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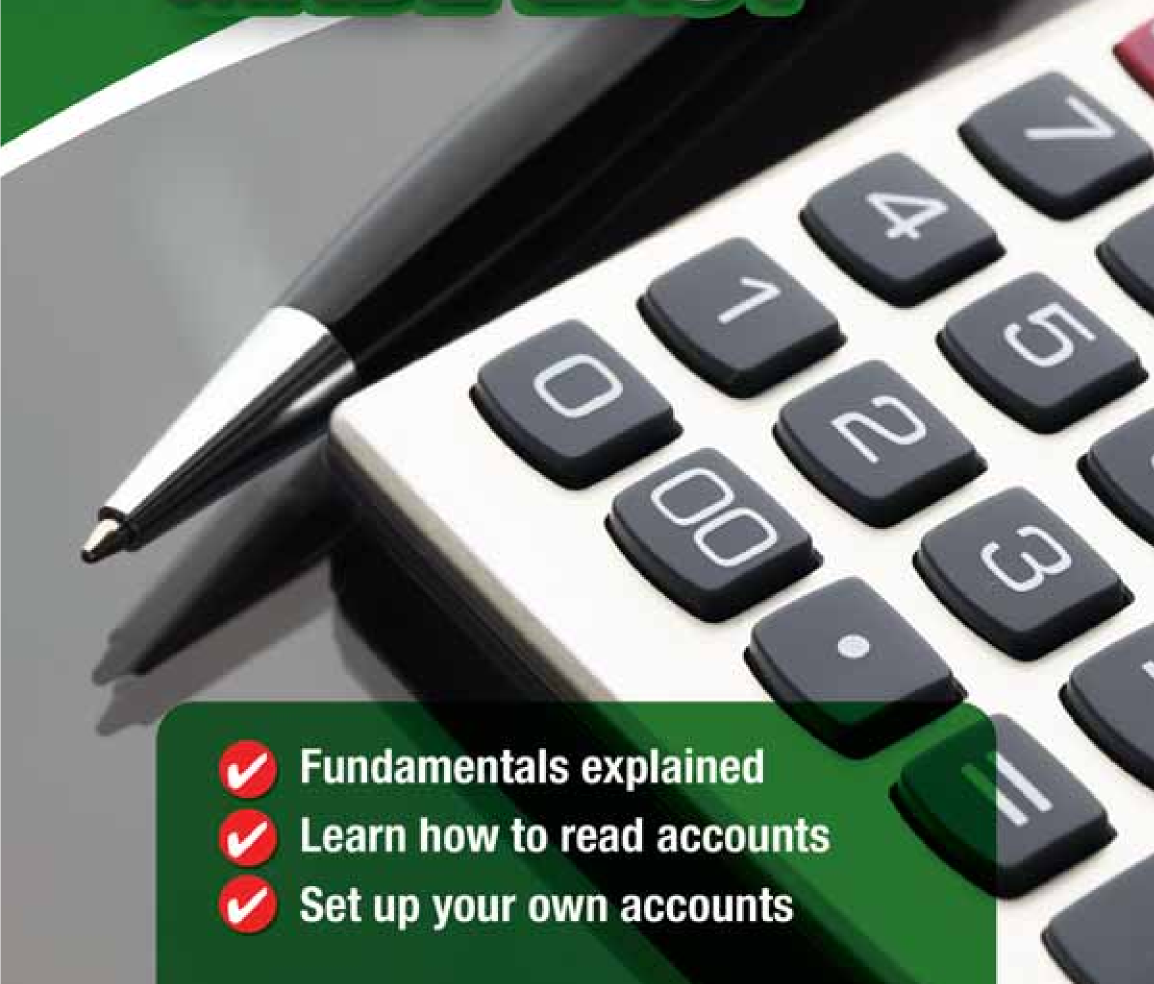

- Fundamentals explained
- Learn how to read accounts
- Set up your own accounts

Book-Keeping Made Easy
by Roy Hedges

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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'.

