INSTANT GUIDE TO

ACCOUNTING & FINANCE

FOR NON-ACCOUNTANTS

2020 Edition

Naeem Anwar FCA

Instant Guide to
Accounting & Finance
for non-accountants

Helping business owners, directors, managers, budget holders and staff to better understand the world of accounting and finance.

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1. Introduction

I'd like to start by asking the question 'Why is accounting important?'

Think about any successful organisation in the world. Whether its tech giants like Apple and Microsoft, supermarket chains like Walmart and Tesco or global sporting brands like Nike and Adidas. Can you imagine them running successfully without having their finances in order?

They have teams of accountants working for them across the globe, measuring and reporting their financial performance on a monthly (if not weekly) basis. It doesn't necessarily mean that their senior managers spend hour after hour poring over Balance Sheets and Profit and Loss Accounts. It simply means they are collecting information, summarising it and presenting it in a set format which makes it easier to understand to help them make decisions.

Accounting helps companies understand if they have enough money. Otherwise, how would they know? How would they know if they are bringing in more money than they are spending? How would they know if they have enough money to invest back into the company and make it even better? How would they know if they have saved enough for a rainy day? How would they know if they are achieving the company's goals and objectives? Accounting helps answer these (and lots of other important) questions.

Every organisation, even not-for-profit organisations need to know where they stand when it comes to money. If they fail to get their finances in order, it's a recipe for disaster. Even some of the biggest companies in the world get it wrong. Big companies go under all the time. Have you ever thought about why this is? How can companies who once dominate the market end up in administration? Usually it's due to a series of bad decisions. That's easy to say in hindsight, but how do we know if a decision is bad at the time of making it? This is where good accounting comes into its own. Looking at accounting information on a regular basis can give early feedback in the form of hard evidence on whether a particular course of action has been successful or not.

I am writing this book because I have a firm belief that organisations that employ staff with an understanding of accounting and finance stand a far better chance of being successful than organisations whose staff don't possess this knowledge.

- Do salespeople in your organisation understand the financial impact of offering discounts to close a sale?
- Do production managers understand the impact of inefficiencies?
- Do budget holders understand how and why budgets are set?
- Do managers have the motivation to meet targets?
- Is there a sense of collective responsibility for taking care of the finances (or is it left to senior management)?

If you answered 'no' to any of these questions, then training your staff on finance is the answer.

So it’s clear, having staff with an understanding of the key principles of accounting will benefit the company or organisation as whole.

What about the employees themselves? From the employees’ perspective, having a firm grasp of key accounting principles will give them a wider set of skills and bring about both personal and professional development. Employees will be able to offer more to the company and achieve more in their individual careers which means it's a win-win situation.

In this book, I will explain the key principles of accounting, provide an overview of the main areas and a reference point for non-accountants. I hope you will come back to it time and again to remind yourself about the purpose of a Balance Sheet, or how to go about setting a budget, or useful Key Performance Indicators (KPIs) you could measure at your organisation (or any other accounting question that pops into your mind.)

So let’s get started with the main things people associate with accounting, Profit and Loss Accounts and Balance Sheets.

2. Profit and Loss Account

Summary Table:

The Profit and Loss Account shows sales at the top of the page and then all the costs are deducted before arriving at the profit or loss figure at the bottom of the page.

Example Company Ltd
Profit and Loss Account
For the year-ended 20X0

	£000s
Sales	**6,587**
Cost of Sales	(2,580)
Gross Profit	**4,007**
Wages	(1,643)
Rent	(1,056)
Heat and light	(179)
Rates	(129)
Insurance	(28)
Freight	(264)
Postage	(12)
Stationery	(10)
Depreciation	(211)
Interest	(124)
Tax	(137)
Dividends	(50)
Net Profit (or loss)	**164**

The Profit and Loss Account shows how the business has performed over a period of time and it's a great way of finding out whether the business has made any money over the last year or so.

However, looking at the Profit and Loss Account in isolation and without any context can be deceptive.

If the Profit and Loss Account shows a loss, is it a disaster or has it just had one bad year amongst many successful years? Maybe there was a one-off event that affected this particular year's bottom line.

On the other hand, a loss could be an indication of further problems to come in the future. Maybe there are quality issues and the business is losing customers. Maybe it has got into a habit of spending too much. Maybe it's not as efficient as it once was. These are all factors that would affect the current year and if they aren't addressed, they may well affect future performance too.

The key point here is the bottom line on the Profit and Loss Account is by no means the only important number in the accounts. It's only one piece of information and it should be looked at in conjunction with all the other information available to make a reasonable assessment of the company's performance.

In particular, when looking at the Profit and Loss Account it is useful to compare the figures to previous years or to budgets and forecasts. You will find any set of published accounts usually show the previous year's figures as well as the current year and the reason for this is to add context. I will talk about budgets and forecasts later in this guide in Chapters 15 and 16 respectively.

Gross Profit

As you can see from my example company's Profit and Loss Account, it shows the Gross Profit as well as the Net Profit. What is the point of this? Is it just a sub-heading?

Well, the Gross Profit is actually a good indicator of profitability and also helps with things like comparing across different industries and to other companies within the same industry. It is often expressed as a percentage of sales and referred to as the Gross Profit Margin.

Gross Profit and Net Profit is a bit like talking about Gross Wage and Net Wage. Your Gross Wage tells you how much you are getting paid compared to others. For example, we know an airline pilot's Gross Wages are likely to be more than those of a janitor and in this example, we can see how the Gross Wages helps us differentiate between higher paid jobs and lower paid jobs. In addition to this, airline pilots and janitors need to know how their Gross Wages compare to other airline pilots and janitors so they know if they are getting a fair deal from their employer.

It's also worth considering the fact that maybe the pilot has higher living costs than the janitor and actually has *less* money left to spend on luxuries after his or her costs.

The same principles apply to companies. They will look to operate within markets with higher Gross Profit Margins and they will try to work as efficiently as possible to ensure that their Gross Profit Margin is at least as good as the industry average. If their Gross Profit Margin is lower than other companies in the same business, they know they need to look into it and do something about it.

