

HOW TO UNDERSTAND ACCOUNTS

Understand and interpret annual
and other business accounts

For sole traders, partners or company directors

Includes case studies, example accounts
and practical checklists

Assumes no previous accountancy
knowledge or experience

by David Rouse FCA

This is an excerpt from Lawpack's book *How to Understand Accounts*.
To find out the secrets of understanding accounts, [click here](#).

How to Understand Accounts
by David Rouse

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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'.

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CHAPTER 1

The Trading and Profit and Loss Account

Overview

The Trading and Profit and Loss Account is a summary of the trading carried on by a business during a given period and shows the profit or loss of the business after taking into account expenses.

The make up of the Trading and Profit and Loss Account is normally as follows:

		£
A	Sales	*
B	Cost of sales	*
C	Gross profit (A – B)	*
D	Expenses	*
E	Net profit or loss (C – D)	*

The Trading and Profit and Loss Account is divided into two parts. The Trading Account ends at the gross profit and the Profit and Loss Account covers the rest of the statement. Sometimes the whole statement, from sales to net profit or loss, is simply referred to as the Profit and Loss Account.

Examples of Profit and Loss Accounts are shown in Appendices A.1, B.1, C.2, C5 and D. These are discussed later in this chapter.

Sales

Where invoices are always issued to customers for sales, the figure shown in the accounts for sales is the total of all the sales invoices issued in the period (excluding VAT) with the following deductions:

- Credit notes issued against sales made before the end of the period (excluding VAT).
- Trade discounts allowed to customers (see below).

All sales made in the period are included, whether or not the customer has paid by the end of the period.

VAT charged to customers is not included with the sales figure, as this has to be paid over to HM Revenue & Customs (HMRC).

Where all sales are paid for immediately, as in a retail business where credit is not given, the sales figure will be the same as the total cash received from customers, excluding VAT.

Sales only include goods in which the business normally trades. They do not include sales of fixed assets used in the business (e.g. buildings, plant and machinery, motor vehicles, etc. – see Chapter 2).

Where the business involves the provision of a service, the term ‘sales’ may not be appropriate. In this case the heading could be ‘fees’ or ‘work done’. The term ‘turnover’ is sometimes used to cover all types of sales and services.

Where a business has several different types of sales, the total for each type may be shown separately.

Trade discounts are allowances made to customers for various reasons. They could be based on quantities sold, type of product, status of customer, etc. and they are usually deducted on the invoice to arrive at the net sales figure. Trade discounts do not normally depend on the date that payment is made.

Cash discounts are allowances that depend on payment being made by the customer, either immediately or within a specific period. Cash discounts are not usually deducted from the sales figure but are shown as a separate item of expense in the Profit and Loss Account.

Goods for own use

If the proprietor takes goods out of the business and pays for them as a customer, the amount paid will be included in the sales figure. If the proprietor does not pay for the goods, the selling price is shown as income under the heading 'goods for own use', or 'personal consumption', so that the treatment is effectively as if it were a sale. If the goods are only partly paid for and it is not intended to pay the balance, the amount paid would be included in the sales figure and the unpaid part under the heading 'goods for own use'. The amount included in goods for own use is also included in drawings as the goods have been taken out of the business by the proprietor without his paying for them.

Goods for own use and drawings are explained further in Chapter 2. An example is shown in Appendices B.1 and B.3. Partner A has this year taken goods for his own use from the partnership amounting to £2,000 and this is shown in Appendix B.1 as income in the Profit and Loss Account and as drawings in note 5 to the accounts in Appendix B.3.

Cost of sales

Cost of sales is the direct cost to the business of all the items included in the sales figure. In a simple business buying and selling goods, the cost of sales is the amount that the business paid to its suppliers for the goods that have been sold. Where the business is registered for VAT, the cost of sales does not include VAT as this is reclaimed from HMRC. Cost of sales for a business not registered for VAT will include VAT, as this is part of the cost to the business and it cannot be recovered from HMRC. A business must register for VAT when the turnover is above a specified level. The current level can be found on HMRC's website at www.hmrc.gov.uk.

In a manufacturing business there will be a number of items making up the cost of sales. These will include the cost of raw materials and parts used in the manufacture, the wages for the employees directly involved in the manufacture, the costs (such as electricity) to operate machinery used in the manufacture and any other direct costs involved in bringing the product into a condition to be sold.

In a business providing a service, the direct cost of providing that service will normally be the salary costs of the employees directly involved in earning the fees.

Although it may be possible in some businesses to keep a record showing the cost of each individual item sold, the cost of sales is more often arrived at by putting together total figures as follows:

		£
A	Opening stock and work-in-progress	*
B	Purchases and other direct costs	*
C	(A + B)	*
D	Closing stock and work-in-progress	*
E	Cost of sales (C – D)	*

Opening and closing stock and work-in-progress are valued at the cost to the business, excluding VAT if the business is registered for VAT but including VAT if the business is not registered for VAT.

For example, if a product which costs the business £60 is sold for £100 and ten items are sold in the period for a total of £1,000, the total cost of sales is $10 \times £60 = £600$. If there were four items in stock at the beginning of the period, eight items bought during the period and two items in stock at the end of the period, the figures would be as follows:

		£
A	Opening stock (4 x £60)	240
B	Purchases (8 x £60)	480
C	(A + B)	720
D	Closing stock (2 x £60)	120
E	Cost of sales (C – D)	600

Gross profit

Gross profit is the amount left after deducting the cost of sales from the sales figure. Using the figures from the above example, the sales total is £1,000 and the cost of sales is £600, giving a gross profit of £400.

