Accountancy is easy.....
when you know how!

Introduction

Understanding accountancy and finance is like driving a car:
- It fills most people with dread and fear
- But once they've had a bit of experience it becomes second nature and they wonder what all the fuss was about. They probably even start to do it without thinking (just as drivers instinctively change gears etc).

Who is interested?

Many people will be interested in your accounts. For example:
- Your *bank manager* - since they will help him to decide whether to lend you money
- Your *building society* - they will need to see your accounts before they will give you a new mortgage
- The *taxman* - he needs to see your accounts to work out how much tax you owe
- Your *customers* - new customers may look at your accounts to decide whether you are a successful and reliable contractor
- Your *suppliers* - who might use your accounts to decide whether you are a good credit risk.

But most of all, *you* should be interested in your own accounts**.**

Who are accountants?

Unfortunately there is nothing to stop anybody calling themselves an accountant. This means that it is vitally important to understand the three main types of accountants.
- *Book-keepers* - Their role is largely to "keep the score" by recording the financial effects of what a company has done. They are usually the best people to do routine accounting work.
- *Qualified accountants* - These are experienced professionals who have undergone rigorous training and passed extremely difficult exams. There are a number of leading qualifications - but if you look for the letters ACA, FCA, ACMA, FCMA, ACCA or FCCA after the accountant's name you should not go too far wrong. Qualified accountants are best at dealing with the non-routine aspects of your business eg helping you to increase your profits, produce your statutory accounts and pay less tax.
- *Unqualified accountants* - There are also many unqualified "accountants". Before deciding to use the services of one, we suggest you ask yourself: "Would I put the health of my family in the hands of an unqualified doctor?" If the answer is no, why consider putting the health of your business in the hands of an unqualified accountant? Don't be afraid to ask what qualifications and expertise an accountant has - and if you have any doubts, try somebody else.

A definition of accountancy

Accountancy is about *identifying* and *recording*, *analysing* and *explaining*, the financial implications of business transactions and decisions to enable businessmen to *understand* the performance of their businesses, and to help them make *decisions* and take *actions* which assist in achieving the objectives of the business.

But don't worry, as we will explain over the next few pages, it's actually really rather simple!

Types of accounts

Just as there are several different types of accountants, there are also many different types of accounts. However they can be grouped under two main headings:

- *Financial* accounts - for limited companies these are sometimes also known as statutory accounts; and
- *Management accounts*

Financial accounts

These are compulsory for companies, and must be sent every year to the shareholders in your company and to Companies House. In addition:

- They must follow a standard set of rules and conventions, and show what went on during the financial year; and
- They are mainly used by people outside your business - eg bankers, customers, suppliers and, of course, the taxman.

Sole traders and partnerships must also produce financial accounts - although they do not need to be sent to Companies House and there are not so many rules governing how they must be set out and what they must contain.

Management accounts

This type of accounts are essential for well-run businesses, but are not strictly required by law. As their name suggests, management accounts are mainly used by management. In fact it is very rare for them to be shown to anybody outside the business - and businesses cannot usually be forced to show their management accounts to anyone other than their auditors and (in exceptional cases) the taxman.

There are no rules that say what management accounts *must* look like - it is up to each business to decide what format will best help it to understand what is going on, control the business and make better decisions

Management accounts often predict the *future* as well as keep track of the *past* i.e. they usually include forecasts of what is going to happen tomorrow as well as recording what happened yesterday. In contrast, financial accounts only ever record what has already happened in the past.

Your books

Both sets of accounts (management & financial) use the same basic information which they get from the same place - the company's "books". We shall describe what type of books you will need to keep later in these notes. However first we shall look at your accounts themselves.

What are accounts?

Introduction

We said before that business finance and accountancy are a bit like driving a car. Good drivers use the dashboard to monitor their progress - and in just the same way good business managers use their accounts to monitor their business progress.

So accounts are, in a sense, your business dashboard. The two key instruments on your car's dashboard are probably the speedometer and milometer. These are equivalent to the two key elements in any set of accounts: the profit and loss account and the balance sheet.

Speedometer

Speedometer = Profit & Loss Account

In a car the speedometer shows you how fast you are going and how quickly you are getting to where you want to go.

This is equivalent to the profit and loss account, which shows how fast your business is accumulating profits.

Both the speedometer and the profit and loss account only make sense when viewed over a period of time:

- The speedometer shows miles per hour
- The profit and loss account shows profits per year.

Milometer

Milometer = Balance sheet

The balance sheet, on the other hand, is like the milometer. A milometer records how far the car has travelled and is often used as an important factor in deciding how much a car is worth

In the same way, your balance sheet measures how far your business has travelled. It is a snapshot of where the business has got to and gives some indication of how much it might be worth (but like the milometer it tells us little or nothing about how, or how quickly, it has got to where it is)

Double entry

You may have heard about, and been terrified at the thought of, double entry book-keeping. If so, relax. We don't usually recommend double-entry book-keeping to our small business clients. But it is useful to have an idea of what it means.

