Everyone going into business will, sooner or later, need to get to grips with accounts. This section will hopefully explain some of the terms that you will be faced with. See further down the page for an explanation.

Capital Items

Revenue

Profit & Loss

Bottom Line

Salaries or "Drawings"

PAYE

Gross Profit

Net Profit

Break Even

Depreciation

Cash Flow

Balance Sheet

Fixed Costs

Capital items relate to the essential fabric of the business and include machinery and premises.

Revenue includes items like rates, fuel, and advertising. It is important to make, and remember, this distinction for tax purposes.

For smaller businesses, the trading account and **profit & loss** account are usually shown together. Only in the case of limited companies with high profit levels is there a need to show items such as tax and dividend payments, in a separate profit & loss account.

The final figure or **'bottom line'** should reflect the net profit (or loss) after all deductions.

Salaries or 'drawings' of sole traders and partners are treated differently in accounts from the salaries of directors of limited companies. The salaries of directors are deducted in the accounts and net profits are shown after these payments. Conversely, the drawings of sole traders/partners are shown in the balance sheet under the heading 'capital accounts' so net profit is shown before these payment. The same also applies to tax.

Income tax due by limited companies under PAYEE, (being a company liability) is usually shown in the accounts. Tax owed on drawings is not usually shown, as it is the personal liability of an individual, not the business.

Gross profit is the difference between sales and direct costs of the goods sold such as raw material costs and manufacturing costs. These costs are often known as direct or variable costs as they are associated directly with the cost of the goods and vary more less in proportion with sales.

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Net profit is arrived at after deducting all other costs from the gross profit. These costs include rates, heating, administration etc. and are known as indirect or fixed costs. This is because they don't vary directly with sales and because they do not generally change; businesses do not receive a reduction on their rates just because they are experiencing lean times. Splitting the figures like allows you to calculate a 'break-even' point.

Break-even is defined as the point when sales reach a level where the gross profit covers the indirect costs. The break-even point is important when looking at profit and loss projections. The nearer the break-even sales figure to the likely maximum sales level, the more risky the business is likely to be.

One figure that often causes some confusion is that of **depreciation** because it is not a cash payment but represents the cost to the business of the decreasing value of the fixed assets.

A machine will lose value and eventually have to be replaced. If this decreases in value and is not allowed for in the accounts, the business may have to write off the original value of the machine when it reaches the end of its useful life.

Depreciation needs to be remembered when calculating prices and profit margins because the decreasing value of the machine is a real cost to the business, which shows itself when the machine has to be replaced. It's worth noting that depreciation is often omitted from pro-forma profit and loss projections.

Cash flow is an area, which is often overlooked, but it needs to be given a top priority because if not properly managed, it will cause problems for your business. It is worth bearing in mind that the accounts show the overall result of trading for a set period and do not necessarily reflect the current performance. This is a good reason for having quarterly, or even monthly, management accounts in addition to annual accounts.

The **balance sheet** shows the financial position of a business on the day the balance is struck. This means the balance sheet acts as a snapshot of the business and the position could alter at any time. Traditionally, a balance sheet was presented showing all the assets of the business on one side and all the liabilities on the other. Nowadays, balance sheets are usually presented showing all the assets,taking off the liabilities to parties outside the business and leaving a figure, which is balanced by the owners capital in the business. Assets are usually split into fixed assets and current assets and liabilities into current and long term.

Fixed assets include property, plant and machinery, vehicles etc. Current assets include cash, debtors and stock, while current liabilities will include trade creditors and other short-term creditors such as rent and rates and bank overdrafts.

PROFIT AND LOSS

Profits are not just essential to keeping you in comfort in your old age - without profit you won't be able to guarantee the long-term survival of your business. Profits provide the vital funds needed for reinvestment and growth.

The profit and loss account gives a picture of a company's trading performance over a period of time in terms of income, sales and expenditure.

An examination of the P&L statement will tell you where to take corrective action in your business. You may find your overheads cost or your raw material cost is too high – so, either reduce these costs or raise the price of the goods and services you sell.

