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What should you learn from a set of accounts?

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As an entrepreneur you can increase your chances of making the right decisions and succeeding once you understand the basic concepts of some business-related subjects such as Economics, Marketing, and Operational Management, among others. Finance and Accountancy are crucial business subjects to be learned. In my opinion, all business subjects have the same value. That is the reason I would like to share with you what I think you should learn from analysis of any set of accounts. I will try to avoid technical words as much as I can and I will try to concentrate on what I think will be most relevant to you. Don't worry if you do not learn everything. At least you will be able to exchange a few words with your accountant when they start talking a lot of jargon with you.

Let's start.

A company set of accounts is a document, usually covering a period of 12 months, which needs to be prepared and signed by the company directors. In some countries, such as the UK, the set of accounts needs to also be submitted to the Government and the company financial information will be publicly available. In the UK, Companies House (www.companieshouse.gov.uk) is the place where you can find public information about companies.

95% of all limited companies' sets of accounts are prepared and submitted with the help of an accountant.

As you can see, the set of accounts can be used for many reasons.
The main ones are:

1. Government control (External use) – the Government wants to control company information for two main reasons: collection of company taxes and data research;
2. Company directors and employees (Internal use) - People working for the company want to understand the financial situation of the company they are working for;
3. Banks and lenders – Information needs to be supplied to the lenders to work out if the company can afford a loan repayment with interest.

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What is usually included in an unaudited set of accounts for a Small or Medium-sized Enterprise in the UK?

- Company information: Company director(s) names, Registered Office Address and Company registration number.

- Company director report: Document produced by the company director with some relevant information such as company activities (what the company does), and what services and products the company sells.

- Profit and loss account (profit and loss statements): this is the financial statement showing the business' financial performance. It shows what the company's profitability is.

- Balance Sheet: This is a financial statement that shows the company assets and liabilities at the end of the financial year. It is a snapshot of the company. Imagine that you took a picture of your whole business at a certain time. Now, start thinking about what the company owes and owns. Imagine what is positive about your company. For example: cash in the bank, stock that can be sold, money to be received by clients, property, vehicles. Now, let's imagine what is negative about your company. For example: loans, money owed to suppliers, money owed to the government. The balance sheet is a statement, which organizes the assets, liabilities and capital in a standardised format.

- Notes of the accounts: there are some points in the profit and loss and in the balance sheet which need to be further explained. These explanations can be found in the notes of accounts section.

- Trading Profit and Loss Accounts: This is a long version of a profit and loss account. It is the profit and loss with more details.

Let me explain a little more about profit and loss.

The profit and loss account will always look like the one below:

Profit and loss account

Turnover	£ xxx, 00
Cost of Sales	(£ xxx, 00)
Gross profit	£ xxx, 00
Administrative expenses	(£ xxx, 00)
Operating profit	£ xxx, 00
Interest payable	(£ xxx, 00)
Profit on ordinary activities before taxation	£ xxx, 00
Tax on profit on ordinary activities	(£ xxx, 00)
Profit on ordinary activities after taxation	£ xxx, 00

Let me see if I can simplify the formula above:

The profit your company generates is your company total sales minus your company total expenses. Right? Yes, correct. Profit is total money in minus total money out. Period.

The most simplified version of profit and loss could be shown as:

Total Sales (-) Total Expenses = Total Profit

Let's say that the company made sales of £14,000 with total expenses of £12,000. (Materials £4,000, Labour £4,500, rent £1,000, utility bills £2,000 and insurance £500).

How much would the company profit be?

Total Sales	£ 14,000
(-) Total Expenses	£ 12,000 (£ 4,000 +£ 4,500 + £ 1,000 +£ 2,000 + £ 500)
= Total Profit	£ 2,000

Now, let's separate materials and labour from all the other administrative expenses (Rent, Utility Bills and Insurance).

Material and Labour is also known as Cost of Sales. (Very simplified explanation)
Now, let's rework our formula above:

Total Sales (-) Total Cost of Sales (-) Administrative Expenses = Total Profit

> In our example:
> Total Sales (-) Total Cost of Sales (-) Administrative expenses = Total Profit
> **£ 14,000 (-) £ 8,500 (-) £ 3,500 = £ 2,000**

There is also another accounting concept called Gross Profit. Gross Profit is always the total sales minus the total cost of sales.