The gross profit percentage is an important figure to look at. This is the gross profit expressed as a percentage of sales. In the example above, the gross profit of £400 gives a gross profit percentage of 40 per cent, being £400 expressed as a percentage of £1,000 (see also Chapter 5).

Expenses

General

The expenses listed after the gross profit are not directly linked to the level of production or sales. They are for the benefit of the business as a whole. These expenses are usually referred to as ‘overheads’ or ‘indirect expenses’. They cover selling, distribution, administration and all other costs that are not included in the cost of sales.

Some expenses can be described as ‘fixed expenses’. Examples are rent and rates, which are unchanged whether sales increase or decrease.

Overheads that change, to some extent according to the level of business, are called ‘variable’ or ‘semi-variable expenses’. Telephone charges may be semi-variable. The rental part of the charge is fixed, while the cost of calls varies according to the extent to which the telephone is used.

Expenses are included in the Profit and Loss Account in the period in which they are incurred, even though payment may not be made until after the end of the period. In some cases the business may not even receive an invoice until some time after the end of the period. For example:

- Your accountant’s fees for preparing the accounts may not be invoiced to the business until the work has been completed after the end of the year. However, the agreed fee, or an estimate, is included as an expense in the accounts being prepared. This does not affect the date that the invoice is actually sent or the date of payment.

- Bills for electricity will be issued periodically, perhaps quarterly. For example, if the financial year end is 30 September, the last bill issued before 30 September may have covered electricity used to the end of July. The next bill would cover the three months to the end of October. Unless an adjustment is made, the Profit and Loss Account for the year ended 30 September will not include a charge for the electricity used in the months of August and September as the bill will not be issued until after the end of September. An estimate to cover those two months is therefore included in the accounts and is called an 'accrual'.

Some expenses are paid in advance. For example, an annual insurance premium paid on 1 July covers the business for the next 12 months ending on 30 June in the following year. If the financial year end is 30 September, only three months of the premium relates to the current year ended 30 September. An adjustment is made to carry forward into the next financial year that part of the premium covering the nine months to the following 30 June. The amount carried forward is called a 'prepayment'. A similar adjustment will have been made in the accounts ended 30 September in the previous year in respect of the premium paid on 1 July in the previous year. The accounts for the year ended 30 September in the current year (year 2) therefore include an insurance charge covering the full 12 months made up as follows:

- Nine months to 30 June in year 2 is the prepayment brought forward from the previous year (year 1), being three-quarters of the premium paid on 1 July in year 1.
- Three months to 30 September in year 2 is part of the premium paid on 1 July in year 2. The balance of the premium paid on 1 July in year 2, representing nine months to 30 June in year 3, is carried forward and charged in the accounts for the year ending 30 September in year 3.

Expenses charged in the Profit and Loss Account do not include reclaimable VAT. If the business is not VAT registered, VAT should be included with the expense item to which it relates.

Accruals and prepayments are also discussed in Chapter 2.

Expense headings

The expense headings can be varied to suit each individual business. The expenses may be listed in a single column (e.g. as in the sole trader's Profit and Loss Account shown in Appendix A.1) or grouped under appropriate headings with totals for each group of expenses (e.g. as in the partnership Profit and Loss Account shown in Appendix B.1). The following are examples of expense groups that are often used showing some of the types of expenses that would be included under each heading:

Selling

- Salespersons' salaries
- Advertising
- Travel and motor expenses
- Entertaining

Establishment (or premises)

- Rent
- Rates
- Light and heat
- Property insurance
- Property repairs

Administration

- Office salaries
- Telephone
- Postage
- Printing and stationery
- Accountancy
- Legal and professional charges
- Bad debts

Finance

- Bank interest
- Hire purchase interest
- Loan interest

Revenue and capital expenditure

A distinction must be made between capital and revenue expenditure. Capital expenditure belongs on the Balance Sheet, while revenue expenditure is included in the Profit and Loss Account as a deduction from profits. Money spent on fixed assets (see Chapter 2) is capital expenditure and sometimes the distinction is clear. For example:

- The cost of a new car is capital expenditure.
- The cost of petrol to run the car is revenue expenditure.

Sometimes the distinction is less certain. For example:

- Alterations or improvements to a building are normally capital expenditure.
- Restoring a building to its original condition is normally revenue expenditure.

The distinction between capital and revenue expenditure is important not just for the presentation of the accounts but also for tax reasons. Revenue expenditure may be allowed as a deduction from profits for tax purposes, whereas there may be no tax relief for capital expenditure or only part of the expenditure may be allowed against tax each year by way of capital allowances.

Depreciation is not allowed as a deduction from profits for tax purposes as any business is free to set whatever level of depreciation it considers appropriate. However, allowances can be claimed on the cost of fixed assets at various rates specified by tax law, according to the type of fixed asset. These are known as 'capital allowances'. Allowances may be claimed on the initial cost and then annually, as long as the fixed asset is in use by the business.

In order to arrive at the taxable profits, it is necessary to add back to the net profit shown in the accounts any depreciation that has been deducted in arriving at that net profit (and also add back any other expenses not allowable for tax purposes) and then deduct the capital allowances claimed.

The line showing additions to fixtures and fittings of £800 in note 1 to the accounts in Appendix A.3 is an example of capital expenditure incurred during the year. The expenses shown in the Profit and Loss Account in Appendix A.1 are all revenue expenditure.