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The period of time is usually a year with all businesses required by law to produce a profit and loss statement, as part of their final accounts. Sales and expenses accrued in the year, but not paid for until the following year, are still included.

Key terms:

Turnover. Also referred to as sales and excluding VAT. This is the sum of all invoices received in the accounting period, regardless of whether they've been paid for yet.

Cost of goods sold. This covers all costs directly attributed to the products/services of the business over the course of the year. Main contributors to cost will be raw materials and employee costs. Stock purchased in the year, but not yet utilised, will not be included. Conversely, stock purchased the previous year and used during the current financial year will be included.

Gross profit. This is turnover less the cost of sales.

Indirect costs. Rents, rates (salaries are sometimes included here instead) and depreciation on fixed assets. These costs would occur regardless of how many products or different services you sell. Subsequently, they cannot be directly attributed to sales.

Depreciation. Depreciation is charged to cover the wear and tear of fixed assets. It allows the cost of the fixed asset to be spread over that asset's working life. If the total cost of the asset was included in the profit and loss account in the year of purchase profits for the first year would appear too low and, for the following years, too high. Calculating depreciation on machinery which, in general, has a fixed working life, is a more simple process than for a fixed asset.

Operating profit/ profit before interest and tax (PBIT). This figure takes into account non-operating income or profit like the sale of a property, for example.

Other 'headaches'

If the profit and loss statement was simple to put together there would be no need for accountants. Income from a contract lasting a number of years may come at different times – how much should you apportion to each year?

You might need to make adjustments to take into account customers unlikely to pay, and the length of time over which your company's fixed assets are depreciated will be important.

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Company X: Profit and Loss account for year ending 30.03.01

	£	£
Turnover		**600,000**
Less Costs of goods sold		
Opening stock/work in progress	60,000	
Raw materials	100,000	
Employee wages	200,000	
TOTALS	**360,000**	
Less closing stock	40,000	
		320,000
Gross Profit		280,000
Less indirect costs		
eg Rent	10,000	
eg Rates	8,000	
eg Depreciation	5,000	
OPERATING PROFIT		**23,000**
		257,000

CASHFLOW

Balance sheets and profit and loss statements indicate the health of your business at the end of the financial year. What they fail to show you is the timing of payments and receipts and the importance of cashflow.

Your business can survive without cash for a short while but it will need to be 'liquid' to pay the bills as and when they arrive. A cashflow statement, usually constructed over the course of a year, compares your cash position at the end of the year to the position at the start, and the constant flow of money into and out of the business over the course of that year.

The amount your business owes and is owed is covered in the profit and loss statement; a cashflow statement deals only with the money circulating in the business. It's a useful tool in establishing whether your business is eating up the cash or generating the cash.

At lot depends on the stage of your company's growth and the type of industry your business is in – young companies need high investment at a time of limited initial sales. Mature businesses are likely to generate more cash.

The cashflow position of your company often depends on the acceptability of selling or buying on credit or dealing in cash. Retailers are generally paid in cash and have good credit terms with their suppliers – it equates to a very healthy cashflow position. Without disciplined credit control businesses that offer good credit terms can end up with have perilous cashflow.

Expenditure is a necessary evil but it also eats up cash. Salaries, stock, raw materials, machinery, tax all have to be paid for. Then there are repayments of bank loans, interest and overdrafts to consider and the payment of dividends bonuses and money owed to the directors

All of this requires skilful financial juggling. How well you manage your cashflow will be a reflection of how well you run your company.

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Forecasting

Danger Signs

Good Practice

Routes to Bad Cashflow

How to Build a Cashflow Forecast

How to build a cashflow forecast
Set up a simple table with columns for the coming 12 months and first enter your most realistic projections of how many units of each product or service you are going to sell. E.g.

Month	**1**	**2**	**3**	**4**	**5**	**6etc**
Product 1 - boxes delivered		50	200	300	400	500
Service 1- consultancy days	10	15	20	20	20	20

Consider the revenue these sales will produce (invoice value) and then consider when this will be likely to be received by you and project it into your table.

