Business Accounts

# Business Accounts

## Tutorial

### Setting up Business

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Capital

The amount a business owes its owner.

### P&L Account

Short term items are classified as expenses of the business. Items providing a benefit for several years are assets.

### Income Statement

Assets and liabilities are shown. One of the assets is usually cash.

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Fixed and current assets

Fixed assets are major assets bought to help the business function. Current assets are cash and liquid assets, such as debtors and stock.

Net assets represent the net worth of the business to the owner. This is the first thing which is looked at when valuing a business/ deciding whether to invest in a business.

But figures can be easily manipulated–for example by not depreciating fixed assets correctly, or by not taking into account that a percentage of debtors will likely not pay. Good practice to make an allowance for possible bad debts.

## Introduction

Keeping business accounts is obviously useful, to both internal and external users, as well as HMRC.

### Accountants and Auditors

Generally, accountants are hired to prepare business accounts, which are then reported. Registered auditors are authorised to sign a statutory audit report. Auditors must provide an opinion about whether accounts give a true and fair view of the affairs of the company and its profits. They are under an obligation to the members of the company and to a professional body.

### Taxes

Accounts are important for taxes. If the business is unincorporated, the proprietor(s) will include business profit in their personal income tax returns. If the business is a company, the company is liable for corporation tax.

A business with employees will operate a PAYE scheme (Pay As You Earn). The employer deducts income tax and pays it straight to HMRC. National Insurance contributions are also deducted. VAT charged/ paid must also be recorded, and accounted for to the government each quarter.

### Regulation

UK Financial Reporting Council lays down standards of financial accounting and reporting (Financial Reporting Standards; FRSs). But moving to a new international standard.

### Accounts

On a daily basis, a business must keep a record of income, expenses, assets and liabilities.

| Term | Definition |
| --- | --- |
| Income | What the business is trying to produce. |
| Expenses | Items paid, the benefit of which is obtained and exhaused in a relatively short time and where the expenditure is necessary to maintain the earning capacity of the business. |
| Assets | Expenditure giving rise to a benefit which can be spread over a longer period and will increase the earning capacity of the business. |
| Liabilities | Amounts owing from the business. |

## Double Entry Bookkeeping

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Bookkeeping

The process of recording financial transactions in the accounting records of a business.

The double entry system was developed by Venetian traders in the 1400s and is still used to this day.

The idea is that there are two aspects to every transaction.

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Example

1. The business pays cash to buy premises
   1. The business has less cash
   2. The business has acquired premises
2. The business pays wages
   1. The business has less cash
   2. The business has incurred an expense
3. The client pays the business owed money
   1. The business has lost the debt it was owed
   2. The business has more cash

### Rules for Recording Transactions

| Left column | Right column |
| --- | --- |
| Expense incurred | Income earned |
| Asset acquired/increased | Asset disposed of/reduced |
| Liability reduced/extinguished | Liability incurred/increased |
| Cash gained | Cash paid |

A key principle is that the business is regarded as completely separate from the proprietor. So the initial capital is incurred as a liability to the proprietor.

#### Debit and Credit

The LHS is debit and the RHS is credit, shortened to DR and CR respectively.

Accounts are usually recorded in the form:

| Name of Account |  |  |  |  |
| --- | --- | --- | --- | --- |
| Date | Details | DR | CR | Balance |
|  |  |  |  |  |

If DR exceeds the CR entry, the balance is described as a DR balance.

#### Business Models

Trading businesses make money by buying and selling stock, either for cash or on credit. The purchase of stock is considered an expense of the business and recorded in the purchases account. The business earns income by selling stock, recorded in the sales account.

Professionals do not sell trading stock, they sell services. The charge for professional services is recorded as a CR entry on an income account (often as “profit costs”), and the client's debt is recorded as a DR entry in the name of a client. When the client pays, the solicitor will record a receipt of cash and the loss of the debt owed by the client to the business.

#### Cash and Ledger Accounts

The 'cash' account is in reality a record of receipts into and payments out of the bank account. But a business will usually need some petty cash in the office to cover day-to-day expenses–these transactions are recorded in a petty cash account.

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Definition

All accounts apart from the cash account are referred to as ledger accounts. There is a single cash account: the petty cash account.

#### Drawings

It is common to record withdrawals by the proprietor in a separate 'Drawings' account, rather than recording withdrawals on the capital account each time. The drawings account is a temporary account; at the end of the accounting period, any balance is transferred to the capital account.