Cost of Sales

Cost of Sales are a key component of Gross Profit. These are the costs associated with bringing a product or service into a state or condition that can be sold. It is important to consider the purpose of the business when looking at Cost of Sales and Gross Profit. Consider the example below:

Hand-knitted scarves

Sam (seller)	Joe (maker)
Cost of Sales: The cost of buying the scarves from the maker Delivery costs	Cost of Sales: Materials: wool Labour: the time to knit the scarves

You can see from this very simple example that both Sam and Joe run a business in the scarf industry. However, the Cost of Sales for the scarf seller are different to the Cost of Sales of the scarf maker.

If Sam buys a scarf from Joe for £20 and sells it on for £50, then Sam's Gross Profit Margin would be 60% because the £30 profit is 60% of the £50 sale price. He could try and find out whether a 60% Gross Profit Margin is typical for that industry and if it's lower than the average, he may need to look for a different maker or negotiate with Joe on cost.

Net Profit

The Net Profit (or bottom-line profit) is self-explanatory in that it's the actual profit the business makes after all wages, admin expenses, overheads, tax and dividends have been deducted. The Net Profit for the current year is added to all the previous years profits and is summarised as a single line at the bottom of the Balance Sheet. I'll talk more about this in the next section.

EBIT and EBITDA

EBIT stands for Earnings Before Interest and Tax. EBITDA stands for Earnings Before Interest, Tax, Depreciation and Amortisation.

Depreciation is the amount by which an asset loses its value over time. A good example of a depreciating asset is a car because its value falls the moment it leaves the dealership forecourt. Most assets depreciate but there are exceptions such as property, jewellery and gold which may *appreciate* in value over time rather than depreciate.

The amount by which a business's assets depreciate in each year is reflected in the Profit and Loss Account.

Amortisation is the same as depreciation but it relates specifically to 'intangible assets' such as goodwill rather than physical assets. I will talk more about intangible assets in the business valuations section later in the guide.

EBIT and EBITDA are popular sub-headings that you may find in a Profit and Loss Account. As with the Gross Profit Margin, these headings help to provide a consistent approach when comparing businesses' profits to ensure that you are comparing like with like.

Length

Note that the Profit and Loss Account can be for a shorter or longer period than a year, for example in the first and last years of trading, but mostly they are annual.

Profit is not cash

A final point I would like to mention on the Profit and Loss Account is that the profit is not the amount of cash generated in the business. It is important to distinguish cash from profit.

If a window cleaner has a good year and buys a new van, it doesn't mean that his profit is lower because he has invested the money back into his business. On the contrary, the van is an asset on the Balance Sheet and it will be used over the coming years to generate even more income.

If he buys the van for £5,000 cash, on the day he buys it his bank balance will be lower by £5,000 but he will have an asset on his Balance Sheet worth £5,000.

For simplicity, let's assume the van will be used for 5 years and it depreciates by £1,000 per year.

In the accounts, the cost of the van is spread over 5 years even though the full £5,000 was paid on day one. Each year, there will be a £1,000 reduction in the value of the asset on the Balance Sheet and a corresponding £1,000 'charge' of depreciation to the Profit and Loss Account.

The Profit and Loss Account gives a true picture of how the window cleaner's business has performed because it spreads the cost over the lifespan of the van rather than showing the whole cost in the first year.

3. Balance Sheet

Most people are familiar with the term 'Balance Sheet' but what does it actually mean and what is its purpose?

The international term for Balance Sheet is 'Statement of Financial Position' which I think is a much better description. The purpose of the Balance Sheet is to show the financial position of a business *at a particular point in time*. Unlike the Profit and Loss Account which covers a period of time, the Balance Sheet is more of a snapshot.

Whilst the Profit and Loss Account is all about income and expenditure (how much money the business has brought in through sales and how much it spent), the Balance Sheet is more interested in assets and liabilities i.e. things you own and things you owe.

Profit and Loss Account	Balance Sheet
Financial performance	Financial position
Over a period of time	At a particular point in time
Income and Expenditure	Assets and Liabilities

It is called a Balance Sheet because the total on the top half of the Balance Sheet matches the total on the bottom half of the Balance Sheet i.e. both halves of the Balance Sheet are 'in balance'.

They balance because there's a list of what the business has got and a list of where it came from, so they must be the same. If you like maths, here's the algebraic version:

Assets - Liabilities = Share Capital + Profit and Loss Reserves

which is the same as

Assets = Liabilities + Share Capital + Profit and Loss Reserves

What the business owns

Where it has come from

The top half of the Balance Sheet shows Assets and Liabilities. The bottom half of the Balance Sheet shows Share Capital and Reserves. Reserves is a fancy way of saying ‘all the previous Profit and Loss Accounts from past years added together’. Reserves also include the current year’s Profit and Loss Account to-date. You can see from this that the whole of the Profit and Loss Account is summarised and effectively denoted as one line on the Balance Sheet.

Share Capital is about ownership. The shareholders own the company whilst the directors are employed to run it. If shareholders are not happy with how the company is being run, they could attend the Annual General Meeting (AGM) and voice their concerns.

A company can issue new shares to raise more capital. This means it can create and sell new shares to bring more money into the company to help it grow. However, this impacts existing shareholders because it dilutes their shareholding and gives them less control compared to the option of borrowing money from a bank. It also makes their shares a bit less valuable because they now have a smaller proportion of total shares in the company.

There can be different classes of shares and each class of shares would have different values, dividends and voting rights. Essentially, it allows for a bit more flexibility.

<u>**Example Company Ltd**</u>
Balance Sheet
As at 31st March 20X0

	£000s
Fixed Assets	
Buildings	3,571
Machinery	2,159
Current Assets	
Stock	548
Trade Debtors	1,646
Bank and cash	352
Current Liabilities	
Trade Creditors	(645)
Tax	(137)
Long-term Liabilities	
Bank loan	(2,569)
Net Assets	**4,925**
Capital and Reserves	
Share Capital	950
Profit and Loss Account	3,975
Capital and Reserves	**4,925**

Match (or "balance")

Another reason for why the Net Assets total always balances (matches) the Capital and Reserves total is that accountants use a system which records everything twice. You may have heard accountants talk about 'debits' and 'credits'. This is a simple rule, a bit like the law of gravity which states that 'what goes up must come down'. Let me use an example to explain this.

Suppose the business buys a new machine for £10k. When the business pays the supplier, the bank balance will go down by £10k but at the same time, the business now owns a machine worth £10k. Everything is recorded in two places. In one place there is a debit and the other place has to be a credit of the same value. If this rule is followed for every single transaction, it's mathematically impossible for the numbers not to balance in the accounts. I will explain this in a bit more detail later in Chapter 8 of the guide.