Month	**1**	**2**	**3**	**4**	**5**	**6etc**
Product 1 - boxes delivered		50	200	300	400	500
Service 1 - consultancy days	10	15	20	20	20	20
Cash received from sales						
Product 1				5000	20000	30000
Service 1		5000	7500	10000	10000	10000
Total cash income		**5000**	**7500**	**15000**	**30000**	**40000**

Then consider the direct costs of making these sales and when you will have to pay for these in order to be able to deliver to your customers. Plot these into your monthly table: - You'll need to consider minimum order quantities and laying down adequate working stocks as well as what is required to send out the goods and services i.e. replacing the stocks.

Month	1	2	3	4	5	6etc
Product 1 - boxes delivered		50	200	300	400	500
Service 1 - consultancy days	10	15	20	20	20	20
Cash received from sales						
Product 1				5000	20000	30000
Service 1		5000	7500	10000	10000	10000
Total cash income		**5000**	**7500**	**15000**	**30000**	**40000**
Direct Cost of Sales						
Product 1 - materials	5000	1000	4000	6000	8000	10000
Service 1 - consultants costs	2500	3750	5000	5000	5000	5000
Sub Total	**7500**	**4750**	**9000**	**11000**	**13000**	**15000**

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You will also have to incur fixed costs and overheads in order to run the business Dependant on the business activity these might include paying for the premises you will operate from, the costs of heating lighting etc, the costs of marketing and promoting your business etc.

They will need to include employment costs of any staff you will require and associated costs of providing them with what they need in order to deliver effectively - computers, office equipment cars etc.

Think about these carefully, considering when you will have to take these costs on and plot them against the headings most relevant to your business into your monthly plan table.

Direct Cost of Sales						
Product 1 - materials	5000	1000	4000	6000	8000	10000
Service 1 - consultants costs	2500	3750	5000	5000	5000	5000
Sub Total	**7500**	**4750**	**9000**	**11000**	**13000**	**15000**
Fixed Costs				5000	20000	30000
Rent, Rates and Utilities	3000		500	3000		500
Staff Costs	1500	2000	4500	4500	4500	6000
Accountancy and Legal costs			200	200	200	200
IT and Office maintenance		100	150	200	200	200
Marketing and PR	5000	250	500	750	1000	10000
Other fixed overheads etc	400	500	600	700	800	800

BALANCE SHEET

What is a balance sheet?

A 'snapshot' of a company's Assets (what is owned) and Liabilities (what is owed). A Balance Sheet has to be prepared at least once a year as part of the company's accounts.

Total assets will always equal total liabilities, hence the 'balance'. For example the money value of what you invest in the business (an asset) is owed to you by the business (a liability).

Why is it useful?

Basically four reasons:

1. It tells you how much capital is used in the business
2. It reveals how 'liquid' your assets are i.e. how quickly they can be turned into cash
3. It indicates how affluent your business is
4. It gives you a breakdown of how your business is financed

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The make-up of the balance sheet

Fixed assets. These include plant and machinery and are recorded at their depreciated value. For an asset to be considered 'fixed' it should have a life longer than one year. A value of 'intangible' assets, such as goodwill, brand names and intellectual property, is also recorded. You will need the help of an accountant to estimate the value of intangibles.

Current assets and current liabilities. These are short-term assets (usually with a life less than a year). This includes stock, work in progress, cash in the bank and trade debtors.

Current liabilities. This is a calculation of the money you owe (trade creditors), overdrafts, any hire purchase arrangements or loans. Current liabilities includes all debts that should be paid back within the year. If your current liabilities are greater than your assets you could have real problems meeting your debts when they arrive. If this problem is not resolved the business could become insolvent.

Long-term liabilities. This covers creditors, bank loans, and directors' loans all falling later than a year. (Only the proportion due after the 12 months is considered). Deducting this figure from the net current assets leaves a figure for net assets.

Capital employed. This covers long-term financing such as bank loans and shareholders funds. Shareholders funds include the total value of shares, reserves and retained profits.

Potential problems

Valuing intangible assets, stocks and shares could pose a problem as well as how quickly you decide to depreciate your fixed assets. You will need to make adjustments for customers you think might not pay and make a provision for future liabilities.

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