

**A PRACTICAL ACCOUNTING  
HANDBOOK FOR  
START-UP BUSINESSES**

## **Introduction**

There is no shortage of advice available about setting up in business. Government agencies, professional firms, consultants and charitable organisations all have a wealth of knowledge and experience to offer new business start-ups. The sheer volume of information can appear to be overwhelming, particularly when it comes to bookkeeping and accounting.

The purpose of this small handbook on bookkeeping is to help you to help yourself. That is, to help you identify some simple steps you can take in order to operate and manage your business accounts effectively and to comply with the current legislation in the areas of income tax, value-added tax (VAT) and employment records.

After that, it is up to you just how far you wish to develop your knowledge and understanding of bookkeeping and accounting. This handbook will get you started and offer tips on good practice and where to find further information.

### **Who is the handbook for?**

If you are starting up a small business or you are the manager or owner of an existing small business then this handbook is designed for you. It is intended to provide you with information and advice on what you need to know, and do, to keep basic accounts and how to use them to help manage your business.

If you are taking over an existing business the previous owner will already have been keeping records, perhaps using the same books and

procedures, for several years. We recommend that you look closely at whatever files and records you take over and then decide with the aid of this handbook how you wish to organise your business records.

If your new business is a limited company then you will need to take professional advice about your responsibilities for keeping accounting records and the form that they should take. This is because there are legal and regulatory obligations on the directors of limited companies to ensure that the financial affairs of the company are conducted properly according to current legislation. It is outside the scope of this handbook to provide you with such advice but the information contained here about basic books and records is relevant nonetheless.

## **What the handbook offers**

By the end of the handbook you should be able to:

- ◆ understand the nature and content of the cash book and other financial records you need for your business;
- ◆ keep simple accounting records yourself;
- ◆ understand and interpret basic financial statements;
- ◆ understand how to use your accounting records to help you manage your business.

## **Assumptions**

You may be relieved to learn that it is not the intention of this handbook to train you in the theory and practice of accounting and finance. There are plenty of courses available at your local college or University if you wish to study the subject. The sections that follow are based on these assumptions:

- ◆ you are a manager or owner starting up or running a small business for the first time;
- ◆ you have little, or no previous knowledge or experience in keeping accounting records or preparing business accounts;
- ◆ you want to learn how to keep simple records and use financial information yourself;
- ◆ your time is at a premium.

After reading section 1 you may decide that your business cannot afford the time you would need to spend bookkeeping. Even if you arrange to employ the services of an agency, employ a bookkeeper part-time or full-time or ask your accountant to keep the books you will benefit from knowing how the records are prepared and how to use the financial information yourself to manage the business.

## How to use the handbook

The sections are arranged to provide a step by step guide to the key books you should keep. Clearly, businesses vary in size and complexity and these two factors, together with nature of your business, will dictate what kinds of records you need. We recommend that you work through Section 1 in order to gain an overview of bookkeeping and accounts. Then use the table at the end of that section to help you decide what books and records you need to keep and how best to use the rest of the handbook.

Throughout the sections that follow we have used some standard terms for the sake of simplicity. They are listed here, together with similar terms that you may be using in your business:

<b>Term used</b>	<b>Similar to</b>
Customer	Client, user, patient
Sales	Takings, turnover, fees, fee income
Purchases	Goods, materials, raw materials
Stock	Unsold purchases, finished goods, (in the USA the term 'inventory' is commonly used)
Motor expenses	Road fund tax, insurance, MOT fee, fuel, servicing and repairs
Sundry expenses	Small items of expenditure, often called 'miscellaneous' expenses, that do not fit neatly into any category or cash book heading

## **Tips - before you begin Section 1**

There are at least two steps that every business is obliged to take in order to get started on a firm footing with the Inland Revenue and HM Customs & Excise. These are to:

- ◆ inform the Inland Revenue that you are setting up in business and how many, if any, employees you intend to employ. To find your nearest office, look under Inland Revenue in your local telephone book;
- ◆ contact your local VAT office and let them know of your new business start-up. They will be able to advise you if you need to be registered. If you neglect to inform the VAT office and they later discover that you should have registered, they can demand that you pay VAT on your taxable supplies regardless of the fact that you did not charge VAT to your customers. In addition, you may also receive a fine. We explain more about VAT in later sections.

**Use this space for your own notes**

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# A Practical Accounting Handbook for Start-up Businesses

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# **Section 1: Why keep books and accounts?**

## **About this section**

In this section we explain why you should keep records for your business. You will learn about the basic records that suit your business needs and how to go about setting them up. At the same we shall introduce some terms that you are likely to meet in conversation with your business customers, suppliers and your bank manager.

Starting up in business is a time when all your efforts are focussed on attracting customers, finding premises and setting up accounts with suppliers. It is easy to overlook the importance of keeping track of all the transactions as they take place by keeping records. However, if you fail to do this you risk wasting time and effort at a later stage trying to remember what you spent, and when, and where the cash came from that you paid into the business bank account. You will also lack valuable information to help you manage your business.

## **Why keep records?**

You need to keep records for your own use and to provide information to other people.

For your own use you will need to:

- ◆ keep track of income and spending in order to know how much cash you have available;

- ◆ monitor your cash flow in order to avoid running up an unplanned overdraft with your bank;
- ◆ keep up-to-date with how much your customers owe you so that you can anticipate bad debts before they arise (a single very large bad debt could put you out of business);
- ◆ know which customers are slow to pay and exercise control by chasing them for payment;
- ◆ keep up-to-date with how much you owe suppliers so that you do not incur additional interest charges for late payment or run the risk of losing your credit status;
- ◆ know when you are likely to reach your credit limit with suppliers and thereby avoid delays in deliveries of goods you have ordered (failure to have the necessary supplies could lead to you losing a customer order);
- ◆ measure your profit so that you can see if you are meeting your business plan targets.

You will also need:

- ◆ to provide information and evidence to the Inland Revenue about your taxable profit. Failure to do so can lead to penalties and the Inland Revenue can insist on payment of tax based on their own assessment of your profit, in the absence of satisfactory evidence from you. If you engage an accountancy firm they will need to see and use your records

in order to calculate your taxable profit for Inland Revenue purposes on your behalf;

- ◆ if you are or should be registered for VAT purposes, to provide the necessary information and evidence to H M Customs and Excise (again, failure to do so can lead to penalties and payment of VAT based on HM Customs estimates of your VAT liability);
- ◆ to provide a financial history of your business to support loan requests;
- ◆ to have evidence of the profitability of your business to support your negotiations with a prospective purchaser should you decide to sell up.

For all these reasons, and above all because you need to protect the time and money that you are investing and steer the business in the direction of increasing wealth and profitability, you need to have clear, complete and correct accounting records.

## **What records?**

You should keep written details of what the business spends on

- ◆ goods for resale,
- ◆ materials,
- ◆ wages,
- ◆ telephone bills,
- ◆ printing costs;

and everything else that you need and must buy in order to carry on your business. If you do not pay for items when you receive them, for example by cash on delivery, or over the counter in a retail store, you also need to keep records to find out how much you owe on a day-to-day basis.

Similar details must be kept of all money you receive from customers and how much cash is due to you from them, again ideally on a day-to-day basis as the money comes in from customers.

In addition, if you are registered for VAT you will need to comply with HM Customs and Excise requirements on the type of records you keep.

## **Which books to use**

In the early stages of a business it is usually sufficient to keep a record of:

- ◆ receipts (from sales and any other business income);
- ◆ payments (for purchases, expenses and any other business expenditure);

in a simple cash book.

As the business grows, more information needs to be recorded. For example, an order book to record customer's orders, a petty cash book to record small daily cash payments, a wages book and some stock records may be needed.

If you offer credit to customers, i.e. goods are paid for at an agreed time after receiving the goods, then accounts for each customer need to be kept. This will mean using double-entry book-keeping, a technique used by

accountants for credit sales and also for other transactions such as credit purchases.

## **Using computers**

If your business involves the use of computers then you may prefer to keep your accounts on computer straight away and not use hand-written records at all. This is an excellent idea provided that:

- ◆ you have access to the necessary accounting software and have the time and skills necessary to use it effectively;
- ◆ if you do not wish to use proprietary accounting software, you have the expertise to design a 'one-off' accounting system, based on standard business software such as Microsoft Excel.

This latter option carries the risk that if you are not entirely clear about the records you need to keep, then you may find that you do not have evidence to satisfy customer queries, the Inland Revenue's minimum requirements and, last but not least, your own management information needs.

There are hundreds of software accounting packages currently available for small businesses. Many of the business and PC magazines carry advertisements for accounting software with offers of free trials and demonstrations. If you do not have experience of this market you are strongly advised to consult an accountant, financial advisor or an experienced friend or business colleague before committing to purchase equipment or software.

If your business has Internet access you will find that the Internet offers a variety of options for small businesses, from web-based book-keeping services to consultancy advice and financial planning. You will need to spend some time and effort investigating the best options for your business and satisfying yourself about the quality, security and confidentiality of the services offered. There is a list of web-sites that offer help and advice to businesses (see 'Help from the Internet' in 'Useful Information') at the end of this handbook). Please note, however, that US websites may offer information and advice that is not appropriate to UK businesses and may not fulfil your particular needs.

## **Summary**

Now that you have worked through this section you have an understanding of why you should keep records for your business. You should also now be able to decide what basic books you need to keep.

Section 2 looks at different types of cash books and how to use them.

## Tips - before you begin Section 2

To be useful the records must be complete, correct and clear.

It is essential to keep all receipts, invoices or other documents that are proof of your business payments, as well as the till roll readings, copy bills or copy invoices for your own goods sold or services provided. The best tip to remember is - keep everything!