Contents

Introduction

Most people who are in business for the first time wrongly believe that keeping a set of books is an unnecessary and unpleasant chore that they have to do just for the benefit of the taxman. It's true that HM Revenue & Customs will use the accounts produced from your business records to extract as much tax as they can. On the other hand, a skilled accountant will be able to use them to minimise your tax liability.

Keeping an accurate detail of all your business transactions should never be classed as a job to be done only when you can fit it into your busy schedule. Your business paperwork needs to be updated daily because it's the gauge of the financial health of your business. It's no good moaning that time could be more profitably spent making sales, because if you sell goods or services at a loss due to poor accounting procedures, what is the point of being in business? Did you know that more businesses fail in their first year or two because of insufficient financial control than for any other reason?

What makes this book different from the many others published over the years on book-keeping? It's because it's written primarily for the entrepreneur. Whilst students and those entering book-keeping and accountancy careers for the first time may find it of interest, it's not a textbook. It's really aimed at small business owners. Apart from showing how to set up accounting records and explaining the jargon used by those in the profession, it also demonstrates the practical uses to which a go-ahead businessperson can put the information stored within the accounts of a business.

Since the financial records of an owner-managed enterprise can differ greatly from those of medium-sized and larger businesses, chapters 2 and

3 relate to the book-keeping requirements of a sole proprietor, for example, a self-employed tradesman or small shopkeeper, in fact anyone mainly trading in cash and not credit transactions. If you fall into this category, you will have little use for double entry book-keeping, and piles of ledgers. What you really need is an easy-to-operate, no-frills system and that's exactly what you get in these chapters. Nevertheless, it's important not to neglect some of the later chapters, as these will be invaluable to you as a source of reference; I refer to the sections on Balance Sheets, Profit and Loss Accounts, computerised accounting and payroll (even if you are only employing one member of staff).

At the end of each fiscal year, putting the final accounts together will be a lot easier for your accountant if he is presented with a full set of well-kept books, instead of just being given piles of invoices and receipts to sort out. Apart from ensuring you are not paying too much tax, his fees will be much lower.

Those of you who are on the threshold of an exciting new business adventure may be interested in reading my other book in Lawpack's Made Easy series: *Running Your Own Business Made Easy*. It draws on personal experience to help you avoid the pitfalls I encountered when embarking on the same path you are now taking.

Finally, I would like to thank the many firms and individuals without whose help I would have been unable to write this book.

Roy Hedges

CHAPTER 5

Final accounts

What you'll find in this chapter

- ✔ Trial balances
- ✔ The Balance Sheet
- ✔ Stock valuation
- ✔ Trading and Manufacturing Accounts
- ✔ Profit and Loss Accounts
- ✔ Adjustments to the accounts
- ✔ Accounts of limited companies
- ✔ Year on year consistency in accounts

Trial balances

Before preparing the Profit and Loss Account and the Balance Sheet, your book-keeper will first draw up a trial balance. This is a list of all the accounts showing their closing balances. The total debits should equal the closing credits. If not, a mistake has been made and must be found. Trial balances are not only done at the end of each year, but can be taken at any time. If your accounts are computerised, a trial balance can be produced at the click of a button.

Every book-keeper should be able to account to trial balance; but at the year-end your acountant needs to step in and finalise your books. Trying to get anyone else to do them is a false economy. Having said that, it's important that you understand what is involved in their preparation and how the information stored within them can be used.

NOTE

A trial balance does exactly what its name implies – it confirms that the totals of the debit and credit entries match each other.

By doing a trial balance on a monthly basis, any slip made by your book-keeper in the month's work can be quickly spotted and rectified. Only doing it once a year could mean hours spent wading through months of paperwork.

The Balance Sheet

The Balance Sheet is just a reorganisation of the trial balance within a prescribed format. The Profit and Loss Account is merely a detailed breakdown of the profits figure shown below under 'Capital'.

A Balance Sheet is simply a list or statement of what you or the business own and what is owed by you at the end of each year.

The aim is to make sure that your assets are equal to or in excess of your liabilities. The Balance Sheet is always calculated on a single date each year.

