Accounts

Users of Accounts

The following stakeholders have an interest in a limited company's accounting records:

Shareholders – need to know the profit and loss the company makes. They will want to know if the business is worth more at the end of the year than the beginning.

Creditors – businesses (other than banks) that have lent money to the business or have supplied goods without receiving payment yet. They will want to know if the business can pay them back.

Users of Accounts

The following stakeholders have an interest in a limited company's accounting records:

Government – the government and the tax office will want to check on profits to know how much tax the business needs to pay. The government can also check output to measure GDP for the economy.

Other companies – the managers of other companies may be considering a bid to take over the business or they may wish to compare performances of their competitors.

Users of Accounts

Managers use them for taking decisions

Managers use them for controlling the operations of a business

Used by shareholders, creditors, government, to check on company performance

Usually computerised

Profit and loss accounts

Every business – however small or large – aims to make a **profit**. For a business to be able to **calculate** whether it has made a profit, it must keep a **profit and loss account**.

A profit and loss account summarizes all of a business's **revenue** and **costs** over a period of time, usually a year. The business then uses the figures in it to work out how much profit or **loss** it made.

Profit and loss

A business produces a profit and loss account because:

- it is a legal requirement
- it sums up the performance of a business to its **stakeholders**
- it can be compared with the previous year's performance
- investors or lenders need to see one before making deals
- it can help to **forecast** future profits and helps with planning.

The financial year

Businesses are legally required by the government to produce annual profit and loss accounts at the end of each **financial year** for the **Inland Revenue**.

At the end of each financial year **private limited** (**Ltd**) and **public limited** (**PLC**) companies must produce **audited** annual accounts for the Inland Revenue – for it to calculate how much tax they owe.

PROFIT

What is profit?

- Profit is the amount of money a business is left with after it has sold the goods or services and paid for all the costs associated with the business. It is important to remember that it is **not the same as cash**.
- There are two types of profit that you will need to be aware of. They are **Gross Profit** and **Net Profit**.

Gross Profit

- Gross profit is the amount of money made when the cost of the goods sold is taken from the sales revenue.
- For example a baker has sold 100 loaves of bread and sold them for $1.
- His sales revenue is $100.
- To produce these loaves he spent $0.50 per loaf. Therefore his Gross Profit is $50

Gross Profit = Sales Revenue – Cost of goods

Net Profit

- Net profit is the profit made by a business after all costs have been deducted from the sales revenue. It is calculated by subtracting overhead costs from the gross profit.

Net profit = Gross Profit – Expenses

Profit can be increased by:

- Increasing sales revenue by more than cost
  - **How could this be done?**
- Reducing cost of making the products
  - **How could this be done?**
- A combination of both

Why is profit important for a business?

Why is profit important for a business?

- Reward for enterprise and risk taking – this provides an incentive for investment into a business. If a business is profitable then its shareholders will benefit financially

- Source of finance – profits can be retained to be reinvested into the business

- Indicator of success – shows how successful a particular business or industry is

Difference between profit and cash?

Difference between profit and cash?

Business transaction	Profit / loss	Impact on cash
1. Sells 5,000 items for cash @ £2 each. Each item cost the business £1.50 but it has not yet paid its suppliers		
2. Sells 25,000 items on credit @ £3 each. Pays cash to its suppliers (£2 per item)		
3. Sells 8000 items for cash @ £4 each. Suppliers paid in cash (£2 per item)		

Difference between profit and cash?

Business transaction	Profit / loss	Impact on cash
1. Sells 5,000 items for cash @ £2 each. Each item cost the business £1.50 but it has not yet paid its suppliers	**£2500** **PROFIT** (£5000 x £0.50)	
2. Sells 25,000 items on credit @ £3 each. Pays cash to its suppliers (£2 per item)	**£25,000** **PROFIT** (25,000 x £1)	
3. Sells 8000 items for cash @ £4 each. Suppliers paid in cash (£2 per item)	**£16,000** **PROFIT** (8000 x £2)	

Difference between profit and cash?