### ***How to decide what records and books are best for your business***

A good rule to apply when setting up your first set of books is - keep it simple! An overly complex approach will take up much valuable time better spent on getting your business started and you can easily develop and expand your accounting systems as your business grows.

The following rough guide may help you decide what books you need initially:

<b>Frequency and type of transactions</b>	<b>Books needed</b>
A few straightforward receipts and payments a week, no employees.	Simple cash receipts book with either a simple or analysed cash payment book

Frequency and type of transactions	Books needed
Some credit sales and/or credit purchases on a regular basis in addition to cash receipts and payments; some employees.	Analysed cash receipts and payments books plus sales and purchase books; accounts for individual customers and suppliers; payroll
Growing volumes of sales invoices raised, purchases made frequently with a number of regular suppliers, together with other receipts and payments, plus employees.	A full double-entry bookkeeping system, manual or computerised, needs to be maintained, with payroll and stock records.

**Use this space for your own notes**

## Section 2: Basic records - cash books

### About this section

In this section we show you how to set up the most important part of your bookkeeping system, the cash book. We will look at a variety of different types of cash books so that you may choose the one most suitable for your business.

### What are cash books?

The first thing to learn about cash books is that they are used for recording all business payments and receipts, no matter how the transactions are made.

Your business may receive cash in many ways, for example:

- ◆ cheques from customers that you then pay in to your bank account;
- ◆ automatic receipts credited to your business bank account following authorisation by you and the payer;
- ◆ cash paid to you that you then pay in to your business bank account;
- ◆ cash paid to you that you retain for making your own cash payments.

All of these must be recorded in the **receipts cash book**.

Similarly, your business pays out cash in a variety of methods, for example:

- ◆ cheques written on your business bank account and sent to suppliers;

- ◆ authorised payments made on your behalf from your business bank account, e.g. direct debits;
- ◆ payments of cash for smaller items.

For these you will need a **payments cash book**.

A typical cash book is ruled in columns and holds details of receipts and payments. Your local stationery supplies retailer should be able to show you a range of cash book stationery. Alternatively you can create your own cash book by buying plain stationery and drawing up the columns you need.

### **Simple cash receipts book**

In order to record the basic information about sales and other business receipts a minimum of three columns is normally needed for the cash receipts book:

- ◆ the date of the receipt,
- ◆ the amount,
- ◆ from whom the amount was received.

In addition, a reference column is useful because it allows you to record details of the nature of the receipt or where any related information is kept.

A very simple cash receipts book for a week for a retail shop making cash sales might look like this:

Cash Receipts			
Date	From	Reference	Amount
<b>October</b>			£
1	Monday		172.50
2	Tuesday		319.00
3	Wednesday		368.75
4	Thursday		318.50
5	Friday		399.00
6	Saturday		523.60
	Total		2,101.35

The reference column could be used to cross reference the cash register till rolls so that a link is made between the entries in the cash book and the evidence of the sales made. The till rolls can then be stored together until such time as they may be needed for checking purposes.

Clearly, this simple cash receipts book provides very limited information and in practice more columns are needed to cope with the day-to-day activities of businesses. However, the end result is always the same in that the receipts cash book records all sales and other business receipts as they come in to the business.

## **Analysing receipts**

When a business has receipts other than from sales these need to be separated out in the records so that they are easily identified. These might be for example:

- ◆ amounts paid in to the business from personal savings;

- ◆ loans from friends or relatives;
- ◆ proceeds from the sale of an asset belonging to the business (e.g. machinery, motor car or office equipment);
- ◆ other miscellaneous receipts, such as a refund of an overpayment of an insurance premium;

Unless these receipts are likely to arise on a regular basis then they can all be analysed to the same column with a brief description next to each entry.

The reference column is used to make a note of where to find the back-up record that provides an explanation of the nature of the receipt. The entry here could be related to a cash register till roll, a receipt issued or a letter from the insurance company etc. depending on the nature of the receipt.

Cash Receipts						
Date	From	Reference	Amount	Sales	Other	
<b>October</b>			£			
1	Monday	sales 1	172.50	172.50		
1	D Smith	receipt r1	5,000.00		5,000.00	loan
2	Tuesday	sales 2	319.00	319.00		
3	Wednesday	sales 3	368.75	368.75		
3	Insurers plc	letter 3/10	600.00		600.00	refund of premium
4	Thursday	sales 4	318.50	318.50		
5	Friday	sales 5	399.00	399.00		
6	Saturday	sales 6	523.60	523.60		
	Total		7,701.35	2,101.35	5,600.00	

Note that each receipt is recorded in the 'Amount' column and also in the relevant analysis column. Also, there is a separate total for each column for 'Sales' and 'Other receipts' and a grand total to represent all the cash received for the first week in October. This may appear to you to be pointless but it is good practice because you will not overlook making entries in the amount column for receipts that need to be analysed over more than one column.

Finally, it is unlikely that you will bank each cash receipt separately as you receive it. It is far more likely that you will accumulate cash and cheques and bank them regularly (see Check your Bankings later in this section.)

## Simple cash payments book

The layout is very similar to the cash receipts book:

<b>Cash Payments</b>		
<b>Date</b>	<b>Paid to</b>	<b>Amount</b>
<b>October</b>		<b>£</b>
1	Landlords ltd	2,000.00
1	Supplies & Co	1,750.00
1	W H Smith	120.00
3	Supplies & Co	600.00
5	Corner Shop	25.00
6	Acme Garage	40.00
	Total	4,535.00

As with the cash receipts book, it becomes necessary to have:

- ◆ a reference column to keep track of the proof for the payment, and

- ◆ a column to record what the payment was for.

Cash Payments				
Date	Paid to	Reference	Amount	
<b>October</b>			<b>£</b>	
1	Landlords ltd	1	4,000.00	3 month's rent
2	Supplies & Co	2	1,750.00	goods purchased
2	W H Smith	3	35.00	stationery
3	Supplies & Co	4	600.00	goods purchased
5	PC Products	5	140.00	printer for PC
6	Acme Garage	6	25.00	petrol
		Total	6,550.00	

The cash payments book will probably fill quickly with a variety of different payments and extra columns are needed in order to see how much is being spent in different areas.

### **Analysing cash payments**

The amount of detailed analysis depends on the quantity and depth of information that you want to produce. For example:

Cash Payments								
Date	Paid to	Ref	Amount	Purchases	Rent & rates	Printing & Stationery	Motor Expenses	Other Expenses
<b>October</b>			£	£	£	£	£	£
1	Landlords ltd	1	4,000.00		4,000.00			
2	Supplies & Co	2	1,750.00	1,750.00				
2	W H Smith	3	35.00			35.00		
3	Supplies & Co	4	600.00	600.00				
5	PC Products	5	140.00					140.00
6	Acme Garage	6	25.00				25.00	
			6,550.00	2,350.00	4,000.00	35.00	25.00	140.00

A typical analysed cash payments book has columns for:

- ◆ Purchases
- ◆ Sub-contractors
- ◆ Wages
- ◆ Payments to Inland Revenue for tax and National Insurance contributions
- ◆ Rent and rates
- ◆ Heat and Light (electricity and other power supplies)
- ◆ Insurance
- ◆ Telephone
- ◆ Printing and Stationery

- ◆ Advertising
- ◆ Motor expenses
- ◆ Travelling expenses
- ◆ Bank charges (including interest)
- ◆ and a column for Other Expenses that do not fit neatly into the other columns.

Any one or more columns can be combined to save space. Experience will show you the columns and headings that are appropriate for your business.

### **Do you need a petty cash book?**

To ensure that a complete record is kept of all cash payments you may need what is known as a 'petty' cash book. A petty cash book will help to record all small items e.g. postage stamps, car park fees.

It is important to ask for a receipt, and to keep your receipts, however small the amount might be.

<b>Petty Cash Payments</b>		
<b>Date</b>	<b>Paid to</b>	<b>Amount</b>
<b>October</b>		<b>£</b>
2	Stamps	5.00
2	Parking fees	1.00
4	Coffee and tea	6.75
5	Stationery	10.50
	<b>Total</b>	<b>23.25</b>

## Separating cash and cheque payments

If you do not make many small payments of cash and do not need a petty cash book you can combine the two in your payments cash book. By adding a couple of extra columns you can keep track of cheques, cash payments and direct debits more easily. The reference column can then hold details of cheque numbers and cash payment receipts.

Cash Payments						
Date	Paid to	Reference	Amount	Cheques	Cash	
October			£			
1	Landlords ltd	chq no 01	4,000.00	4,000.00		3 month's rent
2	Supplies & Co	chq no 02	1,750.00	1,750.00		goods purchased
2	W H Smith	cash1	35.00		35.00	stationery
3	Supplies & Co	chq no 03	600.00	600.00		goods purchased
5	PC Products	chq no 04	140.00	140.00		printer for PC
6	Acme Garage	cash 2	25.00		25.00	petrol
		Total	6,550.00	6,490.00	60.00	

The further analysis columns in the cash book can then be added. It is not uncommon for the payments cash book to have ten or twelve columns to hold the level of detailed analysis required by the business. Experience will show you how many columns will prove useful to you.

## Recording automatic payments out of your bank account

Payments that are made from your business bank account with your authorisation must also be recorded in the payments cash book, if it is to be

a full record of your business outgoings. There are typically two different types of such payments:

- ◆ periodic payments of a regular amount, such as a loan repayment, normally debited from your account on the same date each month, for example insurance premiums paid monthly;
- ◆ direct debits that you have authorised suppliers to take out of your account in payment for goods or services supplied to your business; these are likely to be for varying amounts.