The last thing I want to mention with regards to the Balance Sheet is that it shows everything that has happened in the business from the date on which the business started up to now. It's an accumulation of all the finances over the years. This is different to the Profit and Loss Account which only looks at the past 12 months and ignores everything that happened before the year you are currently looking at.

For example, the Fixed Asset line in the Balance Sheet shows all the Fixed Assets that have been bought over the years. If an asset is no longer owned by the business, it is removed from the Balance Sheet. Similarly, the bank balance on the Balance Sheet is the balance that has accumulated over the years and shows the exact balance as it stands right now (as at the date of the Balance Sheet). On the bottom half of the Balance Sheet, the Profit and Loss Account line in the Reserves section shows the total of all the Profit and Loss Accounts from previous years added together.

Sometimes I like to use the analogy of what celebrities and sport stars' personal Profit and Loss Accounts and Balance Sheets would look like. They would have a number of luxurious cars, properties (a mansion plus holiday homes), fancy watches and jewellery on their Balance Sheets. Their Profit and Loss Accounts would include chefs, personal trainers, first class flights, hotel bills and nights out.

Another thing is, when a soccer star such as Lionel Messi or Cristiano Ronaldo gives one of the fans in the stadium his match shirt at the end of a soccer match, the shirt means nothing to him. However, it means the world to the fan and it would be worth something. It would be a Profit and Loss Account item for Cristiano and Leo (or their football club who provided the shirt) but a Balance Sheet item for the fan. I can imagine a match-worn shirt from one of the legends of the game would be worth quite a lot in 20 or 30 years' time. This is another example of how context is important when looking at accounts.

Have you ever thought about what would be on your personal Balance Sheet and Profit and Loss Account? What assets have you accumulated in your life so far? Maybe your main assets are your house and your car. If you have a mortgage, that would be a Long-term Liability on your Balance Sheet. What does your Profit and Loss account look like? Is there potential to increase your income? Or could you cut back on expenses in order to increase 'profits'? I often think that people who see their personal finances as a mini-business tend to do well financially.

Apart from the two main financial statements in the accounts I have talked about; the Profit and a Loss Account and the Balance Sheet, there are three lesser-known financial statements which I will briefly explain now.

4. Cash Flow Statement

Out of the three lesser-known financial statements that you might find in a set of accounts, the Cash Flow Statement is probably the one that is most likely to ring a bell.

As explained in the Profit and Loss Account section, it is important to distinguish between cash and profit. Careful management of a business's cash flow is essential because if a business runs out of money, it can be the beginning of the end, even if a business is profitable.

Sometimes businesses are profitable but they decide to spend their cash on big expansion projects, marketing campaigns and machinery etc. and they struggle to pay their suppliers or tax authorities.

This is where Cash Flow Statements and Cash Forecasts can be very useful as they help businesses explain and manage their cash effectively.

The Cash Flow Statement summarises the movement of cash from one year-end to the next. In the following example you can see how the company's bank balance has gone from £197k at the start of the year to £352k by the end of the year.

Example Company Ltd
Cash Flow Statement
For the year-ended 31st March 20X0

	£000s
Cash at the start of the year	**197**
Cash flow from Operating Activities	
Payments from customers	6,497
Payments to suppliers	(2,430)
Wages	(1,643)
Other expenses	(1,678)
Dividends	(50)
Interest paid	(124)
Tax paid	(128)
Cash flow from Investing Activities	
Purchase of machinery	(458)
Sale of old equipment	33
Cash flow from Financing Activities	
Income from new loans	500
Loan repayments	(364)
Cash at the end of the year	**352**

Note how the negative cash *outflow* has been shown in brackets whilst the positive cash *inflow* is shown without brackets.

The ‘cash at the start of the year’ at the top of the Cash Flow Statement matches the bank balance on the Balance Sheet at the end of the previous accounting year.

The ‘cash at the end of the year’ at the bottom of the Cash Flow Statement matches the bank balance on the Balance Sheet at the end of the current accounting year.

Everything in between these two figures is an explanation of cash movements within the business over the course of the last 12 months.

Sometimes the starting point for a Cash Flow Statement is the Operating Profit figure (similar to EBITDA) from the Profit and Loss Account and then adjustments are made for non-cash items such as depreciation.

Regardless of how the figures have been computed or presented (there are slight variations), the principles are the same with the cash inflows and outflows being shown under the three headings used in the example above; cash flow from Operating Activities, Investing Activities and Financing Activities.

5. Statement of Comprehensive Income

This financial statement is less well known than the others that I have already mentioned such as the Profit and Loss Account, the Balance Sheet and the Cash Flow Statement.

Its purpose is to include things in the accounts that have not already been captured in the other financial statements. It's a bit like adding the finishing touches to provide the whole picture to anyone reading the accounts.

Examples of items that might be included in the Statement of Comprehensive Income are:

- Adjustments resulting from exchange rates on foreign currency transactions; and
- The rise or fall in the value of investments that are part of the company's pension scheme and not accounted for anywhere else in the accounts

Companies have the option of including the Statement of Comprehensive Income together with the normal Profit and Loss Account or they can include it separately. So it's useful to know that it can be presented in different ways.

6. Statement of Changes in Equity

The last of the five main financial statements is the Statement of Changes in Equity. This is sometimes included within the notes section of the accounts.

I mentioned in the Balance Sheet section earlier in this guide that all the Profit and Loss Accounts from previous years are added together with the resulting number being shown in the bottom half of the Balance Sheet. The Statement of Changes in Equity shows how this works. It's a bit like a bank balance but instead of calling it a bank balance, it is referred to as a 'Reserves' balance because it relates to profits rather than bank transactions.

As shown in the example on the next page, the Statement of Changes in Equity shows the Profit and Loss 'Reserves' balance brought forward at the start of the year. The current year's profit (which is taken straight from the Profit and Loss Account) is added to this figure and this gives you the balance that is taken forward to next year's accounts. This year's recalculated Reserves balance will then become next year's brought forward (or opening) balance.