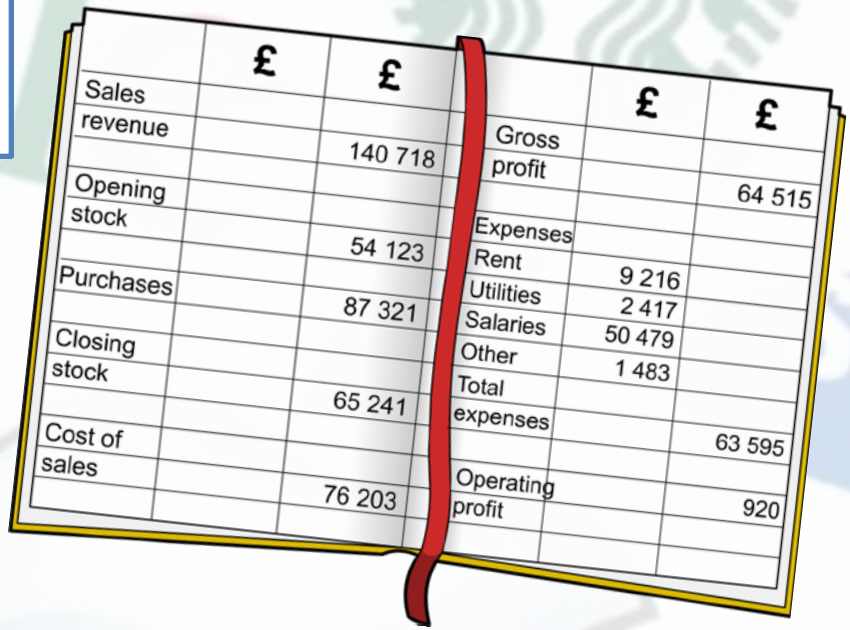
Business transaction	Profit / loss	Impact on cash
1. Sells 5,000 items for cash @ £2 each. Each item cost the business £1.50 but it has not yet paid its suppliers	**£2500** **PROFIT** (£5000 x £0.50)	INFLOW: £10,000 OUTFLOW: £0 NET CASH FLOW: £10,000
2. Sells 25,000 items on credit @ £3 each. Pays cash to its suppliers (£2 per item)	**£25,000** **PROFIT** (25,000 x £1)	INFLOW: £0 OUTFLOW: £50,000 NET CASH FLOW: (£50,000)
3. Sells 8000 items for cash @ £4 each. Suppliers paid in cash (£2 per item)	**£16,000** **PROFIT** (8000 x £2)	INFLOW: £32,000 OUTFLOW: £16,000 NET CASH FLOW: £16,000

Profit and loss account

A profit and loss account can be presented in different ways, but many businesses divide it into three distinct sections:

- the **trading account**
- the **profit and loss account**
- the **appropriation account**.

It can be recorded by hand into an accounts ledger, or entered into a computer spreadsheet or accounts package.



	£	£
Sales revenue		140 718
Opening stock		54 123
Purchases		87 321
Closing stock		65 241
Cost of sales		76 203

	£	£
Gross profit		64 515
Expenses		
Rent	9 216	
Utilities	2 417	
Salaries	50 479	
Other	1 483	
Total expenses		63 595
Operating profit		920

1. The trading account

The first section of the profit and loss account is called the **trading account**.

Trading account		
	£	£
Sales revenue		176 021
Opening stock	30 456	
Purchases	79 863	
Closing stock	50 146	
Cost of sales	60 173	
Gross profit		115 848

It shows the **revenue** the business earned from sales, the cost of production and changes in stock.

The business uses this data to work out how much **gross profit** it has made.

Calculating the trading account

	£	£
Sales revenue		67 865
Opening stock	24 514	
Purchases	47 865	
Closing stock	34 217	
Cost of sales	38 162	
Gross profit		29 703

opening stock + purchases - closing stock = cost of sales

sales revenue - cost of sales = gross profit

2. The profit and loss account

The second section is called the **profit and loss account** as it is where the **net profit before tax** (or loss) is calculated.

The profit and loss account records the business's **expenses** or **overheads** so that the **operating profit** can be calculated.

Profit and loss account		
	£	£
Gross profit		115 848
Expenses		
Wages	56 478	
Rent	8 799	
Utilities	3 456	
Equipment	5 398	
Other	2 471	
Total expenses		76 602
Operating profit		39 246
Interest on loans		11 451
Net profit before tax		27 795

Calculating a profit and loss account

	£	£
Gross profit		29 703
Expenses		
Salaries/wages	8 246	
Rent	3 456	
Utilities	1 897	
Equipment	965	
Other	587	
Total expenses		15 151
Operating Profit		14 552
Interest on loans		1 216
Net profit before tax		13 336

Total expenses = the sum of all the expenses

Gross profit - total expenses = operating profit

Operating profit - interest on loans = net profit before tax

3. The appropriation account

The third section of the profit and loss account is the **appropriation account**. It shows exactly what has happened to the **net profit before tax** the business made.

It shows the **tax** the business had to pay (**corporation tax** if it is a company or **income tax** if not).

Then it shows the **dividends** it paid to its **shareholders** and any **retained profit** it kept for reinvestment.