The simplest way to keep track of such payments is to keep a summary in your cash book on a separate page at the front or back of the book. List all these payments, and note

- ◆ the day of the month they are normally due to be paid;
- ◆ the commencement date and finish date for each agreement;
- ◆ the amount, if a regular payment.

Where the amount may vary make a note of the upper limit you have authorised. When you receive your bank statement, check that the payments have been made according to your instructions and enter them in the cash book.

## **Check your Bankings**

In order to check that amounts paid in to your bank account are correctly credited you will need to compare your bank statements with the entries in

the receipts cash book. Recording a little more detail in the receipts cash book will save you time when doing this check.

In the receipts cash book, add an extra column to show how much you paid into the bank, and when. Then, as you record your receipts, group them in date order and list together the individual amounts that make up a particular banking.

<b>Cash Receipts</b>							
<b>Date</b>	<b>From</b>	<b>Reference</b>	<b>Amount</b>	<b>Banked</b>	<b>Sales</b>	<b>Other</b>	<b>Comments</b>
<b>October</b>			£		£	£	
1	Monday	sales 1	172.50		172.50		
1	D Smith	receipt r1	5,000.00	5,172.50		5,000.00	loan
2	Tuesday	sales 2	319.00		319.00		
3	Wednesday	sales 3	368.75		368.75		
3	Insurers plc	letter 3/10	600.00	1,287.75		600.00	refund of premium
4	Thursday	sales 4	318.50		318.50		
5	Friday	sales 5	399.00		399.00		
6	Saturday	sales 6	523.60	1,241.10	523.60		
	Total		7,701.35	7,701.35	2,101.35	5,600.00	

In this way you can be certain that cash or cheques received have not been overlooked and that all the bankings shown on your bank statements are correct. Of course, if you keep cash back to use for payments then you need to make a note of how much, so that you know why the total bankings do not equal the total amount for receipts.

## Running balances

A running balance is a way of keeping a check on the totals of your receipts and payments on a regular basis. You can calculate a weekly or daily running balance or even keep track of the balance in your cash book following each receipt and payment.

All that you need to do is take the date and amount columns from the receipts cash book and the payments cash book and compare them:

Cash Receipts		Cash Payments		Running balance	
Date	Amount	Date	Amount	Date	
October	£	October	£	October	£
1	172.50	1	4,000.00		
1	5,000.00			1	1,172.50
2	319.00	2	1,750.00		
		2	35.00	2	-293.50
3	368.75	3	600.00		
3	600.00			3	75.25
4	318.50			4	393.75
5	399.00	5	140.00	5	652.75
6	523.60	6	25.00	6	1,151.35
Total	7,701.35		6,550.00		

There is usually space for the running balance column in the receipts cash book.

## **Using a spreadsheet**

If you have a computer and are familiar with the operation of spreadsheet software then you may prefer to create your cash book on computer. The advantages of using a spreadsheet are:

- ◆ entries are easy to make and regular payments such as direct debits and standing orders can be entered once and copied;
- ◆ the totals are calculated automatically, saving you time;
- ◆ running balances can be generated by replicating a simple formula.

It is not advisable to use a single spreadsheet for your cash book unless you only expect to make a few entries each month. Although the power of the software will not be a limiting factor the spreadsheet could become very large indeed and this will make cell navigation slow and unwieldy.

## **Summary**

In section 2 we explained about the different ways you can keep your business cash books. It may be that your particular type of business requires a specialist cash book. Some stationery suppliers sell cash books and other bookkeeping stationery designed for particular businesses, for example retail shops. We advise you to look at the range of stationery on offer at a number of different suppliers and discuss your needs with the customer sales staff.

Section 3 introduces you to the sales and purchase ledgers. If you do not intend to offer credit to customers or take credit from suppliers then you do not need to study this section in detail.

## **Tips - Before you begin Section 3**

### ***Dealing with larger volumes of cash receipts***

Some businesses have such large volumes of cash transactions that daily sheets may be needed to record receipts, and only the daily totals are entered in the cash book. If a cash register is used then the till roll total (often called the 'Z' total) gives the daily total takings figure for the receipts cash book.

### ***Keeping cash on your premises***

We strongly recommend that you obtain a safe if you keep any quantities of cash on your premises or are not able to visit your bank easily on a daily basis. If you do decide to use a safe then make sure that it is included in your business insurance cover.

### ***Petty cash***

Often, if the receipt is in the form of a till roll, only the date and the amount will be shown. Make a note on the receipt of what has been purchased, otherwise you will probably not remember, later, when you write up the petty cash book.

### ***Payments from your own pocket***

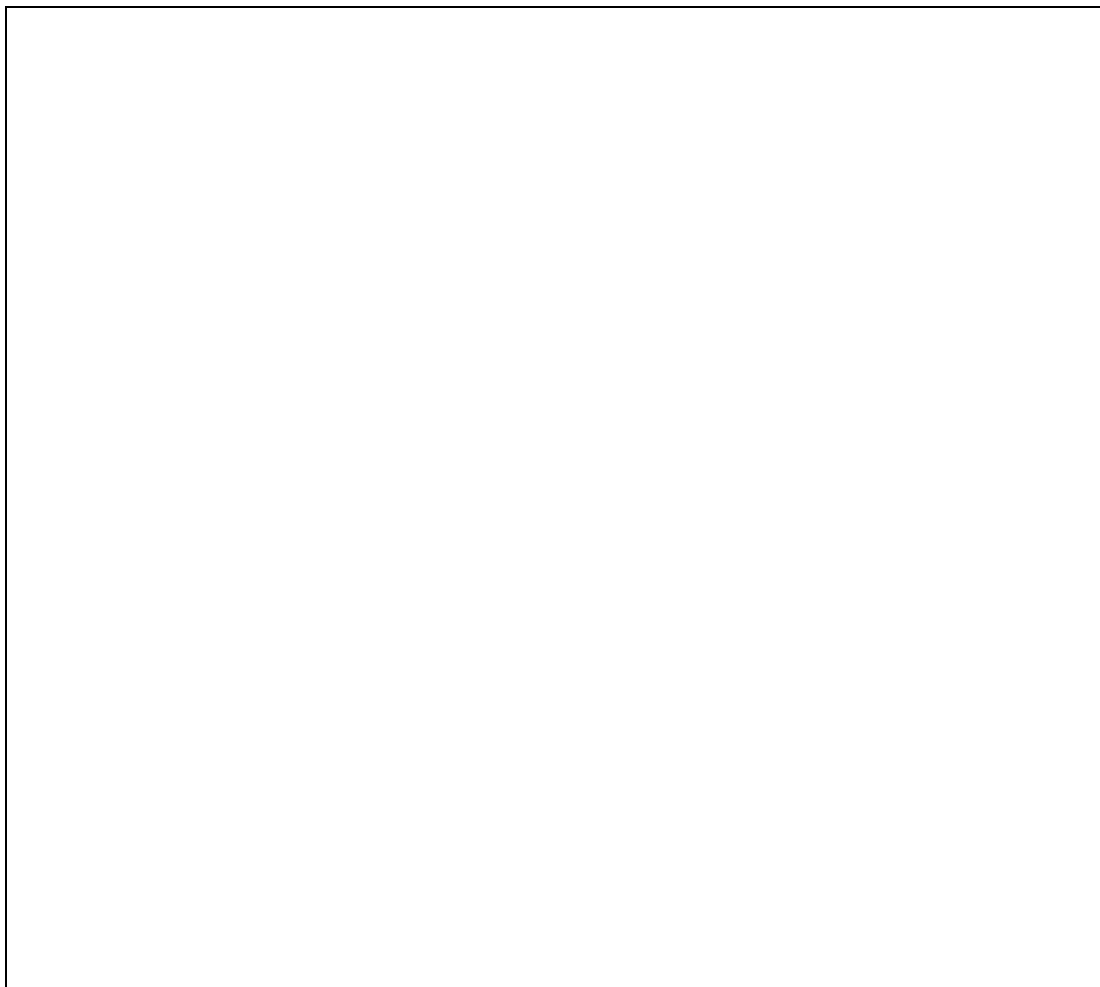
If you make payments for business expenditure (goods or services used by the business) out of your own pocket, either by cash or cheque, or using your own credit card account, you must keep a full record of how much you paid, and when, together with a clear receipt. Your business can then re-

imburse you for the amount and it can be entered in the cash payments book in the normal way.

### ***Using spreadsheets***

It is not advisable to use a single spreadsheet for your cash book unless you only expect to make a few entries each month. Although the power of the software will not be a limiting factor the sheet could become very large and difficult to manage. Instead, create a master worksheet to store your template and copy it to a new sheet each time you begin a new month (or week if you intend to keep weekly records).

### **Use this space for your own notes**

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## **Section 3: Beyond cash books - Sales and Purchases**

### **About this section**

You may decide that a cash book will be sufficient to hold all the details of the financial records of your business. If that is the case then you need not refer to this section. However, if you

- ◆ offer credit to customers;
- ◆ have accounts with suppliers;
- ◆ are a registered person for VAT purposes;
- ◆ have a range of goods that you hold in stock;

then you will need to devise a system for keeping track of all these business activities. This may involve little more than a simple paper system for filing invoices and receipts. If you need to take a more sophisticated approach then this section will help you find out more about the following record books and how to complete them:

- ◆ accounts;
- ◆ sales book, with or without VAT;
- ◆ personal customer accounts;
- ◆ purchases book , with or without VAT;

- ◆ personal supplier accounts.

Although you have no need to study the principles of accounting you may be confronted by some of the technical terms that are used in accounting when you receive invoices and statements from your suppliers or documents from banks and lenders. What follows is a brief explanation of double entry bookkeeping. You can skip this next part if you prefer and move on to find out what accounts you may need to keep.