Example Company Ltd
Statement of Changes in Equity
For the year-ended 31st March 20X0

	Shares	**Profit and Loss Reserves**	**Total**
	£000s	**£000s**	**£000s**
Balance at the start of the year	**900**	**3,802**	**4,702**
New shares	50		**50**
Profit for the year		214	**214**
Statement of Comprehensive Income			
Foreign currency translations		(7)	**(7)**
Pensions value adjustments		16	**16**
Dividends		(50)	**(50)**
Balance at the end of the year	**950**	**3,975**	**4,925**

Typically, the Statement of Changes in Equity will show the company's Shares and the Profit and Loss Reserves balances. It will also include items from the Statement of Comprehensive Income which I explained in the previous section. In addition to this, it might show dividends that have been paid if they have not already been included in the Profit and Loss Account.

7. Notes to the accounts

All of the financial statements I have talked about are in fact summarised reports. There are normally hundreds or even thousands of transactions that occur in the everyday running of the business. Each individual transaction is recorded using software and summarised into reports known as the Profit and Loss Account and the Balance Sheet etc.

Therefore, each number on the Profit and Loss Account or Balance Sheet is a total from a long list of transactions that can be exported from the software to look at in more detail if needed. However, most of the time, this information is so detailed that it's hard to make any sense of it or be able to draw any useful conclusions from it. That's why some notes are included in the accounts to present additional information in a useful way. It's a way of elaborating on certain figures that are included in the main Balance Sheet and Profit and Loss Account.

For example, the Fixed Assets note shows the types of assets that were purchased during the year; were they buildings or machines? It also shows the value of assets that were bought and if any were sold, as well as the amount by which the assets depreciated in value during the year.

Another example is the Long-term Liabilities note. This shows the different types of borrowings, such as bank loans or HP agreements and when they are due. It would be useful to know if they are all due in the next two years or in the next 20 years because that's a big difference.

The Turnover note might show a breakdown of sales by geographical region or type of product for example.

There are also a lot of other useful pieces of information included in the notes which may (or may not) relate to the Profit and Loss Account and Balance Sheet. For example, you can look at the Employees note to see how many employees there are in the company. This note also shows what the Managing Director or CEO has been paid.

8. Debits and credits

You may have heard accountants talk about 'debits' and 'credits'. This is something that was briefly mentioned in the Balance Sheet section of this guide.

Debits and credits are two words used by accountants to describe the dual nature of every transaction recorded in the accounts. This is referred to as 'double-entry' bookkeeping. The example I used earlier in the book was that of a business buying an asset for £10k. The business will have £10k lower cash in its bank but will now have an asset worth £10k.

Everything is recorded in two separate parts of the accounts.

	Balance Sheet	**Profit and Loss Account**
Debit	Fixed Assets Current Assets (e.g. Trade Debtors, stock and cash in bank)	Expenditure
Credit	Current Liabilities (e.g. Trade Creditors) Long-term Liabilities Share Capital & Reserves	Income

If the business makes a sale of £3k, it needs to record that a sale has been made for £3k but it needs to also record that a customer now owes £3k.

The double-entry would be:

Debit Trade Debtors £3k
Credit Sales £3k

Trade Debtors is the term used to describe customers that owe the business money.

When the customer pays, the business needs to record that there is now £3k in the bank but it also needs to record that the customer has paid and no longer owes £3k.

The double-entry would be:

Debit Bank £3k
Credit Trade Debtors £3k

Here is another example:

If a business buys some stationery for £30, the double entry would be:

Debit Stationery costs £30
Credit Trade Creditors £30

Trade Creditors is the term used to describe suppliers to whom the business owes money.

When the supplier is paid, the double-entry would be:

Debit Trade Creditors £30
Credit Bank £30

An alternative way to look at this is to see what happens when a supplier is paid straight away. In this situation, the double entry would be:

Debit Stationery costs £30
Credit Bank £30

This alternative way shows the same end result as the original double-entries combined because the debit and the credit to Trade Creditors cancel each other out. The supplier is paid and the business owes nothing to them.

Also note that the bank balance is a debit item on the Balance Sheet as shown in the grid at the start of this chapter because it is a Current Asset. When the business pays for the stationery, the credit of £30 to the bank balance in the double-entry has the effect of reducing the bank balance by £30.

One misconception is that debits are good and credits are bad or vice versa. Debits and credits are neither good nor bad. They are just words like up and down. Is up good or bad? If your bank balance has gone up, then it's good. If your mortgage has gone up, then it's bad. In the same way, debits and credits can be good or bad depending on the context.

Another common misconception is that if there is a debit in the Profit and Loss Account, the credit has to be in the Balance Sheet. This isn't necessarily the case. The debit and credit can both be in the Balance Sheet or they can both be in the Profit and Loss Account. Again it depends on the context and the nature of the transaction.

By using this universal method of accounting, accountants can ensure that all transactions have been recorded correctly and accurately and nothing has been missed.

9. Accruals and prepayments

In the Profit and Loss Account section of this guide, I put quite a lot of emphasis on the fact that the Profit and Loss Account shows the financial performance *over a period of time*, normally a year.

There are inevitably times where a business receives a bill late or pays for things in advance. Accruals and prepayments help deal with these situations.

For example, if a business pays for gas and electric on a quarterly basis, the billing quarter might not exactly match the year-end date.

If the year-end is March and the last bill was made up to the end of February, an estimate would have to be made for the usage in March. An adjustment is made in the accounts so that the Profit and Loss Account shows 12 months' worth of gas and electric usage rather than the 11 months that have been billed. This adjustment is called an 'accrual'.

The double entry would be:

Debit	Heat and Light
Credit	Accruals

Accruals are shown on the Balance Sheet under the Current Liabilities section. They are similar to Trade Creditors because they show that an amount is owed to suppliers. In this instance, the gas and electricity was used in March but the bill for this month wasn't received until after the year-end.

Prepayments are the other side to the coin.

This is where a bill is received and paid in advance. For example, a Microsoft Office subscription might be paid for a full year in advance. If some of the months relate to the next accounting year, an adjustment is needed.

Prepayments are shown in the Balance Sheet under the Current Assets section. Prepayments are considered to be an asset because in this example, the business has paid Microsoft in advance and owns the license to use the software for a number of months after the year-end.

10. Principles of accounting

The whole point of accounting and financial statements is to provide useful, meaningful, timely, relevant and understandable information to users.

In order to achieve this, the governing bodies of the accountancy profession have introduced some overarching principles.

The purpose of these principles is to prevent companies from misleading the public, shareholders, investors etc. There are instances where the rules and guidelines are being adhered to, but the accounts still do not show a 'true and fair' view.