> In our example:
> Total sales (-) Total Cost of Sales = Gross Profit
> **£ 14,000 - £ 8,500 = £ 5,500**

Gross Profit (-) Total Administrative Expenses = Total Profit

In our example:

Gross Profit (-) Total Administrative Expenses = Total Profit

£ 5,500 - £ 3,500 = £ 2,000

Both calculations are the same. Can you see this? What I am trying to explain to you is: The result is always the same. The only difference is the way our calculation is shown.

In the UK, a limited company needs to pay Corporation tax on the company profits.
In this way, the company profit after tax will be:

Company profit after tax = Total profit (-) Corporation tax

Let's say that Corporation tax is 19% of Company Profit (as of 2019)

In our example:

Company profit after tax = Total profit (-) Corporation tax

Company profit after tax = £ 2,000 – £ 380 (19 % of £ 2,000) = £ 1,620

The last trick in the profit and loss calculation is that if the company has a loan, like a bank loan, the company needs to pay interest on the loan and this interest also needs to be shown separately in the profit and loss. (Also known as interest payable).

Back to our set of accounts explanation: We need to show a full break-down of profit and loss in order to comply with standards and regulations.

Let me explain the technical terms for you:

Turnover (-) Cost of Sales = Gross profit

Gross profit (-) Administrative expenses = Operating profit

Operating profit (-) Interest payable = Profit on ordinary activities before taxation

Profit on ordinary activities before taxation (-) Tax on profit on ordinary activities =

Profit on Ordinary activities after taxation

Let's define the terms above:

Turnover: Total company sales excluding VAT.

Gross profit: Total sales minus total cost of sales (also known as marginal contribution). In general terms gross profit is how much is left in the company to pay all the company expenses.

Administrative expenses: Also known as company overheads. These are company expenses such as: rent, rates, director salaries, motor expenses, accountancy fees, telephone, and others.

Operating profit: Accounting technical term gross profit minus total administrative expenses.

Interest Payable: Financial interest expenses. Example: bank loan interest

Profit on ordinary activities before taxation is a technical accounting term. It is the total operating profit minus the interest payable.

Tax on profit on ordinary activity: In the UK this is also known as "Corporation tax".

Profit on Ordinary activities after taxation: Accounting technical term: total profit on ordinary activities before taxation minus tax on profit on ordinary activity.

Let me give you an example.

Let's say that the company Furniture UK produced the following figures:

Turnover of £ 1,458,255.00

Materials and Labour of £ 471,939.00

Administrative expenses of £ 673,175.00

The company does not have any loans.

The profit and loss statement would be as follows:

Profit and loss account	
Turnover	£ 1,458,255.00
Cost of Sales	(£ 471,939.00)
Gross profit	£ 986,316.00
Administrative expenses	(£ 673,175.00)
Operating profit	£ 313,141.00
Interest payable	(£ 0,00)
Profit on ordinary activities before taxation	£ 313,141.00
Tax on profit on ordinary activities	(£ 59,496.79)
Profit on ordinary activities after taxation	£ 253,644.21

IE: The tax on profit in the UK (Corporation tax) was calculated as being 19% of total profit (as of 2019). Please check the latest rate in your country.

The total profit left in the company (Profit on Ordinary activities after taxation) can be distributed to the company owners as dividends or it can be retained as retained profit. I will talk about this subject later.

Now let's move on to the balance sheet.

What does a balance sheet look like?

Company UK Ltd (Balance Sheet)

Fixed Assets	
Tangible Assets	£ xxx, 00
Current Assets	
Stock	£ xxx, 00
Debtors	£ xxx, 00
Cash at bank	£ xxx, 00
Total Current Assets	£ xxx, 00
Current Liabilities	
Creditors: Amounts falling due within one year	£ xxx, 00
Net current Assets	£ xxx, 00
Long-term liabilities	£ xxx, 00
NET ASSETS	**£ xxx, 00**
Capital and reserves	
Called up share capital	£ xxx, 00
Profit and loss account	£ xxx, 00
Shareholders funds	**£ xxx, 00**

How is the balance sheet organised?

We can divide the balance sheet into three parts:

Assets, Liabilities and Shareholder funds

Let me define the terms first:

Assets

This is what the company owns (positive side). We can divide this into two categories: fixed assets and current assets.