## **What is double-entry bookkeeping?**

**Book-keeping** is the recording of information on a day-to-day basis.

**Accounting** then uses this information to find out about the progress of the business, by calculating the profit (or loss) and preparing the balance sheet.

**Double-entry bookkeeping** is based on the concept that every transaction has two aspects:

- ◆ the value given out by the business, in return for
- ◆ equal value being received.

The simplest example of double-entry is what happens when you buy something for cash in a shop. As far as the shop is concerned goods have been handed over to you, the customer, in exchange for the receipt of cash

from you. From your point of view the exact opposite has happened. You have given out the cash and received goods of equal value.

**Accounts**

The basic record of double-entry bookkeeping is called an account. Since accounts were typically kept in a book known as a ledger they are often referred to as 'ledger accounts' but this term is now falling into dis-use.

The format of an account is as shown here. This is a personal supplier account. It shows on the right-hand side the invoices from the supplier and on the left-hand side what payments have been made to the supplier. There are separate columns for the amount of value in and value out. The date and description of each entry are also included:

<b>Supplier Name:</b>							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
<b>(payments made to the supplier)</b>				<b>(invoices from the supplier)</b>			
			£				£
				Jul 3	Purchases	PB1	940
				Jul 17	Purchases	PB5	1,110
Jul 30	Cheque	CB32	2,000				

The reference column is a sign-post to tell the reader where to find:

- ◆ the entry in the cash book for details of the cheque paid (CB32);
- ◆ the entry in the purchases book for details of the invoice received.

A separate account is needed for each supplier.

Every transaction is recorded in the account for the particular heading it affects. Everything should be recorded in date order, and should show the amount of the transaction being recorded.

Because there are always two parts to a transaction, all transactions have a two-fold effect on the accounts. This means that every transaction must be recorded in two accounts, a fact that explains why the process of recording is referred to as double-entry bookkeeping. There are plenty of examples of this two-fold effect in this section.

## **Sales books and purchases books**

The basic idea of these books is that when sales or purchases are made on credit (that is, the payment is not made in exchange for the goods at the time goods change hands) a record is made.

The entries for a single sale are:

- ◆ date
- ◆ invoice number
- ◆ customer name

- ◆ amount

The entries for a single purchase are:

- ◆ date
- ◆ invoice number
- ◆ supplier name
- ◆ amount

The entering of the transactions can take place at a later date.

### Example Purchases book for October

Page 1					
Date	Supplier	Ref	Goods	Vat	Total
			£	£	£
Oct 1	Argenti & Co		200	35	235
Oct 11	Bronze Ltd		600	105	705
Oct 20	Cornish & Co		1,000	175	1,175
Oct 31	Devonia plc		<u>800</u>	<u>140</u>	<u>940</u>
	Total		<u>2,600</u>	<u>455</u>	<u>3,055</u>

Sales and purchases books are used to record as much detail as a business needs, descriptions, serial numbers and anything else appropriate. They can also show summaries that can be used to update the personal supplier and

customer accounts in total. In this way the accounts are kept as straightforward as possible.

These books are used in most businesses. This is because in addition to the advantages mentioned above they enable the business to operate more efficiently. For example:

- ◆ The books can be kept by someone with no specialist bookkeeping or accounting knowledge, provided the person can copy information and do simple arithmetic. Even these skills are not necessary where a computerised accounting system is in operation.
- ◆ A full record is kept of all original invoices. By using cross references any entry in the accounts can be traced right back to the original invoice. This provides what is known as the audit trail for the accounts to be checked. It also enables the bookkeeper to answer queries about the accounts more easily.

Sales and purchases books are often called sales **day** books and purchase **day** books because they are used to record transactions on a daily basis as they take place.

### **Using the information from the sales and purchases books**

Basically the sales and purchases books are used to 'post', that is, make entries in the accounts, using sub-totals and summaries made in the books.

Each of the books is used in a slightly different way and we will be looking at them in turn. You will see that the accurate use of references now becomes important to the successful operation of a book-keeping system.

### **The purchases book and the personal supplier accounts**

As we have explained the purchases book is used to list and summarise invoices received from credit suppliers.

The reason why only the invoices for purchases on credit are included is that without this entry there would be no record of credit purchases in the book-keeping system at all. Only cash purchases are recorded in the cash book. Credit purchases, by their nature, do not involve cash at the time of purchase and so are not recorded in the cash book. It may be weeks, or sometimes even even months before the supplier requests payment, by which time it might be impossible to keep track of how much is owed.

The following example shows how the entries are made in a personal supplier account. Remember that in reality there will be many more invoices than this processed by a business. There would be no point in operating a system like this for just a few entries.

## Example Purchases book

Page								1
Date	Supplier	Ref	List	Trade	Net	Vat	Total	
				Disc				
			£	£	£	£	£	£
Oct 1	Argenti & Co		240	40	200	35	235	
Oct 11	Bronze Ltd		690	90	600	105	705	
Oct 20	Cornish & Co		1,500	500	1,000	175	1,175	
Oct 31	Devonia plc		800	-	800	140	940	
	Total		<u>3,230</u>	<u>630</u>	<u>2,600</u>	<u>455</u>	<u>3,055</u>	

Before any of these figures are posted we should check the totals of all columns and rows (called down and cross casting) of figures to double check the grand total of £3,055. This will save problems later.

There are no page references at this stage. This is because we have not yet made the postings to the ledger accounts. Some of the figures can be posted into the accounts at the end of the month, or when a page is filled. They do not have to be posted immediately the invoices are received.

The purchases book should be entered on a daily basis as should the personal accounts. This is to keep the balances on these personal accounts as up-to-date as possible.

The personal accounts show how much is owed to creditors, so you must post the actual amounts owed to Argenti & Co, Bronze Ltd, Cornish & Co and Devonia plc. All these accounts will be in the purchase ledger. As the posting is made you cross reference by putting the appropriate personal account page reference in the purchases book as shown below:

### Purchase ledger

PL1 - Argenti & Co							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
				Oct 1	Purchases PB1		235

and the reference in the purchases book will be entered as:

### Purchases book

Page								1
Date	Supplier	Ref	List	Trade	Net	Vat	Total	
				Disc				
			£	£	£	£	£	
Oct 1	Argenti & Co	PL1	240	40	200	35	235	

PL1 stands for purchase ledger account number 1. Most systems, particularly computerised ones, have more complicated references, including an alphanumeric element, but the general principle is the same.

The other three purchase ledger accounts will be posted as shown:

PL2 - Bronze Ltd							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
				Oct 11	Purchases PB1		705
PL3 - Cornish & Co							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
				Oct 20	Purchases PB1		1,175
PL4 - Devonian plc							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
				Oct 31	Purchases PB1		940

Notice that the dates used in the personal accounts reflect the dates on which the invoices were received and entered in the purchases book.

Although the total figure in each case is made up of an amount for the purchase and for VAT, there is no need to separate the two figures in the personal account.

The reason why VAT is not recorded in the personal account is that the account shows only the total amount owed to the supplier. It does not matter how the amount is made up. VAT will be posted to the VAT account in the

general ledger and the net amount to the purchases account in the general ledger. The total of these two amounts, net and VAT will, of course, equal the amount owed to the supplier.

We will continue to use the most straightforward reference PB1 standing for purchase book page 1, as above, and PL1 for purchase ledger account number 1. In some systems each line in the purchases book has a unique reference number to make the audit trail even more precise.

### Purchases book

Page							1
Date	Supplier	Ref	List	Trade	Net	Vat	Total
					Disc		
			£	£	£	£	£
Oct 1	Argenti & Co	PL1	240	40	200	35	235
Oct 11	Bronze Ltd	PL2	690	90	600	105	705
Oct 20	Cornish & Co	PL3	1,500	500	1,000	175	1,175
Oct 31	Devonia plc	PL4	<u>800</u>	-	800	140	<u>940</u>
Total			<u>3,230</u>	<u>630</u>	<u>2,600</u>	<u>455</u>	<u>3,055</u>

Since in most, if not all, cases the postings will be to the purchase ledger, the reference is often just the account number.

One of the advantages of using a purchases book is to keep unnecessary detail out of the ledger by totalling similar entries whenever possible. In the

purchases book we can match all the postings to the personal accounts in the purchase ledger with just two entries, one for purchases and one for VAT.

Both of these accounts are in the general ledger.

The entries will look like this:

**General ledger A/c 1 - Purchases**

Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
Oct 31	Total	PB1	2,600				
	for the month						
General ledger A/c 3 - VAT							
<b>Input tax</b>				<b>Output tax</b>			
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
Oct 31	Total credit	PB1	455				
	purchases						
	for the month						

Notice that the dates and narratives used in each instance indicate that these postings are totals for a period. We have shown the narratives here in full but in practice they are usually abbreviated.

You should bear in mind that these are only part of the whole picture. During the month there may be many other entries on these accounts, for example cash purchases.

The VAT account has the two sides labelled to show input tax on purchases and other expenses, and output tax on sales and other income. The VAT account is like a personal account for HM Customs and Excise who administer the tax.

The final step is to enter the general references in the purchases book. The completed page will now look like this:

### Purchases book

Page							1
Date	Supplier	Ref	List	Trade Disc	Net	Vat	Total
			£	£	£	£	£
Oct 1	Argenti & Co	PL1	240	40	200	35	235
Oct 11	Bronze Ltd	PL2	690	90	600	105	705
Oct 20	Cornish & Co	PL3	1,500	500	1,000	175	1,175
Oct 31	Devonia plc	PL4	800	-	800	140	940
	Total		<u>3,230</u>	<u>630</u>	<u>2,600</u>	<u>455</u>	<u>3,055</u>
					GL1	GL3	

You will notice that there are only two references for the total line. The other column totals, for list price, trade discount and total are there for information but do not form part of the double entry for the ledger.