For example, one of the things accountants are told to do is look for 'substance over form'. This means that the essence of the transaction is more important than the legal form.

A good example is a large firm that buys a fleet of vans. It could enter into a lease agreement and show the monthly payments as an expense in the Profit and Loss Account. However, if the firm has intended to make the final payment all along which essentially transfers the ownership of the vans to the company, the fleet should be treated as an asset on the Balance Sheet from the outset.

If the firm was to put the lease payments through the Profit and Loss Account, the company would show lower profits and there are many reasons for why a company might want to show lower profits. The main ones are that the company directors can 'smooth out' profits rather than having peaks and troughs. This gives the impression of stability and manages expectations. Also, lower profits could justify lower dividends being paid out to shareholders.

Other accounting principles are the 'matching concept' and 'revenue recognition'. These are about accounting for things in the correct accounting period. It's particularly important that sales are recorded in the correct accounting period because recording sales early could lead to a misleading set of accounts.

'Consistency' is another important accounting principle because it wouldn't be fair to record transactions in one way and then record similar transactions in a different way later on because it suits the business owner or director.

The 'historical cost' concept is about recording transactions at the cost at which they were purchased and the 'full disclosure' principle is about not conveniently missing anything out.

The term 'materiality' is used to describe the fact that small items of insignificant value can be ignored because they don't affect the overall picture i.e. they are not material and they are not worth spending time on. However, if there are lots of small transactions that could be deemed to be material if there are added together, they would need to be looked at.

Accountants are expected to apply a 'prudent' approach in their work which means they shouldn't anticipate profits.

Also, most accounts are prepared on a 'going concern' basis which means that it is reasonable to assume the business will continue to trade in the future.

11. Types of businesses

The main types of businesses are Sole Traders, Partnerships, Limited Companies and Public Limited Companies (PLCs).

Sole Traders are small businesses that have not been incorporated. This means that they have not officially been registered as a company. When someone decides to set-up a business, they need to decide if they want to leave it as a Sole Trade business or if they want to set-up a Limited Company.

Many businesses start off as a Sole Trade business but then incorporate (turn it into a company by officially registering it) at a later date when the business has grown a little bigger. However, a new company can be formed from the outset if that's what the business owner wishes.

The main difference between a Sole Trader and a Limited Company is that in a Sole Trader business, the business owner is personally responsible for the business's financial performance. If the business fails and falls into debt, the owner of the business has to pay the debt off using their own personal assets.

A Limited Company on the other hand is seen as a separate legal entity. If the business performs badly, the company is liable for the debt rather than anyone who owns shares or works in the company. The liability is limited, hence the term 'Limited Company'. Only the company's assets can be used to pay off the debt not the assets of the person or people that own the company's shares.

As the company grows and starts to generate more profits, the shares become more and more valuable. The better the financial performance of the company, the greater the value of the shares.

For most Limited Companies, the shareholders are likely to be the person who set-up the business and family members. Friends may also own shares if they are involved in the business.

However, if the company continues to grow, other people may become interested in buying shares in the company. Eventually, the company can get registered on the stock exchange at which point it will become a PLC (Public Limited Company) i.e. shares are available to buy and sell ('traded') by the general public. This differs from a Limited Company which I talked about earlier. A Limited Company is sometimes referred to as a Private Limited Company because shares are held privately by an individual and his or her family (and possibly friends).

There are two benefits of owning shares in a company.

Firstly, owning shares means you own a piece of the company. If the company buys a building, then albeit indirectly, you own a share of the building. As the company accumulates wealth over time, your wealth as a shareholder is also increasing. Therefore, owning shares in a company can be seen to be an investment and this is where the term ‘investing in shares’ comes from. If you invest in shares, you are hoping the companies in which you hold shares perform well and therefore, the value of your shares increase. If that happens, it’s a worthwhile investment. However, nothing is certain in business. The company could start to perform badly and the value of your shares could go down so it’s important to acknowledge that there is an element of risk involved.

The second benefit of owning shares is you could receive some dividends. Dividends are something that can be paid from the company’s profits to reward shareholders for holding shares in the company. Owners of shares in Private Limited Companies often pay themselves a significant dividend in addition to a salary because this is a completely legitimate way of extracting funds from the business in a tax efficient manner.

On the other hand, Public Limited Companies pay dividends as a reward for investing in their company. Making more profit and paying higher dividends results in a more attractive company for potential investors. It’s not obligatory for a company to pay dividends. In fact, if the company makes losses and has no profits to pay dividends from, then from a legal standpoint it is not allowed to pay dividends. Also, the company directors may decide they can’t afford to pay dividends in a particular year because they need the money to reinvest into the business.

The other type of business I briefly want to mention is Partnerships. Partnerships are similar to Sole Traders except that the business is owned by two or more people.

The owners or ‘partners’ don’t have limited liability and they are personally responsible for the business’s performance and any debt that ensues.

12. Accountancy firms

There are three distinct categories of accountancy firms in the UK.

The Big 4

'The big 4' are made up of PriceWaterhouseCoopers (PWC), KPMG, Deloitte and Ernst & Young.

These are multinational firms with lots of offices across the UK and abroad. You would typically find offices in major cities and towns but not smaller towns and villages. They cater for global companies and multinational organisations and you would expect companies such as Amazon, Tesla, Google, Facebook, Apple, Microsoft, Ford, Walmart etc. to hire one of the big 4 accountancy firms. The big 4 don't really cater for corner shops, window cleaners and small businesses.

The big 4 firms carry out the usual work you would expect accountants to do such as accountancy, tax and audit work. However, they also get to do a lot more of what is seen to be the more glamorous work such as consultancy, industry reports, sector reports, complex tax advice, tax planning, business strategy, corporate finance and business recovery.

The Top 10

After 'The big 4' the second category is the top 10 which includes some pretty large firms that have lots of offices in the UK. Like the big 4, their offices are mainly located in major cities and towns but the difference with these firms is they perhaps have a smaller presence overseas.

Examples of Top 10 firms outside the big 4 are Grant Thornton, BDO, RSM, Mazars and PKF.

These firms tend to specialise in helping SMEs (Small – Medium sized Enterprises). They are able to do a lot of the work the big 4 do and have some multinational clients, but not as many.