Loan and hire purchase repayments

Loan and hire purchase repayments will usually consist of both interest and capital. The interest part of the repayment is revenue expenditure to be shown in the Profit and Loss Account while the capital part, reducing the original amount borrowed, is deducted from the balance of the loan shown on the Balance Sheet (see Chapter 2).

Salaries

Gross salaries (i.e. before deducting PAYE and employees' National Insurance, etc.) are charged in the Profit and Loss Account together with the employer's National Insurance. Sometimes the employer's National Insurance is shown separately.

Money taken out of the business by the proprietor or partners is not charged as an expense in the Profit and Loss Account. It is dealt with as drawings and charged to the proprietor's or partners' current accounts shown in the Balance Sheet (see Chapter 2).

Where the business is a company, salaries paid to directors are normally dealt with as expenses in the Profit and Loss Account. For most purposes company directors are treated as employees of the company, whereas a sole trader or partner is the owner, or part owner, of the business. Shareholders are the owners of a company and, although shareholders are often also directors, a distinction is made between money paid to a person as a director (normally a 'salary') and as a shareholder (normally a 'dividend'). Dividends paid to shareholders are not charged as expenses in the Profit

and Loss Account before arriving at the net profit. Dividends are a distribution of net profit to the owners of the company.

Company accounts are dealt with more fully in Chapter 4.

Insurance

Only business insurance is included. Other types of insurance, such as the proprietor's personal life insurance when the beneficiaries are the proprietor's family rather than the business, are usually charged to drawings (see Chapter 2).

Personal pension contributions paid for a sole trader or partner are dealt with as drawings. Tax relief may be available to the sole trader or partner personally. Company pension contributions paid for a company director are normally charged as expenses in the Profit and Loss Account. Tax relief is normally available to the company and not the director personally. A great deal of useful information on tax matters, including tax relief, can be obtained from HMRC's website at www.hmrc.gov.uk.

Bad debts

All sales invoiced to customers are included in the sales figure (unless they are cancelled by credit notes), even if the customer never pays. If it becomes necessary to write off an amount owing by a customer, the amount written off is shown as a 'bad debt'. Normally a bad debt will only be completely written off in the books when it has been established beyond any doubt that payment will never be received (e.g. if the customer is bankrupt and no funds are available to pay creditors). Sometimes a debt is considered doubtful without giving up all hope of recovery. Doubtful debts are included with bad debts written off in the Profit and Loss Account. The heading 'bad debts' may sometimes be changed to 'bad and doubtful debts' to make this clear. If a bad or doubtful debt is subsequently recovered in a future year, the amount recovered is either set off against any other bad debts charged in the Profit and Loss Account or shown separately as an addition to profit under the heading 'bad debts recovered'.

Depreciation

Fixed assets, such as fixtures and fittings and motor vehicles, are usually of benefit to a business for a number of years. Depreciation aims to write down the cost of fixed assets over their expected useful lives so that a fair proportion of the cost is allocated to each accounting period expected to benefit from their use.

The two usual ways of calculating depreciation are straight line and reducing balance.

Straight line

Depreciation is calculated on the cost of the asset so that the same amount of depreciation is charged each year. For example:

Cost of asset – £4,000

Depreciation – 25% straight line

Depreciation charge is £1,000 each year for four years

At the end of the fourth year the value of the asset in the books is NIL

	£	£
Cost of asset		4,000
Depreciation - Year 1	1,000	
- Year 2	1,000	
- Year 3	1,000	
- Year 4	1,000	
		4,000
Book value at end of year 4		NIL

Reducing balance

In the first year depreciation is calculated on the cost of the asset and in

future years on the written down book value. The written down book value is the figure remaining after deducting all the depreciation to date from the original cost. For example:

Cost of asset – £4,000

Depreciation – 25% reducing balance

Depreciation - Year 1 – 25% of £4,000 = £1,000

- Year 2 – 25% of £3,000 (£4,000 – £1,000) = £750

- Year 3 – 25% of £2,250 (£3,000 – £750) = £563

- Year 4 – 25% of £1,687 (£2,250 – £563) = £422

At the end of the fourth year the value of the asset in the books is £1,265 as shown below:

	£	£
Cost of asset		4,000
Depreciation - Year 1	1,000	
- Year 2	750	
- Year 3	563	
- Year 4	422	
		<u>2,735</u>
Book value at end of year 4		<u>1,265</u>

Profit/loss on sale of fixed assets

When a fixed asset is sold or scrapped, the difference between the sale proceeds and the net book value at the time of the sale is either a profit on sale (where the sale proceeds are more than the net book value) or a loss on sale (where the sale proceeds are less than the net book value).

Use of home

Where a business pays rent for a property used in the business the cost of

the rent is charged as an expense in the Profit and Loss Account. If the proprietor uses part of his home in the business, perhaps as an office, which may be either a room set aside exclusively for the business or a room used partly for business and partly for domestic purposes, a charge can be included in the Profit and Loss Account to cover the cost of light and heat, etc. for the time that the room is used for business. The proprietor is given credit in the proprietor's current account for the amount included as use of home and it is treated in a similar way to cash introduced into the business and any other business expenses paid privately. This is explained further in Chapter 2.

Private proportions

Certain expenses may be partly in respect of the business and partly for private purposes. For example, a car used in the business will almost certainly be used for private purposes as well. A log should be kept of all business mileage to work out how to allocate the cost of motor expenses (petrol, repairs, etc.) between business and private use. If the total annual mileage is 10,000 miles and 6,000 of these are for business purposes, motor expenses are allocated 60 per cent as business (an expense in the Profit and Loss Account) and 40 per cent as private (drawings).