## The sales book and the personal customer accounts

As you might expect the sales book is posted in the same way as the purchase book except that now there are personal debtor accounts for customers whereas before there were personal credit accounts for suppliers.

### Example Sales Book

Page							4
Date	Customer	Ref	List	Trade Disc	Net	Vat	Gross
			£	£	£	£	£
Jan 1	A Angliss		300	100	200	35	235
Jan 15	B Barton		1,200	200	1,000	175	1,175
Jan 29	C Cole		400	-	400	70	470

The completed page in the sales book should be:

<b>Page</b>							<b>4</b>
<b>Date</b>	<b>Customer</b>	<b>Ref</b>	<b>List</b>	<b>Trade</b>	<b>Net</b>	<b>Vat</b>	<b>Gross</b>
				<b>Disc</b>			
			£	£	£	£	£
Jan 1	A Angliss	SL1	300	100	200	35	235
Jan 15	B Barton	SL2	1,200	200	1,000	175	1,175
Jan 29	C Cole	SL3	<u>400</u>	-	<u>400</u>	<u>70</u>	<u>470</u>
	<b>Total</b>		<u>1,900</u>	<u>300</u>	<u>1,600</u>	<u>280</u>	<u>1,880</u>
					GL2	GL3	

The next step is to prepare the personal accounts. These are debtors and the accounts will be in the sales ledger.

SL1 - A Angliss							
<b>Date</b>	<b>Detail</b>	<b>Ref</b>	<b>Amount</b>	<b>Date</b>	<b>Detail</b>	<b>Ref</b>	<b>Amount</b>
			£				£
Jan 1	Sales	SB4	235				
SL2 - B Barton							
<b>Date</b>	<b>Detail</b>	<b>Ref</b>	<b>Amount</b>	<b>Date</b>	<b>Detail</b>	<b>Ref</b>	<b>Amount</b>
			£				£
Jan 15	Sales	SB4	1,175				
SL3 - C Cole							
<b>Date</b>	<b>Detail</b>	<b>Ref</b>	<b>Amount</b>	<b>Date</b>	<b>Detail</b>	<b>Ref</b>	<b>Amount</b>
			£				£
Jan 29	Sales	SB4	470				

The postings to the general ledger will be:

General ledger A/c 2 - Sales							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
				Jan 31	Total credit	SB4	1,600
					for the month		
General ledger A/c 3 - VAT							
Date	Detail	Ref	Amount	Date	Detail	Ref	Amount
			£				£
				Jan 31	Total credit	SB4	280
					sales for the		
					month		

## Summary

Now that you have completed this section you should be familiar with the purpose and function of the purchase and sales ledger. Even if you do not decide to keep these books yourself but employ a bookkeeper you will have an understanding of the processes involved and what your bookkeeper needs to do.

In the next section we look briefly at wages, VAT and stock records.

## **Tip - Before you begin Section 4**

### ***A paper filing system for customer and supplier records***

If you have only a few customers or suppliers you do not need to go the extent of setting up sales and purchase ledgers. For example, for sales:

- ◆ Take two copies of each sales invoice.
- ◆ File one copy in sales invoice number order (or date order if you do not use invoice numbers) and keep this file as a record of your sales. It is equivalent to your sales book. You can easily find out the total value of your sales at any time by adding up the invoice totals.
- ◆ File the other copy in customer order, either alphabetically or by customer account code if you wish to have a coding system. You will need to file these copies in a consistent order within each personal account so that you can find the most recent invoices for each customer easily.
- ◆ When you receive an amount from a customer, mark up each invoice that is paid by that particular receipt. If an invoice is only part paid then show clearly the balance that is still outstanding.
- ◆ This is equivalent to the sales ledger holding the personal accounts
- ◆ As an extra check, make a note in the receipts cash book of the invoice, or invoices, that are being paid by each receipt.

- ◆ The amounts due to you from customers can be found by summing the unpaid invoices for each customer.

Clearly, if you are registered for VAT this system will not be sufficient and you should seek the advice of your accountant if you are in any doubt.

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## **Section 4: Wages, Stock and VAT**

### **About this section**

This section looks briefly at three topics that you may need to pay attention to if your business:

- ◆ employs people;
- ◆ is, or is likely to be, registered for VAT;
- ◆ carries stock.

### **Wages**

It is important that you understand the difference between wages paid to employees and the amounts that you (and your fellow business partners if you have them), take out of the business. The business belongs to you (and your partners, if any) and so any amounts that you take out for your personal use are considered to be withdrawals of your investment, your capital in the business. They are referred to in accounting terms as 'personal drawings'.

Every time you take cash out of the business you should record it in the payments cash book, just as you would a payment for goods and services.

In summary, you are not an employee of business because you own the business. The Inland Revenue considers you to be self-employed. The tax and National Insurance contributions that you pay are based on the profits of your business, not the amounts you take out as personal drawings.

[If you have formed your business as a limited company then you will already be aware that you are employed by the company in the same way as every other employee. In this case you are not self-employed.]

However, if you employ other people then you will pay them a wage or a salary. This means that you need to keep wages records.

### **Must I record wages?**

It is not a good idea to take people on in your business without knowing the full implications of your responsibilities as an employer. Regardless of the number of hours a week an individual may work for you (for example, a few hours a week paid for cleaning, a part-time bookkeeper or a salaried salesman) you have legal and statutory obligations.

You are legally required to keep records of all amounts paid to employees, together with deductions of PAYE, National Insurance and Statutory Sick Pay. Full details and instructions on how to keep these records are provided free by the local Inland Revenue office on request.

It is beyond the scope of the handbook to advise on terms and conditions of employment, contractual rights of employers and employees and the implications of other regulations, such as the Health and Safety at Work legislation.

You are strongly recommended to seek professional advice, either from the Inland Revenue or from your accountant or solicitor if you are unsure how to go about employing people in your business.

## **VAT (Value Added Tax) explained**

VAT is a tax businesses charge when they supply their goods and services in the UK and Isle of Man. It also applies to some goods and services that are imported from outside the European Community (EC) and on goods coming into the UK from another member of the EC.

There are currently three rates of VAT applied:

- ◆ 17.5% of the price of most goods and services
- ◆ 5% on supplies of domestic fuel and power (and on fuel and power used by charities)
- ◆ 0% on supplies like:
  - ◆ most food (except where it is served in restaurants and cafes and hot take-away food and drink counters)
  - ◆ books and newspapers
  - ◆ sales of new homes (and long leases on them)
  - ◆ young children's clothes and shoes
  - ◆ prescriptions and aids for less-abled people
  - ◆ goods exported out of the country.

Everything that has a VAT rate applied is considered a taxable supply, even if the rate is 0%, as with books and newspapers.

Exempt supplies are business supplies that have not VAT charged on them at all. They fall outside the scope of VAT rating. Exempt supplies include:

selling leasing and letting land and buildings (this is not the same as hotel and holiday accommodation and letting garages and parking spaces - these are not exempt supplies)

- ◆ insurance
- ◆ some education and training
- ◆ most services provided by doctors and dentists.

Taxable supplies are all goods and services that are VAT rated, at 17.5%, 5% and 0%.

Taxable turnover is the total value of your taxable supplies. Exempt supplies do not form part of your taxable turnover.

## **VAT registration**

Every business with a turnover above a certain amount must register for Value Added Tax purposes with HM Customs and Excise. A registered business must make a return (monthly, quarterly or annually) giving basically two pieces of information. These are:

- ◆ Your outputs - sales of goods or services made by your business
- ◆ Your inputs - purchases of goods or services made by your business

The difference between the output tax and the input tax determines the liability to tax to the amount of tax to reclaim.

VAT is entered in these accounting records:

- ◆ cash book
  
- ◆ petty cash book
  
- ◆ sales book
  
- ◆ purchase day book

There is no VAT on payments such as wages to your employees and withdrawals of cash for yourself.

The VAT regulations are fully explained in booklets 'Scope and Coverage' and 'General Guide' issued by HM Customs and Excise. They are available free from the local VAT office. As the regulations are very detailed it is worthwhile asking the VAT office to help you to decide if, and how, to register and complete the necessary forms. If your business has taxable turnover that exceeds certain amounts over periods of time you are considered a taxable person and you must then register for VAT.

### **Who registers for VAT?**

If you become a taxable person then VAT registration applies to you and not to your business and covers all parts of your business. You can register as:

- ◆ a sole proprietor (a single self-employed individual)
  
- ◆ a partnership
  
- ◆ a limited company

- ◆ a club or association
- ◆ a charity.

If you have been registered before or if you have another business that is already registered for VAT you should make this clear to HMCE.

The rules on registration for VAT have changed over the years. If you are a taxable person from 1 April 2000 onwards you can work out whether you have to be registered by answering the following questions:

- ◆ At the end of any month, is the total value of the taxable supplies you have made in the past 12 months, or less, more than £52,000?
- ◆ Do you expect the total value of your taxable supplies be more than £52,000 in the next 30 days alone?

If you can answer yes to either of these questions then you need to obtain and complete form VAT1 and send it within 30days to the VAT office.

### **What about stock records?**

If you only carry a few stock items of no great value it may not be necessary to keep stock records. However, by keeping stock records you are able to:

- ◆ avoid running out of stock
- ◆ know the value of your stock
- ◆ avoid over-stocking

- ◆ identify slow moving, unsaleable or lost stock

Unless you are prepared to install a fully integrated accounting system with sales order processing and purchase ordering you will not be able to generate stock records automatically. However, you can keep simple stock records that easily provide you with basic information.