The rest

After the top 10 firms, there are lot and lots of small private practices ranging from some that have multiple offices across the UK to single accountant firms. These firms take care of all the small businesses such as the corner shops and window cleaners. They are based in pretty much all towns and villages and their work tends to involve preparing accounts, filing tax returns, bookkeeping and processing payroll. This type of work is often referred to as 'compliance' work and is seen to be less 'glamorous' than the world of corporate finance or complex tax advice.

Nevertheless, it is important work because these practices are working with small businesses which are the backbone of the economy. Whilst writing this guide, I myself am still a small practice owner and I love it because I get the opportunity to work with some fantastic business owners and directors.

13. Accountants

There are a few different types of accountants and accountancy qualifications and I will explain the main ones in this section.

Before I talk about qualifications, I think it's important to mention that there are people who call themselves (and work as) accountants but don't have any formal qualifications. There are no laws against this in the UK. Some of these accountants refer to themselves as QBEs i.e. Qualified by Experience.

I think it would be easy to write-off all QBEs as not proper accountants, but I have worked with a couple of good ones over the years. Sometimes people end up working as accountants and pick up a vast amount of experience over many years and they are actually very good at what they do, but for one reason or another they don't take their accountancy exams, or they don't manage to complete them. Interestingly, many QBE accountants find their opportunities for promotion to senior positions limited, so they often decide to take their exams and get qualified later in their careers.

However, in most instances, I would recommend hiring a qualified accountant because it demonstrates a level of competence which is required to be effective in the role.

It also means that the accountant is under the umbrella of a professional body. Professional bodies ensure that accountants have up-to-date knowledge by asking members to adhere to CPD (Continued Professional Development) requirements, they ensure that members follow strict professional ethical guidelines and they communicate regularly with members to make them aware of global and economic matters that affect the profession.

This means if you hire an accountant who is qualified and a member of a professional body, you will probably receive a better service than hiring an unqualified accountant who hasn't been tested for competence and doesn't necessarily have to adhere to any rules and guidelines.

There are a few different types of accountancy professional bodies and each have their own qualification.

These are summarised in the following table:

Professional Body	**Qualification**	**Work in**
Institute of Chartered Accountants in England and Wales Abbreviated to ICAEW	Associate Chartered Accountant Abbreviated to ACA Accountants can use the letters ACA after their name	Accountancy firms which is often referred to as working 'in practice' Lots of ACA qualified accountants switch to working in industry
Chartered Institute of Management Accountants Abbreviated to CIMA	CIMA qualified accountant Accountants can use the letters CIMA after their name	Commercial organisations often referred to as working in industry Not many CIMA accountants switch to working in practice
Association of Chartered Certified Accountants Abbreviated to ACCA	ACCA qualified accountant Accountants can use the letters ACCA after their name	Practice or industry (accountancy firms or commercial organisations)
The Chartered Institute of Public Finance and Accounting Abbreviated to CIPFA	CIPFA qualified accountant Accountants can use the letters CIPFA after their name	Public sector

As you can see from the table, the reason for having different accountancy bodies and qualifications is that there are lots of different roles for accountants. This is similar to engineers or doctors. For example, there are civil engineers, mechanical engineers, electrical engineers and chemical engineers. In the medical profession, there are GP's (or family doctors), surgeons, paediatricians, neurologists etc. Similarly, in the accountancy profession there are practice accountants, management accountants, auditors, finance directors, financial analysts, public sector accountants and so on. The qualification that an accountant obtains depends on what they choose to specialise in.

Once an accountant has gained a certain amount of experience, normally 10 years, they are known as 'fellows' rather than 'associates' and the letters after their name change from ACA or ACCA to FCA or FCCA. This is an additional indicator of experience as well as qualification.

Other qualifications you may come across in the UK are CTA which stands for Chartered Tax Advisor (qualified tax specialist) and AAT which stands for Associate Accounting Technician (qualified bookkeeper).

14. Audits

In an accountancy context, an audit is the process of independently checking the accuracy of accounts.

There are two types of audits: external audits and internal audits.

External audits

External audits are carried out by accountancy firms such as those mentioned in the last chapter.

The biggest companies will probably hire one of the big 4 to carry out their annual audit. However, if there is a smaller business that needs an external audit, they can hire an accountancy firm to carry it out. Smaller accountancy firms can carry out audits as long as they hold the license and have the expertise.

It is important to note that not all businesses need an external audit. It's normally businesses that have grown to a certain size that are required by law to have their annual accounts audited. In the UK, the criteria (at the time of writing) is around £10 million in Turnover, £5 million of Net Assets and 50 employees (two out of these three need to be true for an audit to be required by law).

You can see from this that the threshold is quite high which means there are a lot of businesses that are not required to have their accounts audited. The reason for this is that the whole point of an audit is to give the readers of the accounts assurance that the accounts are accurate and give a true reflection of the financial position and performance of the business.

Once a business reaches a certain size, there are other interested third parties such as lenders and multiple shareholders. These third parties are relying on the accounts to make decisions. Therefore, it becomes more important to ensure that the accounts are accurate and fair.

On the other hand, smaller owner-managed businesses may only have one or two shareholders and not as many third parties are interested in their accounts. Therefore, there is less of a need to have the accounts independently checked.

Internal audits

Some businesses may choose to carry out internal audits. This is more common amongst large multinational organisations who want to ensure that company policies and procedures are adhered to across all offices and branches around the world. Often the scope of these audits is not limited to finance and encompasses all areas within the business such as HR, IT, production etc.

These organisations often have a team of staff employed not only to carry out internal audits but also to continuously monitor and implement strong internal control procedures.

Why do they do this? The answer is simple. Strong internal controls and procedures minimise risk.

For these companies, the cost of losing money by getting their finances wrong or the cost of a lawsuit when something (in Finance, HR or IT for example) goes wrong easily outweighs the cost of hiring a team of internal auditors.

The process

A common misconception is that auditors check absolutely everything. They don't.

They normally look at processes and procedures and identify potential areas of weakness where the risk of error might be greatest. They will spend some time delving into these areas of interest to see if there are any mistakes and if they come across any errors, they document them and include them in their audit report.

Auditors will also pick samples of items to check. For example, they might pick a sample of Fixed Assets that are included on the company's Balance Sheet. They would typically check buildings' title deeds or motor vehicles' vehicle registration documents to make sure they are all owned by the company. Or they might ask to physically see a sample of the assets or a sample of stock items to ensure that they actually exist.