Telephone is another expense that may sometimes have a private proportion and a record should be kept of all calls to be allocated between business and private use.

Sometimes the full cost of motor expenses and telephone, etc. is charged in the Profit and Loss Account and an adjustment is made in the tax computation instead of charging the private proportions to drawings. When a company director or other employee uses a car owned by the business for private purposes then the full car expenses, being both business and private, may be charged as an expense in the Profit and Loss Account and the director or employee is taxed personally on the private element as if it were additional salary. Other personal expenses paid by the business and included as expenses in the Profit and Loss Account are dealt with in a similar way. Such expenses paid by the business for the benefit of a director or employee are known as 'benefits in kind'.

Net profit/loss

All the expenses are deducted from gross profit to arrive at the net profit. There is a net loss if the total expenses are more than the gross profit. If the business is a sole trader (or partnership), the net profit or loss is transferred to the proprietor's current account. In a limited company the profit is available for distribution to shareholders, normally by way of dividends, and the balance is transferred to the company's reserves (see Chapter 4).

Examples of Trading and Profit and Loss Accounts

A sole trader (Appendix A.1)

In this year the sales are £120,000. The cost of these sales to the business is £90,000. Cost of sales is deducted from sales to give a gross profit of £30,000. The expenses, which include adjustments for accruals and prepayments, amount to £34,640 and this figure is deducted from the gross profit. As the expenses are more than the gross profit there is a net loss of £4,640. There is further discussion on this Trading and Profit and Loss Account in Chapter 5 where the accounts for a sole trader are used in a case study.

A partnership (Appendix B.1)

This year the sales are £409,337. One of the partners has taken goods for his own use amounting to £2,000 from the business and this is added to give a sub-total of £411,337. The cost of sales of £305,810 is deducted and the result is a gross profit of £105,527. Opening and closing stock has not been shown as two separate figures in the cost of sales, as was the case in the Trading and Profit and Loss Account for a sole trader. The partnership closing stock was £2,550 less than the opening stock and is shown on one line as a stock decrease. This is simply an alternative way of showing the stock figures and is a matter of personal choice. There is some other income amounting to £2,130, which is added to the gross profit to give a

profit before expenses of £107,657. Expenses have been grouped into four different headings, 'establishment', 'selling and distribution', 'administration' and 'financial', the details of each group being shown on the second page of Appendix B.1. The total of expenses is £60,515 and this figure is deducted from the gross profit and other income to give a net profit of £47,142. Sometimes 'other income' is not shown on the Profit and Loss Account until after the expenses so that the reader can see the profit before other income is added. The net profit is allocated to the two partners by giving partner A a salary of £10,000 with the balance divided equally. There was no salary last year. The allocation of profit between partners can be in whatever proportions the partners agree. There would usually be a formal partnership agreement drawn up as a legal document so that it is clear how profits are to be allocated.

A small company (Appendix C.5)

The business involves the sale and repairs of office machinery and sales have been analysed between the two activities. The sales total is £811,337 from which the cost of sales figure of £583,229 is deducted to give a gross profit of £228,108. The wages of £52,546 included in the cost of sales figure relate to the employees who carried out the repairs to customers' machinery, which have earned £107,925. If the information is available to analyse stock and purchases between different activities, in this case between office machinery repairs and sales, separate trading accounts may be prepared showing the gross profit for each activity. Bank interest received of £230 is added to the gross profit (to make £228,338) and expenses totalling £169,919 are deducted to give a net profit of £58,419. Expenses have been analysed into four groups with the details shown on the second page of Appendix C.5.

There are two examples of the statutory formats of the Profit and Loss Account for a small company in Appendices C.2 and D and these are explained in Chapter 4.

Income and Expenditure Account

In some organisations it may not be appropriate to refer to a profit or loss.

For example, a club or charity will have income and expenditure, but the organisation is not run to make a profit in the same way that a business operates to make a profit. Such organisations will prepare accounts in a similar way to those prepared by a business, but the summary of income and expenditure may be called an Income and Expenditure Account instead of a Profit and Loss Account. An excess of income over expenditure is called a 'surplus', instead of 'profit', and an excess of expenditure over income is called a 'deficit', instead of a 'loss'.

There are special rules for the way that larger charities prepare their accounts and the Income and Expenditure Account is called the Statement of Financial Activities. Income is referred to as 'incoming resources' and expenditure is referred to as 'resources expended'. The difference between incoming resources and resources expended is referred to as 'net incoming (or outgoing) resources'.

Whatever they may be called, an Income and Expenditure Account or Statement of Financial Activities are both variations of a Profit and Loss Account.

Receipts and Payments Account

It should be understood that a Receipts and Payments Account is not a variation of a Profit and Loss Account; it is something quite different. A Profit and Loss Account takes into account accruals and prepayments and it does not include capital items, such as fixed assets, which appear on the Balance Sheet. A Receipts and Payments Account, however, does not take into account accruals and prepayments and it includes capital items.

As the name suggests, the Receipts and Payments Account is a summary of all money received from whatever source and all money paid for whatever purpose during the period. It will therefore not include any depreciation, as this is not money paid out, but it will include money received for the sale of fixed assets and money paid for the purchase of fixed assets. The Receipts and Payments Account also shows the money held at the beginning of the period and the money held at the end of the period, whether in cash or in a bank account. It does not show a profit or loss.

It may be prepared in either horizontal form or vertical form and examples of each are shown in Appendices G.1 and G.2. The vertical form

clearly shows the movement in cash for the period and this figure should not be confused with profit or loss. The Receipts and Payments Account is, in effect, a type of Cash Flow Statement, which is discussed in Chapter 3. It is a much simpler document than the Profit and Loss Account and Balance Sheet and is often prepared by small clubs and charities as an alternative to a full set of accounts.