Therefore, the Balance Sheet basically shows you how your business is financed. Is it depending on bank loans or is it making a profit? Above all else, it will let you know if the business can pay its bills as they become due in the short term.

The trial balance we produced in the last chapter looked like this:

	£		£
Equipment	2,500	Capital	10,000
Cash	2,500	Sales	5,000
Stock	2,250		
Debtors	5,000		
Cost of sales	2,000		
Rent	750		
Totals	15,000		15,000

We noted at the beginning that the debit side shows what the business owns and the credit side what it owes.

Now does the business owe the owner £15,000? Well, let us take a look at the debit side which records what the company owns.

Which of these debits are assets?

The equipment is a fixed asset which will be used to generate more sales.

Stock and debtors are current assets which it's hoped will be turned to cash as soon as possible.

And then there is the cash itself.

The rent and the cost of sales figures are clearly not assets that the company owns but expenses that have to be deducted from the sales revenue to record the profit for the period.

The trial balance then looks like this:

	£		£
Equipment	2,500	Capital	10,000
Cash	2,500	Sales	5,000
Stock	2,250	Cost of sales	-2,000
Debtors	5,000	Rent	-750
Totals	12,250		12,250

Or by showing the profit calculation on the face of the trial balance it looks like this:

	£			£
Equipment	2,500	Capital		10,000
Cash	2,500	Sales	5,000	
Stock	2,250	Cost of sales	-2,000	
Debtors	5,000	Rent	-750	
		Profit		2,250
Totals	12,250			12,250

The calculation of the profit (sales less cost of sales less rent) is the Profit and Loss account for the period, and it only appears on the face of the Balance Sheet as a single figure:

Profit and Loss Account

	£
Sales	5,000
Cost of sales	-2,000
Rent	-750
Profit	2,250

Balance Sheet

	£		£
Equipment	2,500	Capital	10,000
Cash	2,500	Profit	2,250
Stock	2,250		
Debtors	5,000		
Totals	12,250		12,250

Stock valuation

Valuing stock correctly at the end of your trading year is important since it will reflect in your gross profits. Overvaluing it could result in you paying too much tax. Undervaluing it could turn a profit into a loss, and this will reflect in your purchase price should you decide to sell the business. An incorrect valuation could be looked upon as fraudulent, so care must be exercised at all times.

TOP TIP

When valuing stock, always price it at its cost price, reducing the value where deterioration has occurred.

In most businesses, it's advisable to keep a running total of stock in hand. This means every year you start off with an opening number of items in stock. During the course of the year this stock will be replenished; at the same time items of stock will either be used in your manufacturing process or sold. Stock items received will be added to your total, with those used or sold deducted, ensuring you have a running total of stock at all times. A computerised system will add and deduct these items automatically.

One advantage of completing an annual stocktake is that it will highlight slow-moving items; a stocktaking sale may remove these objects off your shelves whilst making the stocktake easier. A simple calculation to assess the value of your stock is:

Items of stock at start = 4,000, plus number purchased 8,000 = 12,000 less items used or sold 11,000 = closing stock 1,000 items.

Say the cost of these items is £10 each, but because 200 are damaged their value is reduced to £7.50 each, the closing value of stock is:

800 units @ £10 each = £8,000

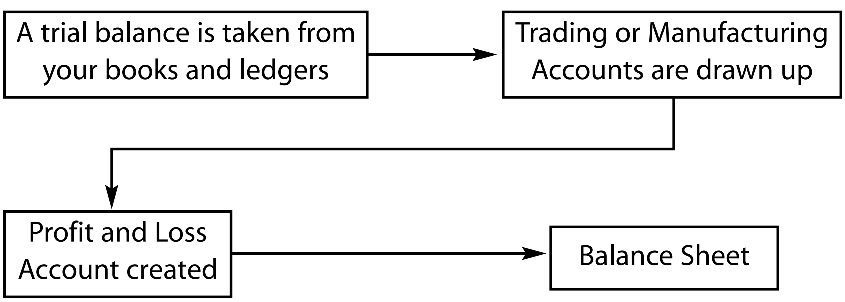
200 units @ £7.50 each = £1,500

The gross value of your stock would be £9,500.

