e. the amount you pay less the cash price).

Not allowed: Cash price of what you are buying on hire purchase (but you may get capital allowances).

Hiring

Normally allowed: Reasonable charge for hire of capital goods, including cars.

Insurance

Normally allowed: Business insurance (e.g. employer's liability, fire and theft, motor, insuring employees' lives).

Not allowed: Your own life insurance.

Trade marks

Normally allowed: Fees paid to register a trade mark, design or patent.

Not allowed: Cost of buying a patent from someone else, but you may get capital allowances.

Legal costs

Normally allowed: Costs of recovering debts, defending business rights. Preparing service agreements. Appealing against rates, renewing a lease for a period not exceeding 50 years.

Not allowed: Expenses (including Stamp Duty) for acquiring land, buildings or leases. Fines and other penalties for breaking the law.

Repairs

Normally allowed: Normal repairs and maintenance to premises or equipment.

Not allowed: Cost of additions, alterations and improvements, but you may get capital allowances.

Debts

Normally allowed: Specific provisions for debts and debts written off.

Not allowed: General reserve for bad or doubtful debts.

Subscriptions

Normally allowed: Payments which secure benefits for your business or staff. Payments to societies that have arrangements with HMRC (in some cases only a proportion). But watch for possible National Insurance contributions.

Not allowed: Payments to political parties, churches, charities contributions (but small gifts to local churches and charities may be allowable).

Keeping accounts

Why prepare accounts?

1. Unless you are in business for enjoyment alone, you are obviously in business to make a profit. As a result, you will want to know how much profit or loss your business is making. This is exactly what a profit and loss account demonstrates and is probably the most important figure contained in the accounts. However, you will find other important information as well.
2. Accounts have to be prepared by law.
3. Accounts have to be prepared for the taxman.

Numbers 2 and 3 are negative reasons for preparing accounts (i.e. you only prepare accounts because you are compelled), so let us concentrate on the positive reason – namely that the documents are informative.

How to prepare them

As you may have seen in its advertisements, HMRC requires you

to keep a record of everything you spend and receive. You can do this in a number of ways:

1. The simplest of methods

For every item of money coming in and going out, you keep a piece of paper (whether receipt, invoice or your own record), keeping incomings in a separate file (or maybe even in a separate 'pile') so that you, your accountant and eventually HMRC know the summary (or account) of what you have received and spent in your accounting year.

2. A better way

In addition to the above, and unless you computerise your records, you actually write down what you have received and spent in a book. You can buy either a general stationery book, or a specialist accounting book (one that shows you how to do it – this is usually on a weekly basis), or, and this is the best of the three, buy a cash analysis book and write the information in it. These books are multi-column (the more columns the better) and, once you have got used to them (they are extremely simple and one that my firm recommends over any other system), they are extremely useful as both a record of what you have done and a source of useful information of all that has gone on in your business.

The left-hand side of the book records money coming in and the right, money going out. Appendix 7 provides a useful set of titles with which to head up each column.



Action point

Have you bought a cash book yet? If so, have you headed up the columns in line with Appendix 7? Have you got some suitable files in which to keep your receipts, etc.?

3. You can computerise

- a) The simplest and cheapest way to do this is to create a spreadsheet using the titles for each column as just described in point 2 above.
- b) You can buy a ready-made computerised package, none of which I particularly like, but, on the other hand, lots of others do find them helpful, and so I shouldn't denigrate them.
- c) You could engage the services of an accountant who lets you keep your books online.

The last point I should make is that keeping accounts is like flower arranging: there are a great many different ways in which you can do it and there is no one way that is the right way. The way that is going to be best for you is the way you find that you like best; it is going to be up to you to find the way that you really like. So, why not ask a number of small business people to show you how they do it and pick the one that you understand best and like using best.

Understanding accounts

The profit and loss account

Essentially, this is a comparatively easy statement to understand. It lists the money that a business has received (or is due to receive) during the period covered by the accounts and, from them, deducts the money the business has paid out (or has been due to pay out) during the period (expenditure). The difference is the profit or loss.

If the statement is read slowly and carefully, there should be no problem in understanding it, especially if you remember exactly why it has been prepared – to show you how well or badly the business has done during the period covered by the accounts.

There are, however, two accounting expressions which may be a little difficult to understand. These are:

Stocks. In most businesses there are goods bought in one accounting period and sold in another. The cost of these goods should be charged, not against the profits of the period in which they were bought, but against the profits of the period in which they were sold. It is necessary to deduct the cost of any unsold stocks at the end of the period covered by the accounts, as this cost will be added to the relevant future accounting period.

Such stocks are called 'closing stocks' and if the accounts contain a figure of 'opening stocks', you will realise that this figure refers to unsold stocks at the end of the previous accounting period. (Check to see if this is so.)

Depreciation. In a business you own plant machinery and/or equipment which will wear out in time. It is the accountant's estimate of how much this property of the business has worn out during the period covered by the accounts.

The balance sheet

As explained, the profit and loss account shows how much the business has made or lost during the period covered by the accounts. It is an 'account' or 'story'. The balance sheet shows how much, in theory, the business was worth at the end of the period covered by the accounts. It is a 'photograph' of the business at a particular date.

The balance sheet is divided into two parts – part 1, the statement of total net assets, shows the net total value of everything the business owns less everything it owes. If you think about this, you will see that such a total figure means, in theory, how much the business is worth.

Part 2, the statement of source of finance, shows how the assets listed in part 1 have been paid for.

Total net assets

As with the profit and loss account, read it through slowly, carefully bearing in mind the purpose of the statement. Again, there are certain accounting terms which may need further explanation:

Assets. The word asset is an omnibus term for anything the business owns.

Fixed assets. A fixed asset is something bought for the business for use in running the business (e.g. a factory or machine).

Current assets. A current asset is something paid for and for which is intended to turn into profit within the near future (e.g. stocks).

Depreciation. Depreciation is the amount by which the accountant has estimated the asset has worn out since it was first bought.

Stocks. As we have seen in the profit and loss account, stocks are bought with the intention of reselling them in one form or another at a later date. Thus any unsold stocks at an accounting period end form part of the current assets at that date.

Debtors. This is the money owed to a business by customers, etc.

Prepayments. These are usually payments made in advance. For example, an insurance premium may have been paid up to a date after the balance sheet date. The amount paid in advance is, theoretically, repayable by the insurance company and, as such, is like a debtor, but is called a prepayment.

Current liabilities. This refers to money which a business owes to other people.

Creditors. This is the most usual type of current liability and therefore refers to money owed by the business as at the balance sheet date.

Working capital. This is the total of current assets less current liabilities. It is a net total thrown up within the balance sheet and, in crude terms, if fixed assets form the engine which runs the business, working capital is the fuel of that engine.

The source of finance

We have established that part 1 of the balance sheet shows you how much a business is worth in theory. However, to round off the statement it must be shown how the net assets have been paid for (i.e. how they have been financed). The usual sources of finance are:

Proprietors' funds:

Capital introduced. This is the money that the owner of the business has 'put up' to start the business as well as any additional funds he may have contributed.

Profits. If the business has been making profits, the money thereby created will have paid for some of the assets. Profits are a source of finance.

Losses. If the business has been making losses, then money will have flowed out of the business – hence losses are a deduction from the proprietors' funds.

(As any profit or loss as shown in the balance sheet will have come from the profit and loss account, the two figures on the statements should be the same.)

Drawings. This is the money you have drawn from the business to live off.

Loans to the business:

If a bank or anyone else has lent money to the business, it is another source of finance.