This is an excerpt from Lawpack's book *How to Understand Accounts*.
To find out the secrets of understanding accounts, [click here](#).

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CHAPTER 1

The Trading and Profit and Loss Account

Overview

The Trading and Profit and Loss Account is a summary of the trading carried on by a business during a given period and shows the profit or loss of the business after taking into account expenses.

The make up of the Trading and Profit and Loss Account is normally as follows:

		£
A	Sales	*
B	Cost of sales	*
C	Gross profit (A – B)	*
D	Expenses	*
E	Net profit or loss (C – D)	*

The Trading and Profit and Loss Account is divided into two parts. The Trading Account ends at the gross profit and the Profit and Loss Account covers the rest of the statement. Sometimes the whole statement, from sales to net profit or loss, is simply referred to as the Profit and Loss Account.

Examples of Profit and Loss Accounts are shown in Appendices A.1, B.1, C.2, C5 and D. These are discussed later in this chapter.

Sales

Where invoices are always issued to customers for sales, the figure shown in the accounts for sales is the total of all the sales invoices issued in the period (excluding VAT) with the following deductions:

- Credit notes issued against sales made before the end of the period (excluding VAT).
- Trade discounts allowed to customers (see below).

All sales made in the period are included, whether or not the customer has paid by the end of the period.

VAT charged to customers is not included with the sales figure, as this has to be paid over to HM Revenue & Customs (HMRC).

Where all sales are paid for immediately, as in a retail business where credit is not given, the sales figure will be the same as the total cash received from customers, excluding VAT.

Sales only include goods in which the business normally trades. They do not include sales of fixed assets used in the business (e.g. buildings, plant and machinery, motor vehicles, etc. – see Chapter 2).

Where the business involves the provision of a service, the term ‘sales’ may not be appropriate. In this case the heading could be ‘fees’ or ‘work done’. The term ‘turnover’ is sometimes used to cover all types of sales and services.

Where a business has several different types of sales, the total for each type may be shown separately.

Trade discounts are allowances made to customers for various reasons. They could be based on quantities sold, type of product, status of customer, etc. and they are usually deducted on the invoice to arrive at the net sales figure. Trade discounts do not normally depend on the date that payment is made.

Cash discounts are allowances that depend on payment being made by the customer, either immediately or within a specific period. Cash discounts are not usually deducted from the sales figure but are shown as a separate item of expense in the Profit and Loss Account.

Goods for own use

If the proprietor takes goods out of the business and pays for them as a customer, the amount paid will be included in the sales figure. If the proprietor does not pay for the goods, the selling price is shown as income under the heading 'goods for own use', or 'personal consumption', so that the treatment is effectively as if it were a sale. If the goods are only partly paid for and it is not intended to pay the balance, the amount paid would be included in the sales figure and the unpaid part under the heading 'goods for own use'. The amount included in goods for own use is also included in drawings as the goods have been taken out of the business by the proprietor without his paying for them.

Goods for own use and drawings are explained further in Chapter 2. An example is shown in Appendices B.1 and B.3. Partner A has this year taken goods for his own use from the partnership amounting to £2,000 and this is shown in Appendix B.1 as income in the Profit and Loss Account and as drawings in note 5 to the accounts in Appendix B.3.

Cost of sales

Cost of sales is the direct cost to the business of all the items included in the sales figure. In a simple business buying and selling goods, the cost of sales is the amount that the business paid to its suppliers for the goods that have been sold. Where the business is registered for VAT, the cost of sales does not include VAT as this is reclaimed from HMRC. Cost of sales for a business not registered for VAT will include VAT, as this is part of the cost to the business and it cannot be recovered from HMRC. A business must register for VAT when the turnover is above a specified level. The current level can be found on HMRC's website at www.hmrc.gov.uk.

In a manufacturing business there will be a number of items making up the cost of sales. These will include the cost of raw materials and parts used in the manufacture, the wages for the employees directly involved in the manufacture, the costs (such as electricity) to operate machinery used in the manufacture and any other direct costs involved in bringing the product into a condition to be sold.

In a business providing a service, the direct cost of providing that service will normally be the salary costs of the employees directly involved in earning the fees.

Although it may be possible in some businesses to keep a record showing the cost of each individual item sold, the cost of sales is more often arrived at by putting together total figures as follows:

		£
A	Opening stock and work-in-progress	*
B	Purchases and other direct costs	*
C	(A + B)	*
D	Closing stock and work-in-progress	*
E	Cost of sales (C – D)	*

Opening and closing stock and work-in-progress are valued at the cost to the business, excluding VAT if the business is registered for VAT but including VAT if the business is not registered for VAT.

For example, if a product which costs the business £60 is sold for £100 and ten items are sold in the period for a total of £1,000, the total cost of sales is $10 \times £60 = £600$. If there were four items in stock at the beginning of the period, eight items bought during the period and two items in stock at the end of the period, the figures would be as follows:

		£
A	Opening stock (4 x £60)	240
B	Purchases (8 x £60)	480
C	(A + B)	720
D	Closing stock (2 x £60)	120
E	Cost of sales (C – D)	600

Gross profit

Gross profit is the amount left after deducting the cost of sales from the sales figure. Using the figures from the above example, the sales total is £1,000 and the cost of sales is £600, giving a gross profit of £400.