#### Trial Balance

Businesses will check their bookkeeping periodically. If every transaction has been properly recorded,

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Definition

The process of adding together all DR and CR balances and comparing totals is known as preparing a Trial Balance.

Note that this is only a check but cannot reveal all errors, e.g., if the bookkeeper has failed to make any entries relating to a particular transaction.

## Final Accounts

### Introduction

The double entry system records aren't very helpful in seeing how a business is doing. To present key information about how a business is doing, two accounts are prepared:

* P&L account ('Income Statement') to present profitability
* Balance sheet ('Statement of Financial Position') to present value of business.

These end-of-year accounts are collectively known as financial accounts. The starting point for creating these is the Trial Balance.

### P&L Statement

Accounting period is usually 1 year.

Income - Expenses = Profit.

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Note

Only items appearing on the trial balance which can be classified as income and expenses will appear on the P&L account.

So step 1 is preparing trial balance and step 2 is distinguishing between income & expenses and assets & liabilities.

#### Preparation

P&L usually set out vertically; with income first, followed by expenses below, and profit at the bottom. The total of expenses will be shown in brackets, since it is negative. Totals are shown on the right-hand side, conventionally.

#### Trading Accounts

A business buying and selling goods has not only a P&L but also a preliminary account called a Trading Account. This shows the income from the sales less the cost of those sales (the cost of buying trading stock), which is the gross profit. This is carried forward to the P&L account, where any other income is added and expenses of running the business subtracted to produce the net profit.

#### Balance Sheet

Lists the assets and liabilities of the business, and is accurate only for one day (the last day of the accounting period). The basic formula is

The balance sheet shows what the business is worth to the proprietor, so it splits the assets–liabilities owed to third parties ('Employment of Capital'), and the amount owed to the proprietor as capital ('Capital Employed'). The two amounts should be the same.

is shown vertically. Liabilities are commonly labelled 'Financed By' or 'Represented By'.

Commonly, assets are divided into:

* Fixed assets–bought not for resale but to improve the efficiency of the business
* Current assets–short-term assets, often known as circulating assets

and liabilities are divided into

* Current liabilities–repayable in months
* Long-term liabilities–repayable in months.

Conventionally, assets are listed in decreasing order of permeance (i.e., increasing order of liquidity). The balance sheet shows current liabilities deducted from current assets to give a figure called 'net current assets'.

A balance sheet usually shows current assets–current liabilities = net current assets. This figure represents the liquid funds available to the business. Low or negative net current assets are a sign of financial difficulty.

Net assets will equal the amount owing to the proprietor as capital at the end of the year.

#### Client Bank Account

The bank account containing money held for clients is usually equalled by the amount a firm 'owes' to clients, so it is usually shown as a self-cancelling item on the balance sheet, after net current assets.

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Summary

1. The Final Accounts of a business comprise a Profit and Loss Account and a Balance Sheet.
2. A Profit and Loss Account shows income less expenses to give net profit.
3. Businesses which buy and sell goods have a Trading Account as well as a Profit and Loss Account. The Trading Account shows income from sales, less the cost of goods sold to give gross profit. The Profit and Loss Account shows gross profit less expenses to give net profit.
4. The Balance Sheet shows assets and liabilities. It is set out as follows:
   1. first fixed assets are added together;
   2. then the net current assets figure is calculated–this is total current assets less total liabilities;
   3. the total fixed assets and net current assets are added together;
   4. any long-term liabilities are deducted;
   5. the result is labelled ‘Net Assets’;
   6. it should equal the new capital figure found by adding net profit to the figure for capital on the Trial Balance and deducting drawings.

## Adjustments

### Introduction

Final Accounts of most businesses are prepared and adjusted on the 'accruals basis'. This requires that income and expenditure are recorded in the period to which they relate, rather than that in which payment or receipt occurs.

This requires Final Accounts to include all income earned during the period, irrespective of whether cash has been received or bills delivered.

Essentially, it is a process of matching the expense to the period in which the benefit of the expense was obtained, and to match the income to the period in which the work producing the income was done.

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Important

1. Adjustments are always made after the preparation of the Trial Balance at the end of the accounting period.
2. Each adjustment will always be reflected on both the P&L Account and the Balance Sheet.

#### Outstanding Expenses

If there is an expense relating to the current period which has not yet been paid, the Trial Balance will be updated to show the true expense for the current accounting period. This adjustment will be reflected on the balance sheet as a current liability. It is common for a business to add up all unpaid expenses at year-end and label them 'Accruals'.