Appropriation account		
	£	£
Net profit before tax		27 795
Corporation tax	5 559	
Profit after tax		22 236
Dividends	7 985	
Retained profit		14 251

Calculating an appropriation account

	£	£
Net profit before tax		13 336
Corporation tax	2 667	
Profit after tax		10 669
Dividends	4 897	
Retained profit		5 772

Net profit before tax - corporation tax = profit after tax

Profit after tax - dividends = retained profit

Profit and loss account activity

Complete this profit and loss account by entering the missing values into the coloured cells

Sales revenue		**178 650**
Opening stock	14 000	
Purchases	65 000	
Closing stock	18 000	
Cost of sales		
Gross profit		
Expenses		
Wages	35 000	
Rent	20 000	
Utilities	12 000	
Other	4 500	
Total expenses		
Operating profit		
Interest on loans	12 500	
Net profit before tax		
Corporation tax	5 750	
Profit after tax		
Dividends	12 000	
Retained profit		

	£	£	
Sales revenue			**178 650**
Opening stock		14 000	
Purchases	65 000		
Closing stock		18 000	
Cost of sales			**61 000**
Gross profit			**117 650**
Expenses			
Wages	35 000		
Rent	20 000		
Utilities	12 000		
Other	4 500		
Total expenses			**71 500**
Operating profit			**46 150**
Interest on loans		12 500	
Net profit before tax			**33 650**
Corporation tax		5 750	
Profit after tax			**27 900**
Dividends	12 000		
Retained profit			**15 900**

Balance sheet

Basic principles of a balance sheet

A balance sheet explains two main financial factors:

- where a business has got its money from
- where a business has spent its money.

Every single penny that has been borrowed and every single penny that has been spent must be accounted for.

Like profit and loss accounts, balance sheets are usually produced on an annual basis at the end of each financial year. However, whereas a profit and loss account summarizes a company's activities over a period of time, the information on a balance sheet refers only to the day on which it is produced.

Basic principles of a balance sheet

Balance sheets have two main sections:

- liabilities – how much money has been borrowed or invested and where this money has come from
- assets – where the money has been spent.

As the name suggests, it is essential that balance sheets 'balance' out, so all liabilities must be accurately and clearly accounted for in the assets section.

The key principle of a balance sheet

Accurate balance sheets must obey the following principle:

all assets → **must equal** → all liabilities

Which means that:

where money has been spent → **must equal** → where money came from

Why is it so crucial assets and liabilities balance?

Fixed assets

Fixed assets are those which the business in question actually **owns** and which are therefore 'fixed' into the company. These include buildings and furniture fittings, machinery and company vehicles.

- They generally cost a lot of money and represent a large investment for the business.
- They usually last for a long period of time.
- They can be sold to increase capital (i.e. the money invested in the business).
- They more often than not depreciate in value over time.

However, owing to their nature, fixed assets often prove quite difficult to sell on. **Why do you think this might be?**

Current assets

Current assets are those which the business holds temporarily or that are always changing.

For example, in a shop, the value of the stock is a current asset. Similarly, for an interior designer working on a job for a client, that work in progress is a current asset. Computer equipment is also increasingly being seen as a current asset because it needs to be updated and replaced so often.

The final main types of current asset are customers who owe money for goods bought (debtors) and also the amount of money in a company's current bank account.

Current liabilities

Current liabilities, like current assets, are short-term and always changing. However, this is money that a business actually owes. The people or companies that the business owes money to are known as creditors.

Common current liabilities include:

- short-term loans
- bank overdrafts
- interest to debenture holders
- share dividend payments.

All current liabilities on a balance sheet must be addressed before the next one is produced.

Liabilities: capital and reserves

Liabilities also include capital and reserves. This is the money that a business has borrowed in order to fund itself on a long-term basis. There are three main parts:

- Share capital – money which shareholders have invested in the business.
- Reserves – profit from previous years which has been retained to finance future developments.
- Profit and loss account – money kept back from the current year's profits (the net profit).

Why is the money personally invested by a business a liability and not an asset?

Balance sheet structure: assets

Company Balance Sheet 2006/7

ASSETS	£
FIXED ASSETS	
Buildings	160,000
Vehicles	47,000
Total fixed assets	**?**
CURRENT ASSETS	
Stock	10,000
Debtors	38,000
Bank account	1,000
Total current assets	**?**

What are the total fixed assets?

What are the total current assets?