The gross profit percentage is an important figure to look at. This is the gross profit expressed as a percentage of sales. In the example above, the gross profit of £400 gives a gross profit percentage of 40 per cent, being £400 expressed as a percentage of £1,000 (see also Chapter 5).

Expenses

General

The expenses listed after the gross profit are not directly linked to the level of production or sales. They are for the benefit of the business as a whole. These expenses are usually referred to as ‘overheads’ or ‘indirect expenses’. They cover selling, distribution, administration and all other costs that are not included in the cost of sales.

Some expenses can be described as ‘fixed expenses’. Examples are rent and rates, which are unchanged whether sales increase or decrease.

Overheads that change, to some extent according to the level of business, are called ‘variable’ or ‘semi-variable expenses’. Telephone charges may be semi-variable. The rental part of the charge is fixed, while the cost of calls varies according to the extent to which the telephone is used.

Expenses are included in the Profit and Loss Account in the period in which they are incurred, even though payment may not be made until after the end of the period. In some cases the business may not even receive an invoice until some time after the end of the period. For example:

- Your accountant’s fees for preparing the accounts may not be invoiced to the business until the work has been completed after the end of the year. However, the agreed fee, or an estimate, is included as an expense in the accounts being prepared. This does not affect the date that the invoice is actually sent or the date of payment.

- Bills for electricity will be issued periodically, perhaps quarterly. For example, if the financial year end is 30 September, the last bill issued before 30 September may have covered electricity used to the end of July. The next bill would cover the three months to the end of October. Unless an adjustment is made, the Profit and Loss Account for the year ended 30 September will not include a charge for the electricity used in the months of August and September as the bill will not be issued until after the end of September. An estimate to cover those two months is therefore included in the accounts and is called an 'accrual'.

Some expenses are paid in advance. For example, an annual insurance premium paid on 1 July covers the business for the next 12 months ending on 30 June in the following year. If the financial year end is 30 September, only three months of the premium relates to the current year ended 30 September. An adjustment is made to carry forward into the next financial year that part of the premium covering the nine months to the following 30 June. The amount carried forward is called a 'prepayment'. A similar adjustment will have been made in the accounts ended 30 September in the previous year in respect of the premium paid on 1 July in the previous year. The accounts for the year ended 30 September in the current year (year 2) therefore include an insurance charge covering the full 12 months made up as follows:

- Nine months to 30 June in year 2 is the prepayment brought forward from the previous year (year 1), being three-quarters of the premium paid on 1 July in year 1.
- Three months to 30 September in year 2 is part of the premium paid on 1 July in year 2. The balance of the premium paid on 1 July in year 2, representing nine months to 30 June in year 3, is carried forward and charged in the accounts for the year ending 30 September in year 3.

Expenses charged in the Profit and Loss Account do not include reclaimable VAT. If the business is not VAT registered, VAT should be included with the expense item to which it relates.

Accruals and prepayments are also discussed in Chapter 2.

Expense headings

The expense headings can be varied to suit each individual business. The expenses may be listed in a single column (e.g. as in the sole trader's Profit and Loss Account shown in Appendix A.1) or grouped under appropriate headings with totals for each group of expenses (e.g. as in the partnership Profit and Loss Account shown in Appendix B.1). The following are examples of expense groups that are often used showing some of the types of expenses that would be included under each heading:

Selling

- Salespersons' salaries
- Advertising
- Travel and motor expenses
- Entertaining

Establishment (or premises)

- Rent
- Rates
- Light and heat
- Property insurance
- Property repairs

Administration

- Office salaries
- Telephone
- Postage
- Printing and stationery
- Accountancy
- Legal and professional charges
- Bad debts

Finance

- Bank interest
- Hire purchase interest
- Loan interest

Revenue and capital expenditure

A distinction must be made between capital and revenue expenditure. Capital expenditure belongs on the Balance Sheet, while revenue expenditure is included in the Profit and Loss Account as a deduction from profits. Money spent on fixed assets (see Chapter 2) is capital expenditure and sometimes the distinction is clear. For example:

- The cost of a new car is capital expenditure.
- The cost of petrol to run the car is revenue expenditure.

Sometimes the distinction is less certain. For example:

- Alterations or improvements to a building are normally capital expenditure.
- Restoring a building to its original condition is normally revenue expenditure.

The distinction between capital and revenue expenditure is important not just for the presentation of the accounts but also for tax reasons. Revenue expenditure may be allowed as a deduction from profits for tax purposes, whereas there may be no tax relief for capital expenditure or only part of the expenditure may be allowed against tax each year by way of capital allowances.

Depreciation is not allowed as a deduction from profits for tax purposes as any business is free to set whatever level of depreciation it considers appropriate. However, allowances can be claimed on the cost of fixed assets at various rates specified by tax law, according to the type of fixed asset. These are known as 'capital allowances'. Allowances may be claimed on the initial cost and then annually, as long as the fixed asset is in use by the business.

In order to arrive at the taxable profits, it is necessary to add back to the net profit shown in the accounts any depreciation that has been deducted in arriving at that net profit (and also add back any other expenses not allowable for tax purposes) and then deduct the capital allowances claimed.

The line showing additions to fixtures and fittings of £800 in note 1 to the accounts in Appendix A.3 is an example of capital expenditure incurred during the year. The expenses shown in the Profit and Loss Account in Appendix A.1 are all revenue expenditure.

Loan and hire purchase repayments

Loan and hire purchase repayments will usually consist of both interest and capital. The interest part of the repayment is revenue expenditure to be shown in the Profit and Loss Account while the capital part, reducing the original amount borrowed, is deducted from the balance of the loan shown on the Balance Sheet (see Chapter 2).