#### Payments in Advance

This is the opposite; where a business pays an expense this year but will not get the benefit until later on (e.g., rent paid in advance). The amount of the payment in advance is shown on the Balance Sheet as a current asset (usually after cash). The 'asset' is the benefit of the payment having already been made. Usual to add up all payments in advance for the year and show a composite figure labelled 'Prepayments'.

#### Work in Progress

The estimated value of work done but not yet billed increases the profit costs properly attributable to the current period and must be added to the balance on the profit costs account appearing on the Trial Balance. This must be shown on the income section of the P&L, though it is usual to show the costs actually billed and value of work in progress as two separate items. The figure will also appear as an additional item in the current assets section of the balance sheet (usually shown first).

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Note

The modern approach is to calculate work in progress by treating the right to payment as accruing gradually as the work is done, so much of the work in progress is actually shown as part of the debtors figure, rather than a separate item.

#### Closing Stock

It is necessary for a trading business to make an adjustment for the value of any stock purchased during the year and left unsold at the end of the year. This is done by showing the value of closing stock appearing in the Trading Account as a deduction from purchases in order to calculate the cost of goods sold. It also appears as an additional item in the current assets section, showing that the business will start the next accounting year with the benefit of that stock having been purchased. The value of opening stock must also be taken into account when calculating the cost of goods sold.

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Warning

By convention, stock is valued in the Final Accounts at the lower of its acquisition cost or its realisable value.

The value given for closing stock is always an estimate–the business cannot predict with total accuracy how much of the remaining stock it will be able to sell (e.g., clothing which has gone out of fashion).

#### Bad and Doubtful Debts

Debtors are a current asset of the business, so can increase the net value of the business. A business will periodically review its debtors to decide whether any should be declared bad and written off. The debtor is then no longer shown as owing the firm money. Bad debts are regarded as an expense of the business–and will appear in the P&L statement as an additional expense labelled 'bad debts'.

Note that at the end of the accounting period before preparing the final accounts, it is normal to reassess whether there are any bad debts.

#### Doubtful Debts

After the bad debts have been written off, there may still be debtors who may or may not pay. An adjustment is made to take into account this uncertainty. A separate item, 'Provision for Doubtful Debts', is added to the P&L statement.

#### Depreciation

Depreciation is accumulated over the life of an asset, such as a piece of machinery. There are different methods for calculating deprecation–either linearly or using a 'reducing balance' method.

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Tip

It is common:

* to depreciate all assets held at the end of an accounting period for the entire accounting period, regardless of when in the period they were purchased
* not to depreciate assets sold part way through an accounting period.

#### Revaluation

Assets like premises may slowly appreciate in value from their book value. The asset can be revalued, and the new value put on the balance sheet. This is often done just before bringing on a new partner, so that the increase in value is shown as belonging to the original proprietor.

#### Disposal of Fixed Asset

Is an asset is sold for book value, the transaction appears only on the balance sheet, since there is only a transfer of the type of asset the business owns (into cash).

If the disposal is not at book value, the excess/shortfall will be a profit/loss. Note that these should be shown separately on the accounts from trading profits/ losses.

## Partnership Accounts

In a partnership, need to record the capital contributed by each partner, profit owed to each partner, and amount withdrawn during the year by the partner. The partners will either have an agreement themselves, or the Partnership Act 1890 will imply terms into the business arrangement.

Each partner has a capital account in their own names. The capital account also shows the partner's share of an increase/ decrease in value of an asset recorded in the accounts (either explicitly agreed, else in the same ratio as profits).

Partners may receive both salaries (fixed) and 'interest on capital', as well as a share of the profits.

| Payment | Description |
| --- | --- |
| Salary | Fixed. Common where one partner is doing more of the day-to-day running of the business. |
| Interest on capital | Percentage of initial capital invested, which is returned every year. |
| Profit-sharing | Any remaining profits shared. |

### Appropriation Account

P&L account is extended to an appropriation account on which the allocation of net profit among the partners is shown.

### Current Account

It is usual to have separate current accounts for each partner to which the appropriation of net profit is added and from which drawings are deducted. This keeps everything accountable and neat.

#### Balance Sheet

Capital and current account balances of each partner are shown separately on the Balance Sheet in the Capital Employed section. This is often done in the appendix to avoid clutter.

#### Partnership Changes

If there is a change, net profits apportioned and two appropriation accounts prepared.

#### Taxation

The senior partner of the firm makes a (tax) return of partnership income. HMRC makes a joint assessment to tax, based on each partner's share of profit less reliefs and charges. Tax liabilities of individual partners are not shown in partnership accounts.