It's this last figure that is transferred to your Trading Account. As all items of stock are rotated, stock purchased first is sold before more recently bought items. The cost price of your calculation is taken from the latest invoice received from the supplier.

Trading and Manufacturing Accounts

Before attempting the Profit and Loss Account, there is one other small account to draw up. In a trading firm, one that buys and sells finished products, this account is called the Trading Account and in a manufacturing concern, it's called the Manufacturing Account. The same account in a professional firm is referred to as the Revenue Account.



Your path from Trial Balance to Balance Sheet is like the illustration above.

Whatever it's called, the aim of this account is to establish the gross profit of a going concern, and in truth they really all are revenue accounts.

Taking these one at a time, we shall begin with the Trading Account. This account defines the turnover of the business and its gross profit or loss; this final figure is then transferred to the Profit and Loss Account. It's in the Profit and Loss Account that the net profit or loss will be calculated. An average Trading Account will show the following entries:

Trading Account
For the year ending 31 December 20XX

	£	£		£	£
Opening stock		15,500	Sales		95,000
Purchases	39,000		Less returns		-3,500
Less returns	-1,450		Net turnover		91,500
Net purchases		37,550			
Total stock		53,050			
Less closing stock		-10,460			
Cost of stock sold		42,590			
Gross profit					
Transferred to P & L a/c.		48,910			
		91,500			91,500

Of course, the purchase and sales returns accounts will be closed off and the totals transferred to the Trading Account.

The Manufacturing Accounts will be comparable to those pictured above, but with one main difference. Manufacturers don't buy in goods for resale;

they purchase raw materials to make them into finished goods. Therefore, the stock of a manufacturer falls into three categories:

- Stock of raw materials
- Work in progress or partly finished products
- Stock of finished goods

Like all closing stocks, these three items will appear in the Balance Sheet as assets of the business. The Manufacturing Account will be in two parts: the first will be the same as a Trading Account but with the stock classified differently, and below this will be a cost of manufactured goods section; this will include items such as general overheads. These general expenses will include items such as power, rent, rates and wages among others.

Profit and Loss Accounts

When closing off the balances at the time of the trial balance, any losses due to non-payment will be debit balances and these are now transferred to a Bad Debt Account. A Bad Debt Account will list every debt that is considered or proven to be unrecoverable during the course of the year under review.

Any losses during your trading year due to damaged or stolen stock will be reflected in the gross profit figure arrived at in the Trading Account.

Bad Debt Account

		£			£
8 Mar	Mark Cash	150	31 Dec	Transfer to Profit	
21 Nov	P. Sterling	450			600
		600			600

In fact, a Profit and Loss Account is no more than a continuation of your Trading Account. Many firms do, in fact, put these two together and produce a Trading and Profit & Loss Account. To arrive at a net profit, the expenses will be listed in your Profit and Loss Account. See the illustration below.

Profit and Loss Account

For the year ending 31 December 20XX

	£		£
Bad debts	600	Gross profit (transferred from Trading a/c.)	48,910
Rent & rates	3,350		
Wages	9,800		
Commission paid	2,100		
Printing	250		
Total expenses	16,100		
Net profit	32,810		
	48,91		48,910

As we saw earlier, the net profit sum shown in this illustration will now be transferred to the Capital Account. A point to note in respect of your final accounts is that any figure or total that represents a loss is often placed within brackets, thus allowing it to be easily recognisable. At this stage of accounting, the double entry system concludes. All that remains now is for the Balance Sheet to be prepared, and any necessary adjustments to the final accounts to be made.

In this guide there have been a lot of accounts omitted, simply because this is not a book targeted to students where an incredible amount of detailed explanation is required, but to the businessperson. After the next sections, the subsequent chapters embrace wages, computerisation and most of all what you can learn from your accounts, and the uses to which they can be put. This in my mind is far more important for today's entrepreneur than learning about the entries your book-keeper will be doing on your behalf anyway. However, it's necessary to provide a basic understanding of what is required to enable the remaining chapters to make sense.