Salaries

Gross salaries (i.e. before deducting PAYE and employees' National Insurance, etc.) are charged in the Profit and Loss Account together with the employer's National Insurance. Sometimes the employer's National Insurance is shown separately.

Money taken out of the business by the proprietor or partners is not charged as an expense in the Profit and Loss Account. It is dealt with as drawings and charged to the proprietor's or partners' current accounts shown in the Balance Sheet (see Chapter 2).

Where the business is a company, salaries paid to directors are normally dealt with as expenses in the Profit and Loss Account. For most purposes company directors are treated as employees of the company, whereas a sole trader or partner is the owner, or part owner, of the business. Shareholders are the owners of a company and, although shareholders are often also directors, a distinction is made between money paid to a person as a director (normally a 'salary') and as a shareholder (normally a 'dividend'). Dividends paid to shareholders are not charged as expenses in the Profit

and Loss Account before arriving at the net profit. Dividends are a distribution of net profit to the owners of the company.

Company accounts are dealt with more fully in Chapter 4.

Insurance

Only business insurance is included. Other types of insurance, such as the proprietor's personal life insurance when the beneficiaries are the proprietor's family rather than the business, are usually charged to drawings (see Chapter 2).

Personal pension contributions paid for a sole trader or partner are dealt with as drawings. Tax relief may be available to the sole trader or partner personally. Company pension contributions paid for a company director are normally charged as expenses in the Profit and Loss Account. Tax relief is normally available to the company and not the director personally. A great deal of useful information on tax matters, including tax relief, can be obtained from HMRC's website at www.hmrc.gov.uk.

Bad debts

All sales invoiced to customers are included in the sales figure (unless they are cancelled by credit notes), even if the customer never pays. If it becomes necessary to write off an amount owing by a customer, the amount written off is shown as a 'bad debt'. Normally a bad debt will only be completely written off in the books when it has been established beyond any doubt that payment will never be received (e.g. if the customer is bankrupt and no funds are available to pay creditors). Sometimes a debt is considered doubtful without giving up all hope of recovery. Doubtful debts are included with bad debts written off in the Profit and Loss Account. The heading 'bad debts' may sometimes be changed to 'bad and doubtful debts' to make this clear. If a bad or doubtful debt is subsequently recovered in a future year, the amount recovered is either set off against any other bad debts charged in the Profit and Loss Account or shown separately as an addition to profit under the heading 'bad debts recovered'.

Depreciation

Fixed assets, such as fixtures and fittings and motor vehicles, are usually of benefit to a business for a number of years. Depreciation aims to write down the cost of fixed assets over their expected useful lives so that a fair proportion of the cost is allocated to each accounting period expected to benefit from their use.

The two usual ways of calculating depreciation are straight line and reducing balance.

Straight line

Depreciation is calculated on the cost of the asset so that the same amount of depreciation is charged each year. For example:

Cost of asset – £4,000

Depreciation – 25% straight line

Depreciation charge is £1,000 each year for four years

At the end of the fourth year the value of the asset in the books is NIL

	£	£
Cost of asset		4,000
Depreciation - Year 1	1,000	
- Year 2	1,000	
- Year 3	1,000	
- Year 4	1,000	
		4,000
Book value at end of year 4		NIL

Reducing balance

In the first year depreciation is calculated on the cost of the asset and in

future years on the written down book value. The written down book value is the figure remaining after deducting all the depreciation to date from the original cost. For example:

- Cost of asset – £4,000
- Depreciation – 25% reducing balance
- Depreciation - Year 1 – 25% of £4,000 = £1,000
- Year 2 – 25% of £3,000 (£4,000 – £1,000) = £750
- Year 3 – 25% of £2,250 (£3,000 – £750) = £563
- Year 4 – 25% of £1,687 (£2,250 – £563) = £422

At the end of the fourth year the value of the asset in the books is £1,265 as shown below:

	£	£
Cost of asset		4,000
Depreciation - Year 1	1,000	
- Year 2	750	
- Year 3	563	
- Year 4	422	
		2,735
Book value at end of year 4		1,265

Profit/loss on sale of fixed assets

When a fixed asset is sold or scrapped, the difference between the sale proceeds and the net book value at the time of the sale is either a profit on sale (where the sale proceeds are more than the net book value) or a loss on sale (where the sale proceeds are less than the net book value).

Use of home

Where a business pays rent for a property used in the business the cost of

the rent is charged as an expense in the Profit and Loss Account. If the proprietor uses part of his home in the business, perhaps as an office, which may be either a room set aside exclusively for the business or a room used partly for business and partly for domestic purposes, a charge can be included in the Profit and Loss Account to cover the cost of light and heat, etc. for the time that the room is used for business. The proprietor is given credit in the proprietor's current account for the amount included as use of home and it is treated in a similar way to cash introduced into the business and any other business expenses paid privately. This is explained further in Chapter 2.

Private proportions

Certain expenses may be partly in respect of the business and partly for private purposes. For example, a car used in the business will almost certainly be used for private purposes as well. A log should be kept of all business mileage to work out how to allocate the cost of motor expenses (petrol, repairs, etc.) between business and private use. If the total annual mileage is 10,000 miles and 6,000 of these are for business purposes, motor expenses are allocated 60 per cent as business (an expense in the Profit and Loss Account) and 40 per cent as private (drawings).

Telephone is another expense that may sometimes have a private proportion and a record should be kept of all calls to be allocated between business and private use.