Fixed assets are tangible assets such as properties, equipment, furniture, vehicles and computers. These assets usually depreciate. Depreciation means they lose value as they get older. They are also known as "fixed" because they are tangible and we usually need to sell them to yield cash.

Current Assets: these assets can be cash or any other asset which can easily become cash. Examples: cash, deposits, stocks, amounts to be received by clients (also known as trade debtors).

Total Assets in the balance sheet is the total fixed assets plus total current assets.

Company liabilities

The company liabilities are divided into two categories:

Current liabilities: These are liabilities which become due within 12 months. The main examples are: Amount owed to suppliers (also known as trade creditors), Tax (amounts owed to the Government); short term loans.

Long term liabilities: These are liabilities which become due in more than 12 months. They could be long term loans, bank loans, or other types of loan.

Let's move onto the last part:

Capital and reserves

The two main categories are: called up share capital and profit and loss account.

Called up share capital is the total value of the company shares. These shares are owned by the company shareholders.

The profit and loss account is the account which shows the accumulated retained profit or loss in the company in the last years, as well as the profit or loss for the current period.

We also need to understand the following accounting terms:

Net current assets/liabilities

This is the total current assets minus the total current liabilities. It shows the liquidity of the company (also known as working capital).

Net Assets/liabilities

This is the total assets minus the total liabilities. It shows how strong or weak the balance sheet is. It is the real financial position of the company. It is what is left or what is missing.

Let me give you an example.

Let's say that the company Furniture UK produced the following figures:

> Plant and machinery £ 9,630.00 (nominal value after depreciation)
>
> Stock £ 53,580.00
>
> Amounts to be received by clients (trade debtors) £ 372,086
>
> Business bank account balance £ 32,137
>
> Amounts owed to suppliers within 12 months (trade creditors) £102,396.00
>
> No amounts owed more than 12 months
>
> Share capital £ 1,000
>
> Profit and loss account £ 364,037

The balance sheet of the company would appear as follows:

Furniture UK Ltd	
Fixed Assets	
Tangible Assets	£ 9,630.00
Current Assets	
Stock	£ 53,580.00
Debtors	£ 372,086.00
Cash at bank	£ 32,137.00
Total Current Assets	£ 457,803.00
Current Liabilities	
Creditors: Amounts falling due within one year	£ 102,396.00
Net current Assets	£ 355,407.00
Long-term liabilities	£ 0,00
NET ASSETS	**£ 365,037.00**
Capital and reserves	
Called up share capital	£ 1,000.00
Profit and loss account	£ 364,037.00
Shareholders funds	**£ 365,037.00**

Now, we need to talk about the profit and loss accounts for a moment.

The total Profit on ordinary activities after taxation in the profit and loss can be distributed as dividends or kept as retained profit.

In our example, the company had accumulated profits of £ 145,168 for the previous years. Let's make an analysis:

Profit and loss account	
Opening balance	£ xxx,00
Profit for the year	£ xxx,00
Dividends	£ xxx,00
Closing Balance	£ xxx,00

Let's use the figures from our example. In this financial year, the company shareholders cashed £ 31,643.80 as dividends (profit distribution) as shown below:

Profit and loss account	
Opening balance	£ 145,168.00
Profit for the year	£ 250,512.80
Dividends	£ 31,643.80
Closing Balance	£ 364,037.00

You'll notice that the close balance of the profit and loss account £ 364,037.00 can also be found in the capital and reserves in the balance sheet. It is not a coincidence.

The total Shareholder funds of the company will always be the total of the share capital plus the profit and loss accumulated balance.

Capital and reserves	
Called up share capital	£ 1,000.00
Profit and loss account	£ 364,037.00
Shareholders funds	**£ 365,037.00**