Ideally, the stock record needs to show, for each type of product sold:

- ◆ description;
- ◆ cost per item;
- ◆ date of each receipt of goods and quantity received;
- ◆ date of each sale (or delivery, if earlier than the date you invoice your customer);
- ◆ quantity sold.

### Example

Stock item			Packs of floppy disks			Cost each £25.00	
Received from supplier			Sold to customers			Balance in stock	
Date	Quantity	Total cost	Date	Quantity	Total cost		
October		£	October		£		£
8	50	1,250.00				50	1,250.00
			9	15	375.00	35	875.00
13	40	1,000.00				75	1,875.00
			15	65	1,625.00	10	250.00
24	60	1,500.00	24	5	125.00	65	1,625.00
Total	150	3,750.00		85	6,550.00	65	1,625.00

In this way you can easily see:

how many items you have in stock on any particular day;

the value of these goods at cost price.

If you are buying in materials and producing goods to sell to customers your stock records can show:

- ◆ the quantities of materials you have ready for production;
- ◆ the cost of those materials;
- ◆ the quantities of finished goods you have available for sale;
- ◆ the cost of the finished goods.

## **Summary**

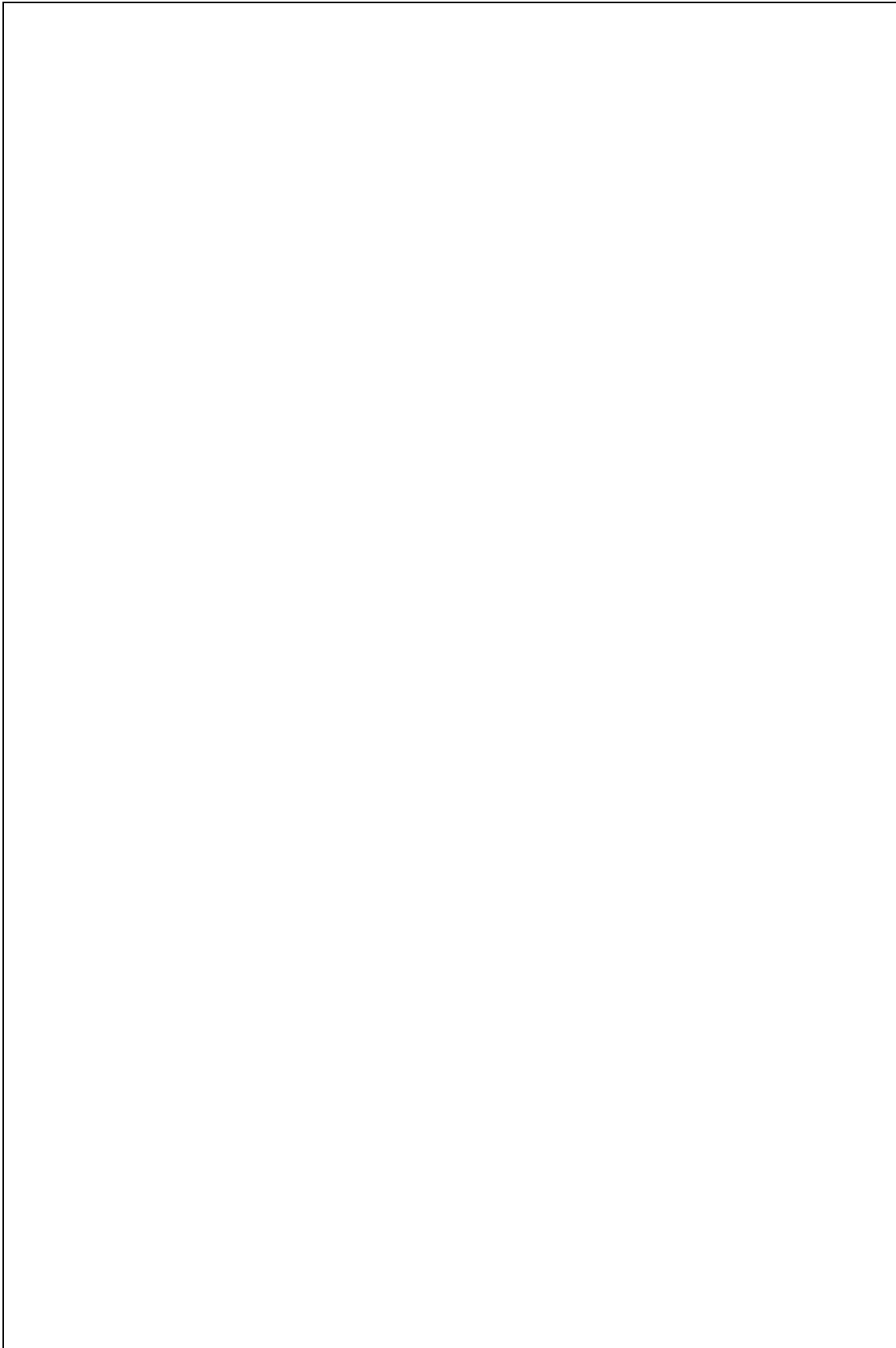
This section offered you a brief explanation of how you should go about employing people and advised you to contact the Inland Revenue for guidance. We explained that you (and your partners if you have any) are self-employed for taxation and National Insurance contribution purposes unless you have formed your business as a limited company

We also provided more information about VAT and reminded you that early registration with H M Customs & Excise was advisable.

Finally we suggested some simple ways in which you can keep track of your stock.

In the final section of this handbook we look at basic financial statements and show you how you can use your accounting records to produce useful information to help you manage your business.

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## **Section 5: Producing Financial Statements**

### **About this section**

In this section we show you how to prepare and use simple financial statements. We also explain how to read and interpret the information in the statements by using some basic financial ratios.

An understanding of the preparation and uses of the financial statements of your business will help you gain skill in using the information when making business decisions. It should also help you in meetings with your bank manager or accountant when you explain and discuss your business plans, seek advice or request an overdraft or loan.

This section will help you to:

- ◆ explain where the information used in the accounts comes from;
- ◆ prepare a simple profit and loss account;
- ◆ describe a simple balance sheet;
- ◆ understand the meaning of some common financial terms;
- ◆ understand how financial ratios relate to business performance.

In earlier sections of this handbook we have shown you how to keep clear, complete and correct records. This is the bookkeeping process and is the first

stage within your business accounting system.

The next stage in the accounting system is to take the information contained in the records and prepare useful financial reports that answer some basic questions about your business:

- ◆ Has the business made a profit, and if so, how much?
- ◆ Considering the money, time and effort put into the business is this profit enough?
- ◆ How much is the business worth, in terms of the assets it owns, or in terms of future potential?

These are questions about the **financial performance** of the business.

The simplest way to help answer such questions is to draw up a trading and profit and loss account.

## **What is a trading and profit and loss account?**

A simple trading and profit and loss account looks like this:

	£	£
Sales		21,000
Less Cost of Sales		13,125
Gross profit		7,875
<u>Less Expenses</u>		
Shop rent	1,200	
Telephone	400	
Advertising	800	
Miscellaneous	1,800	
Depreciation of delivery van	<u>500</u>	
		<u>4,700</u>
Net profit		<u>£3,175</u>

Probably the most important fact to grasp when looking at a trading and profit and loss account is that **profit is not the same as cash**. In other words,

- ◆ the figures for sales do not take into account whether the customers have yet paid for the goods or services

and

- ◆ the figures for purchases and other costs do not take into account whether the business has paid for them yet.

In a profit and loss account we are concerned only with **matching sales with**

**the cost of those sales.**

It is usual to show the profit the business makes from trading, that is, on buying and selling goods, separately from the expenses of the business. Trading profit is referred to as the **gross profit** because not all the expenses of the business have been met.

All the other expenses of the business are deducted from the gross profit to arrive at a figure of **net profit**. All of this information is shown on one account known as the **trading and profit and loss account**.

We will look at the two sections of the trading and profit and loss account separately and then combine them.

### **Example**

Jake sets up a business in July trading in computer floppy disks. He purchases the disks in packs for £25 each and sells them for £40 each over the counter of his rented shop. During the first three months of trading Jake buys 600 packs of disks and sells 175 packs for cash and 350 packs on credit. His business is called Jake's PC Supplies.

We can work out whether Jake has made a profit for the first three months. It will help to look more closely at the sales and purchases for the three months:

Cash sales	175 packs at £40 = £7,000
Credit sales	350 packs at £40 = £14,000
Purchases	600 packs at £25 = £15,000

The first step in calculating the gross profit is to work out how many unsold packs were in stock at the end of September.

You should find this layout useful:

	Packs	Packs
Opening stock at 1 July		0
<u>Add</u> purchases during the three months		<u>600</u>
Total available for sale		600
<u>Less</u> number of packs sold during the three months		
Cash sales (in number of packs, not £)	175	
Credit sales (in number of packs, not £)	<u>350</u>	
		<u>525</u>
Closing stock at 30 September		<u>75</u>

The reason we have used two columns for the figures here is so that each step in the arithmetic can be shown clearly. This is common practice in accounting.