Adjustments to the accounts

The purpose of adjusting the final accounts is to generate an accurate set of accounts and Balance Sheet for the period under examination. One of the main instances where adjustments have to be made is when dealing with payments made or received in advance. Payments nearly always made in advance include insurance premiums, rent and rates. Taking 31 December as your year-end, if you paid three months' rent on the first of December, only one month of that rent would be treated as an expense in calculating the current year's profit. So a rental charge of say £3,000 per quarter means the accounts would need to be adjusted to show only £1,000 in the current year's Profit and Loss Account, with the rest held over in the Balance Sheet to the next accounting period. In this instance, if you took a look at your rent account it will appear as below.

Rent Account

		£			£
1 Dec	Rent paid	3,000	31 Dec	Profit & Loss a/c.	1,000
				Balance c/fwd	2,000
		3,000			3,000
1 Jan	Balance b/fwd	2,000			

Payments made in advance to your firm for services not yet rendered cannot be treated as profits, but they will be carried forward to the next trading year as liabilities. The reasoning behind this is that if you are unable for any reason to fulfil your obligations, the money will be returned to your customer.

Another example of an adjustment to your final accounts may be accrued expenses. This usually applies to wages, or commissions due to salespeople. If wages are paid weekly or fortnightly, they may span a year-end. The Wages Account will have entries similar to the above Rent Account, but reversed. The portion of the wages due but not yet paid will therefore show as a current liability in the Balance Sheet.

NOTE

In a small business, it's not really necessary to make adjustments for small items such as telephone bills. HM Revenue & Customs realise the problems this can cause.

There are many other adjustments that may be made to the final accounts of a business; provision for bad debts is one, depreciation of assets is another and so is goodwill. Let's take these one at a time. In providing for possible bad debts, if it's usual in your trade for, say, five per cent of debts to be not collectable, the sum of £437.50 will be deducted from the debtor's total under current assets in the Balance Sheet. Simply because a debt is being transferred to a Bad Debt Account doesn't mean that you have to give up on it. The debt must be pursued until all avenues of collection have been exhausted.

Most other assets of a business, such as machinery (but not for bricks and mortar), wear out over a given period. Depreciation reduces the value of the asset over its normal life span. Therefore it can be said that depreciation reduces the profits available for use by the owner. However, it does leave an undistributed wealth in the firm because profit is normally turned into cash, and depreciation is a non-cash transaction, so it's easy to have more cash than profit – for a while! A prudent manager will invest these funds outside the business to replace the asset when the time comes. Otherwise, the undistributed funds can be frittered away, and the business will have to resort to borrowing to replace worn out machinery.

In respect of leases, should the one you purchase have five years to run, simply deduct a fifth from its purchase price each year.

'Goodwill' is the valuation placed on a going concern over and above the value of its assets. It's a sum that is paid by a buyer of a business to the vendor in expectation of the profits to be made that are directly from the hard work of the previous owner. Goodwill is an intangible asset, and it relates to the relationship the former owner built up with the clientele. The customers of the vendor will continue to use the business because of its reputation of fair dealing. As it's not an asset that can be touched, a new owner will probably write this asset off over a period of between three to five years.

NOTE

Assets of a limited company must be shown in the Balance Sheet at the original cost, less depreciation to date, and quoted at its net value.

Valuing the goodwill of a business is very difficult indeed; its value is only what a third party is prepared to pay for the customer loyalty that has been built up over the years, through the vendor's hard and honest work.

Accounts of limited companies

The accounts of limited companies differ from sole traders' in a number of ways: first there is the distribution of capital. Investors who become shareholders 'subscribe' the capital of the business, which is then used to purchase assets for the company's use and to generally allow it to run its day-to-day business activities. The number of shareholders in an ordinary company can be as few as two, but in a public company the number can run into thousands.