Balance sheet structure: assets

Company Balance Sheet 2006/7

ASSETS	£
FIXED ASSETS	
Buildings	160,000
Vehicles	47,000
Total fixed assets	**207,000**
CURRENT ASSETS	
Stock	10,000
Debtors	38,000
Bank account	1,000
Total current assets	**49,000**

	160,000
+	47,000
	207,000

	10,000
+	38,000
	1,000
	49,000

Balance sheet structure: current liabilities

Company Balance Sheet 2006/7

LIABILITIES	£
CURRENT LIABILITIES	
Creditors	(10,000)
Overdraft	(2,000)
Total current liabilities	**(12,000)**
Net current assets/liabilities	**37,000**
Total assets less current liabilities	**244,000**

Negative numbers are written in brackets.

Current assets minus current liabilities. AKA working capital

Total assets minus current liabilities. This is also known as capital employed.

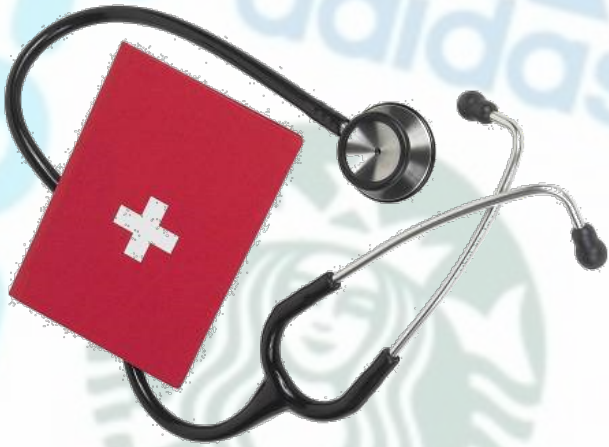
Balance sheet structure: capital and reserves

Company Balance Sheet 2006/7

CAPITAL AND RESERVES	£
Share capital	95,000
Reserves	55,000
Profit and loss account	94,000
Shareholders' funds	**244,000**

This is the total amount in capital and reserves. It must equal total assets less current liabilities.

Reading a balance sheet



Both the balance sheet and the profit and loss account show the ‘health’ of the business.

Shareholders, customers, suppliers, employees and other stakeholders will be interested in both types of account. They will want to see how the business is getting its money (for example, whether it is borrowing large amounts of money or whether it is using profits) and how well and on what it is using this money.

Important balance sheet considerations

It is important for companies to bear in mind the following considerations when preparing balance sheets:

- Fixed assets – is there enough money secured in items which could be sold to raise capital? Or is there too large an investment in fixed assets and not enough liquidity (the ability to meet current liabilities) in the business?
- Cash in bank – is there enough to cover a short-term crisis?
- Net current assets/liabilities or working capital – if this figure is negative, the business hasn't enough money to pay all its debts in a reasonable time, if required.
- Shareholders' funds – are these increasing? Shareholders will want their investment to grow.

Golding's Department Store

Using the following information you must produce a draft version of the company's balance sheet.

Golding's Department Store Balance Sheet 2006/7	£
ASSETS	
Fixed assets	
Buildings	
Equipment	
Total fixed assets	0
Current assets	
Stock	
Debtors	
Bank	
Total current assets	0
LIABILITIES	
Current liabilities	
Creditors	
Net current assets/liabilities	0
Total assets minus current liabilities	0
Capital and reserves	
Share capital	
Reserves	
Profit and loss account	
Shareholders' funds	0

Buildings	£74,000
Debtors	£34,000
Creditors	£32,000
Share Capital	£126,000
Bank	£24,000
Profit and loss-account	£20,000
Stock	£64,000
Retained Profit-(reserves)	£60,000
Equipment	£42,000

Golding's Department Store

Using the following information you must produce a draft version of the company's balance sheet.

Golding's Department Store Balance Sheet 2006/7	£
ASSETS	
Fixed assets	
Buildings	74,000
Equipment	42,000
Total fixed assets	**116,000**
Current assets	
Stock	64,000
Debtors	34,000
Bank	24,000
Total current assets	**122,000**
LIABILITIES	
Current liabilities	
Creditors	32,000
Net current assets/liabilities	**90,000**
Total assets minus current liabilities	**206,000**
Capital and reserves	
Share capital	126,000
Reserves	60,000
Profit and loss account	20,000
Shareholders' funds	**206,000**

Buildings	£74,000
Debtors	£34,000
Creditors	£32,000
Share Capital	£126,000
Bank	£24,000
Profit and loss-account	£20,000
Stock	£64,000
Retained Profit-(reserves)	£60,000
Equipment	£42,000

Ratios

Once a business has its financial documents completed it will need to analyse the information within them.

In order to do this it can perform a set of calculations that will enable it to analyse its performance as well as it liquidity.