We now have all the information we need to write up a trading account. The completed trading account should look like this:

<b>Jake's PC Supplies</b>		
<b>Trading account: three months ending 30 September</b>		
	£	£
Sales		
Cash sales (175 packs at £40 each =)		7,00
Credit sales (350 packs at £40 each =)		<u>14,000</u>
Total sales (525 packs at £40 each =)		21,000
<u>Less</u> Cost of sales		
Opening stock (0 packs at £25 =)	0	
<u>Add</u> purchases (600 packs at £25 =)	<u>15,000</u>	
Total available for sale		
(600 packs at £25)	1,5000	
<u>Less</u> closing stock (75 packs at £25)	<u>1,875</u>	
		<u>13,125</u>
Trading or gross profit for the three months		<u>£ 7,875</u>

This trading account shows a trading or gross profit of £7,875 for the three months. **Gross** simply means before taking away the other expenses that Jake has incurred in running his business during the same three months.

Note that under **less cost of sales** we are calculating how much the packs

that have been sold have cost Jake. Sometimes this is called **cost of goods sold**.

During the three months Jake spent £800 on advertising and paid £1,200 for three months rent of the shop. His telephone bill for the three months was £400 and he spent £1,800 on items of stationery, and decorations to the shop.

Inserting these figures into the rest of the profit and loss account gives:

<b>Jake's PC Supplies</b>		
<b>Trading and Profit and Loss account</b>		
<b>for the three months ending 30 September</b>		
	£	£
Sales		21,000
<u>Less</u> cost of sales		
Purchases	15,000	
<u>Less</u> closing stock	<u>1,875</u>	
		<u>13,125</u>
Gross profit		7,875
<u>Less</u> Expenses		
Shop rent	1,200	
Telephone	400	
Advertising	800	
Miscellaneous	<u>1,800</u>	
		<u>4,200</u>
Net profit		<u><u>£ 3,675</u></u>

The trading part of the statement has now been simplified from the earlier

versions in this section. The extent of simplification depends on what detail the business (Jake, and his accountant if he has one) finds useful. However, you would not show the actual quantities even in a small business. Sometimes only the phrase **cost of sales** and the amount (in this case £9,600) would be shown.

## **Depreciation in the profit and loss account**

Before we continue with this section, there is one more expense that must be considered.

Jake owns a small van that he bought for £8,100 just before he started trading in July. He uses it to carry his stock to the shop from the wholesalers and to make deliveries to his credit customers. The local garage has told him that it has about four years of useful life left, after which time he will probably be able to sell it for scrap and get about £100.

This value reflects the fact that the van will suffer wear and tear over the four years as Jake uses it in his business to earn profits. We account for this loss in value of the van by charging an expense against profit called **depreciation**.

There are many ways to describe depreciation, for example:

- ◆ the benefit of using the van should be spread over the four years;
- ◆ Jake's business uses up the asset over the four years and this is an expense of the business;

- ◆ the cost of buying the van should be spread over the whole of its useful life to the business;
- ◆ the business is charged for the use of the van;
- ◆ the van is wearing out and therefore decreasing in value over the four years.

**Depreciation is not the same thing as cash.** We have explained that depreciation is an expense charged against profit for the loss in value of the van over the period of its use in Jake's business. It is shown in the profit and loss account but this does not mean that it **is** cash. Cash was only involved in June when Jake bought and paid for the van.

There are several ways Jake could calculate a figure for depreciation, but here is a fairly simple method that is in common practice. This method is known as the **straight-line method of depreciation** that means that the cost is spread evenly over the useful life of the van.

First, take the estimated scrap value (£100) away from the cost (£8,100):

$$£8,100 \text{ minus } £100 = £8,000$$

Second, divide the result (£8,000) by the expected life of the van (4 years):

$$£8,000 \text{ divided by } 4 \text{ years} = £2,000 \text{ per year}$$

Third, if you want the depreciation for part (3 months) of a year (12 months), take the appropriate fraction (3 divided by 12) of the depreciation for the year:

£2,000 multiplied by 3/12 = £500.

So you should deduct a further £500 as an expense from Jake's gross profit as follows:

<b>Jake's PC Supplies</b>		
<b>Trading and Profit and Loss account</b>		
<b>for the three months ending 30 September</b>		
	£	£
Sales		21,000
<u>Less</u> cost of sales		
Purchases	15,000	
<u>Less</u> closing stock	<u>1,875</u>	
		<u>13,125</u>
Gross profit		7,875
<u>Less</u> Expenses		
Shop rent	1,200	
Telephone	400	
Advertising	800	
Miscellaneous	1,800	
Depreciation of van	<u>500</u>	
		<u>4,700</u>
Net profit		<u>£3,175</u>

## The uses of a profit and loss account

The profit and Loss account helps you with

- ◆ **Managing performance** - see how much gross and net profit has been made and determine whether this is adequate.
- ◆ **Assess further investment** - people who may be interested in joining in a partnership or lending the business money, can assess whether levels of profit are adequate.
- ◆ **Competition** - if they had access to this document, competitors could compare their own levels of profit.
- ◆ **Taxation** - the Inland Revenue will charge taxation based on profits. However, the profit for tax purposes is calculated according to a different set of rules from the ones we have used here. For example, depreciation is ignored and capital allowances are claimed instead. Generally, these allowances are based on the purchase price of assets acquired and given at a fixed rate, typically 25%. Some expenses correctly included in the profit and loss account are not allowed for taxation purposes, for example, most entertaining expenses and gifts to customers.

However, although of considerable interest, a profit and loss account may be limited in what it shows because the profit and loss account is concerned with the past (for July to September in the case of Jake's PC Supplies). By the time it is prepared the business has moved on with the result that trading

conditions and business performance may have improved or worsened.

To some extent the profit and loss account is an estimate. Although your records should be complete and correct the amount entered for depreciation of any assets is based on an estimate of an asset's useful life; the amount entered for the telephone bill may only include charges to the end of say, August and standing charges for the period September to November.

In other words, buying, selling and other day to day business activities do not take place at times and dates to suit the preparation of a profit and loss account. If the information provided in the records does not fall neatly into the time period covered by the profit and loss account then it becomes necessary to guess to a certain extent.

The account is for a limited period of time and should not be taken as typical of the whole year. This is important to remember when setting up in business as it is unusual for a new small business to make a profit straight away and early losses are not necessarily a bad sign.

Although the profit and loss account reveals how much profit (both gross and net) has been made in money terms, it says nothing about whether the amount is high or low (without further investigation) compared with, for example:

- ◆ the amount of money invested in the business
  
- ◆ the planned (budgeted) level of profit

- ◆ the amount of profit needed to generate and increase cash flow
- ◆ others in the same type of business.

## **Financial ratios**

Financial ratios are used a great deal to aid owners, lenders and competitors of businesses to understand and interpret the profit and loss account. There is a large number of different ratios that may be calculated but in this section we shall concentrate on some basic ones that help you assess the performance of your business.

We are going to apply **percentages** to Jake's figures for the July to September profit and loss account. Before doing this you need to be quite clear about the use and calculation of percentages.

### **Example**

Jake buys a pack of disks for £25 and sells it for £40. The percentages are written like this:

	£	%
Sales price	40	100.0
Cost of sales	<u>25</u>	<u>62.5</u>
Profit	£ <u>15</u>	<u>37.5%</u>

In other words, treat the selling price as being 100% and then express the costs and the profit as a percentage of that. Jake has made a 37.5% **profit margin**.

On the other hand, Jake might say that he had bought the pack for £25 and added 60% on to the purchase price for profit (£25 multiplied by 60% = £15). Accountants usually refer to this adding on to the purchase price as **mark-up**.

So one explanation is that Jake made a profit of £15 that represented a profit margin on his selling price of 37.5%. To achieve this required a mark-up on his purchase price of 60%.

In view of the obvious misunderstanding that can arise, you should make it clear what you mean when talking about percentages.

Now that you are clear about percentages, we can add percentages to Jake's profit and loss account.

**Jake's PC Supplies**

**Trading and Profit and Loss account**

**for the three months ending 30 September**

	£	£	%
Sales		21,000	100.0
<u>Less</u> cost of sales			
Purchases	15,000		
<u>Less</u> closing stock	<u>1,875</u>		
		<u>13,125</u>	<u>62.6</u>
Gross profit		7,875	37.5
<u>Less</u> Expenses			
Shop rent	1,200		
Telephone	400		
Advertising	800		
Miscellaneous	1,800		
Depreciation of van	<u>500</u>		
		<u>4,700</u>	<u>22.5</u>
Net profit		<u>£3,175</u>	<u>15.0%</u>

At this point it is useful to ask some questions such as:

- ◆ Is the gross profit percentage of 37.5% adequate?
- ◆ How does it compare with the business plan?

- ◆ Is the net profit margin of 15% enough for the owner's needs?
- ◆ How does it compare with the business plan or budget?
- ◆ Is it better or worse than for others in the same line of trade?
- ◆ How can the net profit margin be improved?
- ◆ Should the business try to reduce expenses, which are 22.5% of sales?
- ◆ Is the net profit margin better or worse than for others in the same line of trade?
- ◆ If it is worse, is the business buying goods at the best price obtainable or should the selling price increase?

The important thing to note is that percentages in themselves are of limited use. What they do reveal is to what extent the business is achieving its budget or business plan.

## **What is financial position?**

We looked at profit and loss accounts, which measure **financial performance** over a period of time. In the case of Jake this period was the first three months of his trading, ending 30 September.

The **balance sheet** measures the financial position of a business at one particular moment in time. In other words what the business is worth in terms of what it owns and what it owes at a particular date.

We will use the Jake example to illustrate the balance sheet but first need some more information.

On 28 June, before he started trading in July, he opened a business account at his bank with £9,000 from his personal account. He paid for the van, making out a cheque for £8,100 using his business account.

The important thing to note here is that we should treat Jake and Jake's PC Supplies as completely separate entities. This separation of Jake and his business is particularly important when we look at balance sheets. The balance sheet shows us the financial position of the business and not of the owner.