External auditors work through all the individual sections of the accounts and check for accuracy using the techniques mentioned above. Each section of the accounts will require audit tests which are tailored for that particular section.

Internal auditors carry out audit checks to determine whether systems and procedures are adequate. If they find a certain area is not compliant with company standards, they can make recommendations and help implement procedures which are then tested and re-tested until they meet the required standard.

Segregation of duties

An example of a good internal control process that can be implemented within a business's finance department is called 'segregation of duties'. This means there should never be a single person in charge of an entire process.

One person shouldn't be able to set up a new supplier or a new employee on the system, prepare the payment and process the payment on their own because it makes it easier for someone to potentially commit fraud or theft. It is significantly less likely for fraud to be committed when it involves the collusion of two or more people. Therefore, new suppliers and employees should be set-up by one person but approved by another to make sure they are genuine. Similarly, payment runs for suppliers or wages should be prepared, approved and processed by two or more people.

15. Budgets

My definition of a budget is that it is a numerical representation of financial goals for the next year. It is often used as a motivational tool to help achieve a certain financial outcome.

Normally, it concentrates on the Profit and Loss Account rather than the Balance sheet or Cash Flow Statement.

A good budget isn't just about controlling costs, it also includes setting realistic income targets for the year.

A lot of the time, the budget is broken down into lots of smaller Profit and Loss Accounts representing the different departments or geographical regions. This means there are several 'budget holders' (normally managers in charge of a department or region) who are given the responsibility of looking after their own individual department's budget. These individual budgets are added together to give the overall picture and the total budget for the business.

Budgets are produced before the start of each accounting year and are communicated to budget holders at the start of the year. During the course of the year, usually monthly, the budget holders are sent progress reports by the accounts department to show how they are performing against the budget. This is done via the management accounts which I will explain in more detail later in Chapter 18.

The budget is produced by the accounts department and should be prepared in conjunction with the budget holder or manager. Traditionally, the accounts department will look at actual income and expenditure from the previous year as a starting point. The accountant will then speak to the budget holder and talk about expected income and expenditure for the coming year. The advantage of this method is that it is fairly realistic to assume most things will stay the same and any exceptions can be accounted for. The disadvantage is that this method doesn't really encourage budget holders to look for ways of improving financial performance because they are given some money to spend almost by default.

Another way to set a budget is for the accountant to start with a blank piece of paper and ask the budget holder what they need. This is known as a zero-based budget. The advantage of this method is that there isn't any spend automatically built into the budget. The disadvantage is that things can easily get missed which will inevitably lead to overspend against the budget.

It is important to acknowledge that budgets aren't perfect and it's impossible to predict what is going to happen. However, if they are used correctly, they can be a very useful tool to motivate managers and staff to improve financial performance.

16. Forecasts

Financial forecasts are similar to budgets but they involve looking at a longer time period.

Budgets are normally set for a year in advance whilst a forecast is more of a medium-long term prediction of financial performance.

Just like a weather forecast for example, the financial forecast is a prediction of what might happen. A budget is used as a *motivational* tool whilst the forecast is used as a *planning* tool. Businesses tend to use forecasts to set income and profit targets to predict long-term growth and sustainability.

Forecasts normally cover the Profit and Loss Account but there can also be Cash Flow forecasts which are very useful. A typical forecast might show 5 years' worth of Profit and Loss Accounts with the first of those 5 years being the budget. It's difficult to argue that anything longer than 5 years is useful because things get harder to predict in the longer term and there are so many variables and assumptions, it's debateable how accurate the forecast is beyond 5 years.

As with the budget, the forecast will probably include a top-level summary that would be presented to senior management but there would be lots of detailed calculations that build up to the top-level summary. The forecast will include predicted income, costs, the effects of inflation and the financial impact of all one-off planned events which are known at the time of preparing.

The current year figures can also be reforecast to show the effect actual figures and more up-to-date information. This gives management an idea of what the finances might look like by the end of the year.

17. Business plans

The purpose of a business plan is to set out a proposal for a project in a document that can be reviewed (by senior management, investors, banks etc.) for approval.

A business plan includes details of the proposal, its purpose, objectives and the expected outcomes. It should include a financial section detailing the required investment and the expected income and expenditure relating to the proposed project.

The finance section will include a financial forecast or perhaps some sort of project appraisal such as a Net Present Value (NPV) calculation to help the decision-makers to assess the project's viability. I will talk about NPV and project appraisal later in Chapter 23 the guide. The finance section of the business plan may be included in the appendices with references to the figures being made in the commentary.

18. Management accounts

Management accounts are accounts that are produced with the intention of helping managers within a company to manage the finances of the business. The main difference between management accounts and financial accounts is that management accounts are prepared for *internal use* whilst financial accounts are prepared with the intention of reporting financial performance to people *outside* the company. This differentiating factor of internal vs external reporting actually makes quite a lot of difference because the information that would be useful for internal users is vastly different from the information that is useful for external users.

Internal users such as company directors, managers and budget holders want to know about how the company is performing in relation to its goals and targets. External users such as shareholders want to know whether the business is a safe investment. Similarly, banks are another example of an external user and banks would want to know if the company can afford to repay loans. Therefore, the information presented and the way in which it is presented needs to be tailored to suit the audience.

In addition to this, there are certain things a company may not wish to disclose to the outside world, for example information on a new product or a new division. There is no law to say that everything about a company's finances needs to be disclosed to everyone in the world. In fact, disclosing everything could be detrimental if the company's competitors gain access to it. Therefore, as long as a company meets its legal obligations and discloses the minimum amount of information required by law, it's fine. The law protects external users by ensuring there is enough information within the required criteria for them to be able to make decisions. At the same time, management are able to keep some information confidential and use it to help them make decisions.