In fact, the dashboard on your car, and your accounts are both examples of double entry at work:

- On a car, for every extra mph on the speedo, an extra mile is added to the milometer
- In business every extra £ on the profit and loss account adds an extra £ to the balance sheet.

In both cases only *one* thing happens (either you travel a mile or your earn a pound). But in both cases there are *two* effects - the mile changes both the speedo and the milometer - the pound changes the profit and loss account and the balance sheet. There are two effects (or "entries"), and so for hundreds of years accountants have referred to it as *double*-entry. That is really all there is to it.

Basic principles

Most accounting is little more than applied common sense. However there are two golden accounting rules that are not immediately obvious - and so it is worth spending two minutes describing them.

The accruals principle - Your accounts should reflect things when they arise or are earned - which is not necessarily the same as when you actually pay or are paid for them. For example, your accountant will include an April sales invoice in your April accounts, even if your customer doesn't pay you until August.

Revenue v capital payments - Some of the things you spend money on will not be regarded by your accountant (or the taxman) as reducing your profits. For example, the money you pay to buy a new car or pay off a loan. Accounting conventions say that payments like these shouldn't appear in the profit and loss account - instead their effect is confined to the balance sheet.

The key distinction here is between capital expenditure and revenue payments:

- *Revenue payments* are the running costs of the business - the type of expenses that buy goods and services that are used up quickly (eg wages, advertising, rent, stationery etc). This type of expenditure is shown in the profit and loss account (and is often referred to as having been "expensed")
- *Capital payments,* on the other hand*,* relate to things that continue to benefit the company for several years (eg computers, cars etc). They also include paying off loans. This type of expenditure is shown in the balance sheet (and is often referred to as having been "capitalised")

Your accounts

We have now explained the building blocks of every set of accounts. On the next two pages you will see stylised versions of what these building blocks are used to construct - your profit and loss account and balance sheet.

Your profit and loss account

Figures for	Description
Sales	Made by your business - even if not yet paid for
Less	*Less*
Costs	*Revenue expenditure* - costs of goods and services used to generate, supply and support those sales - even if not yet paid for
=	=
Profit	How much your business has really made

Your balance sheet

Balance sheets are always presented in two halves. The top half shows the company's *net assets* i.e.

Figures for	Description
Assets	What your business OWNS
Less	*Less*
Liabilities	What your business OWES
=	=
Net assets	Rough measure of how much your company is "worth"

The bottom half shows where these net assets have *come from* i.e.

Share Capital	How much money you and any other shareholders have invested in the business
Plus	*Plus*
Profits	How much profit you have earned but not spent since the business started
=	=
Net assets	This will be the same figure as in the top half of your balance sheet - ie roughly how much your business is "worth"

Book-keeping basics

Introduction

Your accounts can only ever be as accurate as the books you keep. In this section we explain the books you will need - and those you won't!

Cash Book

This is your single most important "book". It records all of the payments made into and out of your businesses bank account. It is vitally important to set the book up appropriately at the commencement of business. At the end of each month the totals for each column for that month should be calculated and checked and a separate page should be started for the next month. You should then also do a bank reconciliation (ask us for a copy of our free bank reconciliation factsheet).

Sales invoice file

It is both very helpful to your business, and reassuring to the tax man, if you issue your sales invoices in strict numerical order. You should also set up a file with file dividers for each month and file your sales invoices in strict numerical order. The only exception to this rule is that unpaid invoices should be kept in a special section at the front of the file until they have been settled, at which point you should mark the invoice "paid" and also write on it the date paid, and then file it in strict numerical order. You should also regularly review the unpaid section of the file and take steps to chase payment as often as possible.

Purchase invoice file

This is a file with a file divider for each month and a front section for unpaid bills. On receiving an invoice, file it in the unpaid section until such time as you pay it. On paying the invoice you should write "paid" and the date on the invoice itself, and then transfer it from the unpaid section of the file to the section for the month in which you made the payment. You should also, of course, ensure that the payment is recorded in your cashbook.

Expense claims

Whenever you pay any expenses of the business by using your own money you are entitled to ask the company to pay you back. We recommend you do this fortnightly or monthly and use a pre-printed expense claim form.

Other books

Most small businesses that use the VAT cash accounting method are likely to find that the books described above will be sufficient for both VAT and basic financial control purposes.

Some slightly larger businesses who do not use the VAT cash accounting method also find it helpful to use a number of other types of books such as a:

- Sales Day Book;

- Sales Ledger ;
- Purchase Day Book;
- Purchase Ledger;
- Petty Cash Book; and a
- Nominal Ledger.

Whilst such books do undoubtedly have their place in a more sophisticated business and accounting environment, they are often not necessary for many smaller businesses, and the cost of the additional training necessary to master their double-entry book-keeping foundation often far outweighs their additional benefit. Of course, we would be delighted to advise on the most cost-effective and suitable accounting system for the needs of your business.

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