The first balance sheet of Jake's PC Supplies, at midnight on 29 June after Jake has paid £1,300 into his business bank account, is a financial snapshot of the business at that date. It will show all the resources the business owns, such as land, premises, stock, cars, cash, etc. These are known as **assets**. The business can only obtain these assets by borrowing funds from someone else. The sources of these funds, that is, those to whom the business owes money, are known as **liabilities**. These are also shown on the balance sheet.

Jake pays £9,000 into his business bank account. He lends the money to provide the business with its start-up capital of £9,000. The business now has assets of £9,000 cash in the bank but has liabilities of £9,000 because it owes £9,000 to Jake.

## Example

<b>Jake's PC Supplies: Balance sheet as at 28 June</b>			
Assets (£)		Liabilities (£)	
Cash at bank	<u>9,000</u>	Capital	<u>9,000</u>

The date at which the balance sheet is drawn up is given at the top of the statement. The assets are shown on the left-hand side of the balance sheet and liabilities on the right-hand side.

On 29 June after Jake purchased the van for the business the balance sheet of Jake's PC Supplies looks like this.

<b>Jake's PC Supplies: Balance Sheet at 29 June</b>			
Assets (£)		Liabilities (£)	
Motor van	8,100	Capital	9,000
Cash at bank	<u>900</u>		
	<u>£9,000</u>		<u>£9,000</u>

The asset of cash has been partly replaced by the motor van, because £8,100 was spent buying the van.

By the end of September the balance sheet for Jake's PC Supplies contains more items.

<b>Jake's PC Supplies: Balance sheet as at 30 September</b>			
	£	£	£
Fixed assets:		Capital	9,000
Motor van	8,100	Add profit	<u>3,175</u>
Less depreciation	<u>500</u>		12,175
	7,600		
Current assets:		Creditors:	
Stock	1,875	Trade	2,500
Debtors	<u>6,000</u>	Overdraft	<u>800</u>
	<u>7,875</u>		<u>3,300</u>
	<u>15,475</u>		<u>15,475</u>

[Debtors - amounts due from customers; trade creditors - amounts owed to suppliers; overdraft - amount owed to the Bank]

Now you have an idea about the structure and the content of the balance sheet, we can look at its uses. Of course, the owner needs to see the balance sheet to find out the financial position of the business, its assets and its liabilities. Other people are also interested, such as lenders of money, customers, managers and employees in general.

## **The limitations of a balance sheet**

A balance sheet can tell us many things, but there are limitations. A business will have many things that are valuable and help the business but which cannot be valued in monetary terms, for example,

- ◆ the enthusiasm of junior managers;
- ◆ goodwill which the business has built up with customers;
- ◆ expertise in manufacturing or trading;
- ◆ technical experience and development;
- ◆ skills and loyalty of staff.

It is important to appreciate the effect of these omissions. If you consider a successful public relations business, its strengths are its reputation in the industry, the standing it has with its clients and the flair and professionalism of its employees. None of these items appear on the balance sheet.

What the van is worth depends on its condition and market forces. The figure for the van in the balance sheet therefore does not tell us its value.

There is a number of items like this in a balance sheet. When we look at the amounts for cash and debtors, we can be reasonably confident that these are actual amounts. We may wish to be cautious about our debtors, however, in case they go out of business. But with fixed assets we cannot be certain and the safest guide is to accept that a balance sheet does not tell us the value of

the business.

The final important limitation of a balance sheet is that it tells us about the financial position on one particular date. This may not be typical of all the other days in the period and therefore may not be a good basis for predicting the future.

For example, on that date the business may have a healthy cash balance, but may purchase a very expensive fixed asset the next day. If you are the lender who is considering a loan of £1/2m to the business for three years, you will be very aware of the limitation of the balance sheet.

Although these limitations are very important, they do not mean that the balance sheet is of no use. However, you should bear them in mind when you use a balance sheet.

## **Profits and profitability**

You have seen how the profit and loss account shows how much **profit** has been made and in this way tells us about the financial performance of the business. However, the profit figure alone is not so helpful as at first may be thought.

- ◆ Is the profit sufficient?
  
- ◆ How do the results compare with previous years?
  
- ◆ How do the results compare with those of the market leaders?

- ◆ How do the results compare with the average for the industry?
- ◆ Is it worthwhile investing in this business?

If you only know the profit you will not be able to answer all these questions, but it can help in providing some of the answers.

## **Ratio of return on capital employed (ROCE)**

An owner or manager of a business obtains finance from investors in order to earn profit for the business. The investors expect to get a return on the capital they have invested. This ratio sets out to measure the **return on capital employed** in the business.

At its simplest **return** means profit.

The term **capital employed** means the net capital invested in the business. It is represented by fixed assets plus current assets less current liabilities. Another way of calculating capital employed that will give you the same answer is capital plus retained profits plus long-term loans.

The formula is:

$$\text{ROCE} = \frac{\text{Profit}}{\text{Capital employed}} \times 100$$

## Example

If we have the following figures for profit and capital employed:

	£
Profit	56,000
Capital employed	121,000
The ROCE =	$\frac{£56,000}{£121,000} \times 100 = 46.3\%$

Now that we have this figure we can compare it with previous years to see whether the return on capital employed has been increasing or declining.

You can compare your figures with those of other businesses and with the industry averages, where these are available.

## Summary

By following the advice given in this section you should be able to construct a simple trading and profit and loss account for your business. You should also now appreciate the relationship between purchases, stock and cost of sales, and have gained a basic understanding of the principle of depreciation.

We have looked at the basic construction of a balance sheet as a snapshot of the financial position of a business at one point in time. You have learnt that it shows the **financial position of the business and not that of its owner(s)**.

In the final balance sheet of Jake's PC Supplies, we have created a statement

that shows what the business has in the way of assets, and how this has been financed. This is known as its **financial position**.

Finally you should now be familiar with a number of ratios that measure financial performance and financial position and be able to make simple calculations for your own business.

# Useful Information

## Inland Revenue Small Firms Service Publications

- ◆ IR57 Thinking of Working for Yourself?
- ◆ IR56 Employed or Self-Employed
- ◆ IR28 Starting in Business
- ◆ IR53 Thinking of Taking Someone On?

## More information about Value Added Tax

Appendix A of Notice 700 'The VAT Guide' tells you about the different types of supplies. It is one of a range of booklets you can obtain from your local VAT Office. Other booklets deal with topics such as:

- ◆ Exempt supplies of land and buildings
- ◆ Working or living abroad
- ◆ Previous registrations
- ◆ Taking over a business from someone else
- ◆ Changes in level of business and the need for registration
- ◆ Registration for business with zero-rated supplies
- ◆ Voluntary registration

- ◆ Registration numbers
- ◆ When to charge VAT
- ◆ VAT return dates

You can telephone or write to your local VAT Business Advice Centre or look up the information you require on the website:

<http://www.hmce.gov.uk/>

After registration HM Customs and Excise will also offer:

- ◆ seminars to introduce you to VAT
- ◆ private meetings at your local VAT office
- ◆ instructional 'Welcome to VAT' video and leaflet.

Again, contact your local VAT Business Advice Centre for more details.

## Help from the Internet

Many websites holding useful information and offering advice about business accounting and finance. Here is a sample:

Name of organisation	<a href="#">http://www.</a>
Barclays Bank	<a href="http://www.barclays.co.uk/">barclays.co.uk/</a>
Business Connect (Wales)	<a href="http://www.businessconnect.org.uk/">businessconnect.org.uk/</a>
Business Links (England)	<a href="http://www.businesslink.co.uk/">businesslink.co.uk/</a>

Business Shops (Scotland)	<a href="http://business-shops.co.uk/">business-shops.co.uk/</a>
<b>Name of organisation</b>	<b><a href="http://www.">http://www.</a></b>
Department for Education and Employment (Employment Zones)	<a href="http://dfee.gov.uk/ez/">dfee.gov.uk/ez/</a>
EDnet (Economic Development Network for Northern Ireland)	<a href="http://ednet.ledu-ni.gov.uk/">ednet.ledu-ni.gov.uk/</a>
HM Customs & Excise (VAT)	<a href="http://hmce.gov.uk/">hmce.gov.uk/</a>
HSBC	<a href="http://banking.hsbc.co.uk/">banking.hsbc.co.uk/</a>
Inland Revenue	<a href="http://inlandrevenue.gov.uk/">inlandrevenue.gov.uk/</a>
Livewire (sponsored by Shell UK Ltd for young people wanting to set up businesses)	<a href="http://shell-livewire.org/">shell-livewire.org/</a>
Lloyds TSB	<a href="http://lloydstsb.com/">lloydstsb.com/</a>
National Federation of Enterprise Agencies (Business Volunteer Mentoring Association scheme)	<a href="http://nfea.com/">nfea.com/</a>
NatWest	<a href="http://natwest.com/">natwest.com/</a>
New Deal (for presently unemployed young people wanting to set up businesses)	<a href="http://newdeal.gov.uk/">newdeal.gov.uk/</a>
Prince's Trust (for young people wanting to set up businesses)	<a href="http://princes-trust.org.uk/">princes-trust.org.uk/</a>

Small Business Service	<a href="http://businessadviceonline.org/">businessadviceonline.org/</a>
<b>Name of organisation</b>	<b><a href="http://www.">http://www.</a></b>
Successful Entrepreneurs Inc	<a href="http://bizroadmap.com/">bizroadmap.com/</a>
UK Department for Trade and Industry support for Business	<a href="http://dti.gov.uk/support/">dti.gov.uk/support/</a>
UK Science Parks	<a href="http://ukspa.org.uk/">ukspa.org.uk/</a>