Sometimes the full cost of motor expenses and telephone, etc. is charged in the Profit and Loss Account and an adjustment is made in the tax computation instead of charging the private proportions to drawings. When a company director or other employee uses a car owned by the business for private purposes then the full car expenses, being both business and private, may be charged as an expense in the Profit and Loss Account and the director or employee is taxed personally on the private element as if it were additional salary. Other personal expenses paid by the business and included as expenses in the Profit and Loss Account are dealt with in a similar way. Such expenses paid by the business for the benefit of a director or employee are known as 'benefits in kind'.

Net profit/loss

All the expenses are deducted from gross profit to arrive at the net profit. There is a net loss if the total expenses are more than the gross profit. If the business is a sole trader (or partnership), the net profit or loss is transferred to the proprietor's current account. In a limited company the profit is available for distribution to shareholders, normally by way of dividends, and the balance is transferred to the company's reserves (see Chapter 4).

Examples of Trading and Profit and Loss Accounts

A sole trader (Appendix A.1)

In this year the sales are £120,000. The cost of these sales to the business is £90,000. Cost of sales is deducted from sales to give a gross profit of £30,000. The expenses, which include adjustments for accruals and prepayments, amount to £34,640 and this figure is deducted from the gross profit. As the expenses are more than the gross profit there is a net loss of £4,640. There is further discussion on this Trading and Profit and Loss Account in Chapter 5 where the accounts for a sole trader are used in a case study.

A partnership (Appendix B.1)

This year the sales are £409,337. One of the partners has taken goods for his own use amounting to £2,000 from the business and this is added to give a sub-total of £411,337. The cost of sales of £305,810 is deducted and the result is a gross profit of £105,527. Opening and closing stock has not been shown as two separate figures in the cost of sales, as was the case in the Trading and Profit and Loss Account for a sole trader. The partnership closing stock was £2,550 less than the opening stock and is shown on one line as a stock decrease. This is simply an alternative way of showing the stock figures and is a matter of personal choice. There is some other income amounting to £2,130, which is added to the gross profit to give a

profit before expenses of £107,657. Expenses have been grouped into four different headings, 'establishment', 'selling and distribution', 'administration' and 'financial', the details of each group being shown on the second page of Appendix B.1. The total of expenses is £60,515 and this figure is deducted from the gross profit and other income to give a net profit of £47,142. Sometimes 'other income' is not shown on the Profit and Loss Account until after the expenses so that the reader can see the profit before other income is added. The net profit is allocated to the two partners by giving partner A a salary of £10,000 with the balance divided equally. There was no salary last year. The allocation of profit between partners can be in whatever proportions the partners agree. There would usually be a formal partnership agreement drawn up as a legal document so that it is clear how profits are to be allocated.

A small company (Appendix C.5)

The business involves the sale and repairs of office machinery and sales have been analysed between the two activities. The sales total is £811,337 from which the cost of sales figure of £583,229 is deducted to give a gross profit of £228,108. The wages of £52,546 included in the cost of sales figure relate to the employees who carried out the repairs to customers' machinery, which have earned £107,925. If the information is available to analyse stock and purchases between different activities, in this case between office machinery repairs and sales, separate trading accounts may be prepared showing the gross profit for each activity. Bank interest received of £230 is added to the gross profit (to make £228,338) and expenses totalling £169,919 are deducted to give a net profit of £58,419. Expenses have been analysed into four groups with the details shown on the second page of Appendix C.5.

There are two examples of the statutory formats of the Profit and Loss Account for a small company in Appendices C.2 and D and these are explained in Chapter 4.

Income and Expenditure Account

In some organisations it may not be appropriate to refer to a profit or loss.

For example, a club or charity will have income and expenditure, but the organisation is not run to make a profit in the same way that a business operates to make a profit. Such organisations will prepare accounts in a similar way to those prepared by a business, but the summary of income and expenditure may be called an Income and Expenditure Account instead of a Profit and Loss Account. An excess of income over expenditure is called a 'surplus', instead of 'profit', and an excess of expenditure over income is called a 'deficit', instead of a 'loss'.

There are special rules for the way that larger charities prepare their accounts and the Income and Expenditure Account is called the Statement of Financial Activities. Income is referred to as 'incoming resources' and expenditure is referred to as 'resources expended'. The difference between incoming resources and resources expended is referred to as 'net incoming (or outgoing) resources'.

Whatever they may be called, an Income and Expenditure Account or Statement of Financial Activities are both variations of a Profit and Loss Account.

Receipts and Payments Account

It should be understood that a Receipts and Payments Account is not a variation of a Profit and Loss Account; it is something quite different. A Profit and Loss Account takes into account accruals and prepayments and it does not include capital items, such as fixed assets, which appear on the Balance Sheet. A Receipts and Payments Account, however, does not take into account accruals and prepayments and it includes capital items.

As the name suggests, the Receipts and Payments Account is a summary of all money received from whatever source and all money paid for whatever purpose during the period. It will therefore not include any depreciation, as this is not money paid out, but it will include money received for the sale of fixed assets and money paid for the purchase of fixed assets. The Receipts and Payments Account also shows the money held at the beginning of the period and the money held at the end of the period, whether in cash or in a bank account. It does not show a profit or loss.

It may be prepared in either horizontal form or vertical form and examples of each are shown in Appendices G.1 and G.2. The vertical form

clearly shows the movement in cash for the period and this figure should not be confused with profit or loss. The Receipts and Payments Account is, in effect, a type of Cash Flow Statement, which is discussed in Chapter 3. It is a much simpler document than the Profit and Loss Account and Balance Sheet and is often prepared by small clubs and charities as an alternative to a full set of accounts.