The most common shares offered by a limited company are 'ordinary' and 'preference' shares. The ordinary shareholders take the greatest risk; as their name implies, preference shareholders have preferential treatment when it comes to the payment of dividends – they are always paid before ordinary shareholders if the company gets into difficulties. Whilst ordinary shareholders may lose their money if the company fails, they do enjoy a larger share of the profits when times are good.

Loans to a company from sources other than shareholders are called 'debenture'. A debenture is a loan secured upon the company's assets. There are two types of debenture: fixed and floating. Fixed debentures are secured on the firm's fixed assets, and if interest is not paid at regular intervals, the assets can be seized and sold to recoup the money loaned. Floating debentures are secured on circulating assets, such as stock.

NOTE

Dividends are never guaranteed, except to preference shareholders. Dividend payments are paid at the discretion of the directors of a company.

A Balance Sheet is required by statute to set out the assets of a limited company in a certain order. First, the fixed assets are split into three:

- Intangible assets – goodwill and other legal rights.
- Tangible assets – such as premises, etc.
- Trade investments – these are investments in subsidiary companies.

Current assets are also displayed in strict order of:

- Stock
- Debtors
- Cash

One can bring the current liabilities over to the assets side and show them as a deduction from the current assets. This presents you with the net working capital of your business (current assets less current liabilities), and when added to the fixed assets provide you with the net value of assets, as shown below.

Balance Sheet

	£	£		£
Fixed assets		6,000	Capital	1,000
Current assets	7,000		Accumulated profit	1,000
Current liabilities	-3,000		Long-term loan	8,000
		4,000		
Totals		10,000		10,000

This company's net assets are worth £10,000, but the owner should not be fooled – the long-term creditors own 80 per cent of the business!

Don't ever be put off by the Balance Sheet – it's only a snapshot of what your business owes you at a particular moment in time.

Year on year consistency in accounts

The idea behind the production of final accounts is to provide you and your shareholders with a financial picture of your business at the end of each year of trading. To enable you to measure any decline or progress of your business from year to year, the annual accounts must be prepared in a uniform manner; otherwise it will be impossible to use them as a gauge.

The principles of accounting are many, but the two mentioned in this chapter are the most commonly used in today's environment.

Accountants will prepare your final accounts on the basis that your business is a 'going concern', i.e. that the business will continue to trade in the foreseeable future. On the other hand, if they have reason to believe the business will cease to trade in the near future, they have a duty to amend the value of the firm's assets. To illustrate this point, say the machinery used in your business is valued at £5,000 as a 'going concern'; this machinery will be making you money and any buyers of your business will gladly pay this price, because the value it provides will be passed onto them. Now, if your business ceases to trade, the machinery will not be earning its keep, and if it's something that has very limited use it can only be sold as scrap, meaning it has little or no value. So in the preparation of your final accounts, you have an obligation to inform your accountant if there is any likelihood the business will close.

Another prudent principle of accounting is that businesspeople and their accountants don't take profit into account until it's actually realised, but they do take account of losses as soon as they occur. At the first hint that a loss is possible, the offending account is transferred to a Suspense Account, thus making provision for a bad debt.

Manufacturing, Trading, and Profit and Loss Accounts must take into account all income received, plus what is due and yet to be received.

However, it should be noted that whilst this principle works in the case of, for example, stock, the opposite applies to property. If you purchase 100 items of stock at £1 each, and demand is such that their current value is £2 and 50 items remain in stock, you cannot say you have made £50 profit on that stock until you sell them. This is due to the fact that between valuing your stock and selling it, the demand may plummet, and those items are now worth considerably less, leaving you with a loss situation. How the prudent businessperson handles this situation will be seen when reading the section relating to Profit and Loss Accounts.

With regard to property, increases in property value tend to remain stable; only on rare occasions do property prices nose-dive. By taking this appreciation into account, one wards off predators thinking of taking over your business simply to sell its premises and thereby taking the profit for themselves. This practice, known as asset stripping, was rife in the 1960s.