Liquidity ratios:

- Current ratio
- Acid test ratio

Performance ratios:

- ROCE (return on capital employed)
- Gross profit margin
- Net profit margin

ROCE

Businesses use the information present in a balance sheet in formulae which help them to calculate overall performance.

The ROCE (return on capital employed) is used to help monitor how efficiently a business is being managed. It also indicates to shareholders the profitability of their investments. It is calculated using the following formula and expressed as a percentage:

$$\frac{\text{Net profit}}{\text{Capital employed}} \times 100$$

Based on the figures from your balance sheet, work out the ROCE

Gross Profit Margin

The **Gross profit margin** calculates the gross profit as a percentage of the sales turnover of the business. This result needs to be compared with other years and other companies.

$$\frac{\text{Gross Profit}}{\text{Sales turnover}} \times 100$$

Based on the figures from your balance sheet, work out the Gross profit margin

Net Profit Margin

The **Net profit margin** calculates the net profit as a percentage of the sales turnover of the business. The higher the result the more successful the managers are at making net profits from sales. This result also needs to be compared with other years and other companies.

$$\frac{\text{Net Profit}}{\text{Sales turnover}} \times 100$$

Based on the figures from your balance sheet, work out the Net profit margin

Current ratio

The current ratio is an important calculation used by businesses, calculated in the following way:

$$\frac{\text{Current Assets}}{\text{Current liabilities}}$$

Expressed as a ratio, this calculation allows a business to see whether they would be financially capable of paying off their short-term debts. The current ratio is useful however it assumes that all current asset could be turned into cash quickly. This is not always the case as not all stock might be sold quickly.

What would be the current ratio for Golding's?

Acid test ratio

The acid test ratio is another important calculation used by businesses. It serves to measure liquidity (the ability to meet current liabilities) using the following formula:

$$\frac{\text{Current assets - closing stock}}{\text{Current liabilities}}$$

Expressed as a ratio, this calculation allows a business to see whether they would be financially capable of paying off their short-term debts without having to sell off any stock. This information is important because stock is the least liquid current asset, so deducting it gives a business a better idea of their liquidity.

What would be the acid test ratio for Golding's?

During 2014 Youssef has recorded the following figures for his takeaway meals business:

He sold £529,300 worth of takeaway meals. Unfortunately Youssef had one bad week where some customers were complaining of sickness after eating his meals so he had to make customer refunds of £300.

At the start of the year he had burgers, buns, chicken etc in the freezer to the value of £40,500. He spent £270,000 on raw materials during the year. At the end of the year the value of the stock in his freezer was £20,000.

At the end of the year he has worked out that the value of his café building is £245,000, of which £132,000 is owed to the bank as mortgage. His equipment is worth £17,500 and his fixtures and fittings are worth £23, 025. He has £8,010 in his bank account. He has £965 in his cash register.

He is owed £49,600 by customers that he provided catering for parties. He owes £12,150 to his suppliers. He also owes £26,000 in VAT.

Youssef provided £265,000 at the start to finance his business. He pays himself £26,000 at the end of the year. His other expenses are Light and Heating for which he pays £3,600 as well as rent and rates for which he pays £7,200. His final expense is his general administration charges which come up to £2,250 per year.

Complete a trading profit and loss account and balance sheet using this information and work out the ROCE, gross profit margin, net profit margin as well as the current ratio and the acid test ratio.

Profit and Loss		
	£	£
Sales	529,300	
Less refunds	300	
		529,000
Less cost of goods sold		
Opening Stock	40500	
Purchases	270000	
Closing Stock	20000	
		290500
Gross Profit		238,500
Less Expenses		
light and heating	3600	
rent and rate	7200	
Salary	26000	
general admin	2250	
Total Expenses		39050
Net Profit before tax		199,450

Balance Sheet		
	£	£
Fixed Assets		
Premises	245000	
Equipment	17500	
Fixtures and Fittings	23025	
		285525
Current Assets		
Stock	290500	
Debtors	49600	
Cash at bank	8010	
Cash in hand	965	
		349075
Less Current Liabilities		
Creditors	12150	
VAT	26000	
		38150
Working Capital		310925
Less Long Term Liabilities		
Mortgage	132000	
Net Assets (capital employed)		464450
Financed by		
Capital	265000	
Retained Profit	199,450	
Capital Employed		464450

ROCE: (199,450/464,450) x 100 = 42.94%

Gross profit margin: (238,500/529,000) x 100 = 45.09%

Net profit margin: (199,450/529,000) x 100 = 37.7%

Current ratio: (349,075/38,150) 9.15:1

Acid test ratio: [(348,075-290,500)/38,150] = 1.54:1