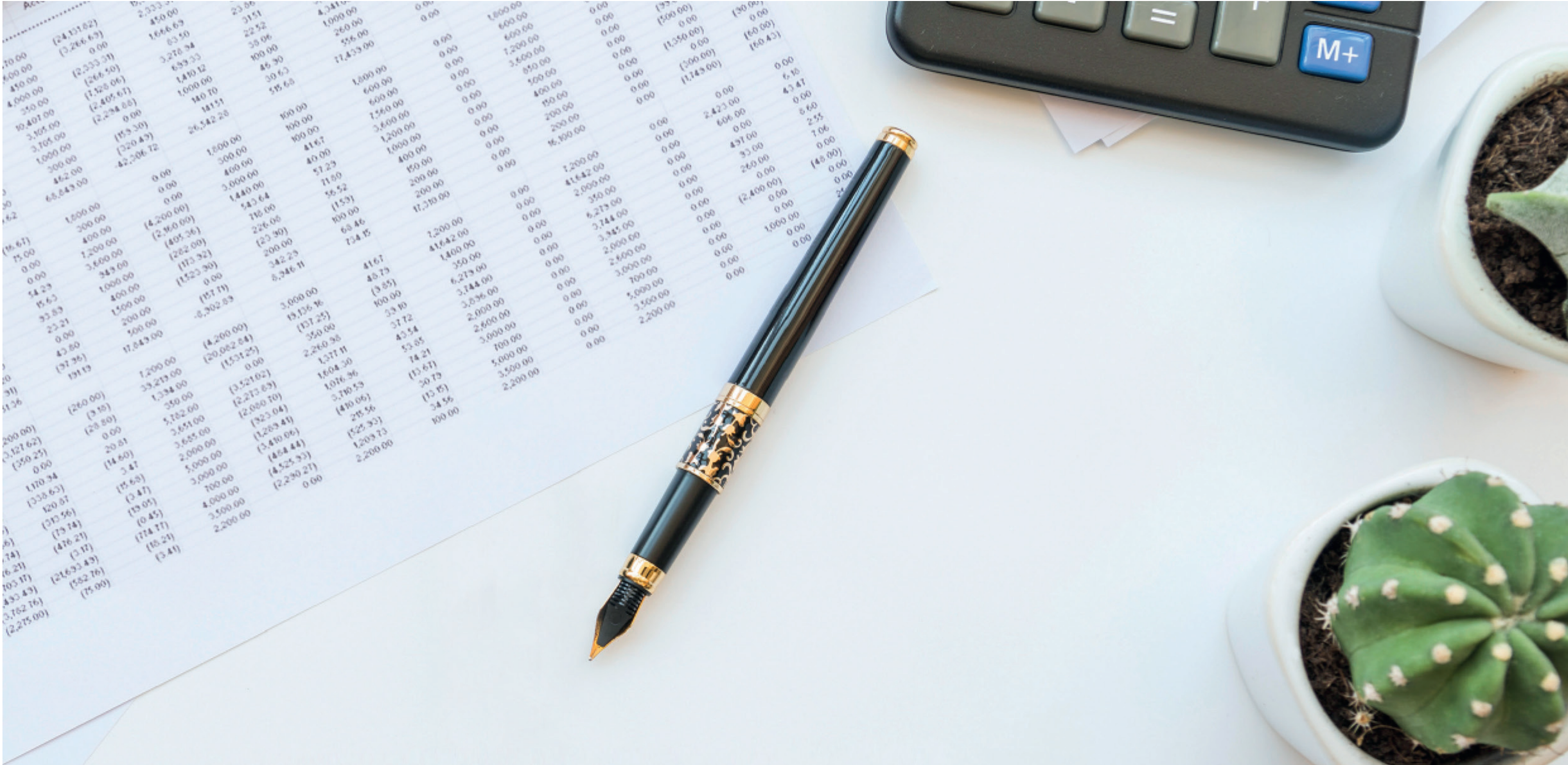
The last lesson I woud like to teach you is: in any company balance sheet, the following equation is always applicable:

Total Assets = Total liabilities + Total capital (share capital + profit and loss)

Tangible Assets £ 9,630.00 + Total Current Asset £ 457,803.00 = Current Liabilities £ 102,396.00 + Called up share capital £ 1,000.00 + Profit and loss account £ 364,037.00

Total Assets = Total liabilities + Total capital (share capital + profit and loss)

£ 467,433 = £ 467,433



I hope you learned a lot from this report prepared specially for you.

If you have any comment about the report please send me an email at:
rodolfo.b@verticeservices.com

Best wishes

Rodolfo Basilio

www.verticeservices.com

info@verticeservices.com

VERTICE™ SERVICES

020 7328 8338

1 College Yard,
56 Winchester Avenue,
London, NW6 7UA

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