Here is an example of a set of management accounts:

Example Company Ltd
Management Accounts
For the year-ended 31st March 20X1

	July 20X0				
	Actual	**Budget**	**Last Year**	**Variance vs Budget**	**Variance vs Last year**
	£000s	**£000s**	**£000s**	**£000s**	**£000s**
Sales	**549.6**	**555.9**	**547.3**	**(6.3)**	**2.3**
Cost of Sales	(214.3)	(217.2)	(217.2)	2.9	2.9
Gross Profit	**335.3**	**338.7**	**330.1**	**(3.4)**	**5.2**
Wages	(137.3)	(137.0)	(136.6)	(0.3)	(0.7)
Rent	(87.9)	(88.8)	(86.0)	0.9	(1.9)
Heat and light	(15.2)	(15.0)	(14.9)	(0.2)	(0.3)
Rates	(10.8)	(10.3)	(10.5)	(0.5)	(0.3)
Insurance	(2.4)	(2.4)	(2.3)	0.0	(0.1)
Freight	(22.1)	(23.8)	(22.0)	1.7	(0.1)
Postage	(1.1)	(0.9)	(1.0)	(0.2)	(0.1)
Stationery	(0.9)	(0.8)	(0.8)	(0.1)	(0.1)
Net Profit (or loss)	**57.6**	**59.7**	**56.0**	**(2.1)**	**1.6**

	Year-to-date				
	Actual	**Budget**	**Last Year**	**Variance vs Budget**	**Variance vs Last Year**
	£000s	**£000s**	**£000s**	**£000s**	**£000s**
Sales	**2,197.3**	**2,197.0**	**2,195.6**	**0.3**	**1.7**
Cost of Sales	(858.3)	(858.0)	(860.1)	(0.3)	1.8
Gross Profit	**1,339.0**	**1,339.0**	**1,335.5**	**0.0**	**3.5**
Wages	(548.7)	(547.9)	(547.8)	(0.8)	(0.9)
Rent	(352.1)	(355.0)	(352.0)	2.9	(0.1)
Heat and light	(60.6)	(61.3)	(59.8)	0.7	(0.8)
Rates	(43.2)	(43.5)	(42.9)	0.3	(0.3)
Insurance	(9.6)	(9.8)	(9.5)	0.2	(0.1)
Freight	(88.3)	(89.1)	(87.9)	0.8	(0.4)
Postage	(4.4)	(4.1)	(4.0)	(0.3)	(0.4)
Stationery	(3.8)	(4.1)	(3.9)	0.3	0.1
Net Profit (or loss)	**228.3**	**224.2**	**227.7**	**4.1**	**0.6**

The preceding example shows a typical set of management accounts. It's not important to try and understand every single number in detail. I will just highlight a couple of things for you.

Management accounts can be prepared monthly or quarterly. The example above shows a set of management accounts for the month of July. They show the monthly figures in the first table and the year-to-date figures in the second table.

They show that the company has under-performed against the month's budget. The Sales are £6.3k lower than budgeted and the Net Profit is £2.1k lower than the month's budget. However, both the Sales and Net Profit figures are better than the month of July in the previous year.

The year-to-date figures tell a different story. They show that at this point in the year (4 months from the start of April to the end of July), the company has generated £4.1k more profit than budgeted. This is mainly due to significant savings in expenses, particularly rent. Maybe the business was able to negotiate a better rate on its rent and has made a concerted effort to spend less.

Hopefully, you can see from this example that the management accounts can be quite insightful and a number of useful conclusions can be drawn by looking at the numbers alone. However, in reality the numbers should be accompanied by commentary and it is important to acknowledge that the management accounts are but one useful tool (amongst many) managers use help manage and run the company.

Note that budget holders would normally get their own set of management accounts for their area and all the individual management accounts would be added together to form the overall picture for the whole company.

A budget holder can always ask for more detail from the accountants that have prepared the management accounts to help them understand things better. In the example above, a budget holder might ask for a breakdown of the Sales by product type or region to try and understand why they are lower than target in the month.

Regular review of management accounts is of paramount importance.

This is because all businesses make decisions; some good, some bad. It is inevitable some bad decisions will be made. Reviewing management accounts regularly helps to identify the impact of decisions and address issues early. It's much better to highlight and address issues early on rather than producing a single set of accounts at the end of the year and realising the company has underperformed when it's too late to do anything about it.

In other words, companies often fail when they make a series of bad decisions but were not able to quickly identify that the decisions were bad.

The management accounts are often part of a management information pack. As mentioned, the idea behind this is that management accounts form one part of a whole suite of information that is useful for managers to help them make decisions.

The management information pack would include accounting and non-accounting information. Non-accounting information might include things like the number of customer complaints or staff turnover or social media interactions such as followers, likes and comments. Whatever is important for that particular business could be included in the management information pack. The important thing when it comes to management information is to include only the most useful and relevant information because nobody wants to look through pages and pages of information and senior managers certainly won't have the time or inclination.

Some companies produce a document that is referred to as a 'Balanced Scorecard' and the idea behind this is to have only the key facts and figures presented in a one-page summary for senior managers. The Balance Scorecard includes Key Performance Indicators (KPIs) and I have dedicated a separate section to KPIs later in Chapter 22 this guide where I talk about the most common KPIs that are measured by companies.

19. Pricing

There are a few different pricing strategies to help companies decide on the best price for their products.

The obvious one is called ‘cost-plus pricing’ which is about working out the amount it costs to produce something and then adding on a profit margin to determine the final selling price.

Another method is ‘competitor-led pricing’ or ‘market-led pricing’ which is about looking at your competition and seeing what their prices are before setting your own price.

Most companies will try to distinguish themselves from their competitors and adjust their prices accordingly. For instance, they might deliver a slightly better product or service which justifies a higher price. Alternatively, they may choose to cut out optional extras and provide a good product at a cheaper price point. There is no right or wrong answer and the good thing about pricing is that it can be changed so if one strategy isn’t working, companies can try another.

One of the main challenges when it comes to pricing is not to set prices that are too low. Selling feels good so it is all too tempting to lower prices. Customers have a way of sniffing out a good deal very quickly.

If a business has a sustained period of selling at too low a price, it will feel the effects of little or no profit margins and it won’t be long before it finds itself in financial difficulty.

If a business is unable to deliver a product or service at a price that customers are willing to pay, then it’s not a viable business. It means the business either needs to communicate better to customers about why its product is worth more or it needs to find ways to reduce costs (or a combination of both of these things).

A good strategy to consider when setting prices is actually to try looking at things from the customer’s perspective. As long as the customer feels they are getting value for money, then they will be prepared to part with their hard-earned cash for the business’s product or service. So the question to ask is ‘Is it worth it?’ or ‘would you buy it for that much and why?’

Often, businesses will need to experiment with their prices to find the optimal price point for their particular product or service and it’s about finding the point at which profits are highest. It’s not always about increasing prices, especially when price increases affect the volume of sales. This is known as the ‘sales-volume mix’ and this type of analysis can be very useful.

20. Cost Accounting

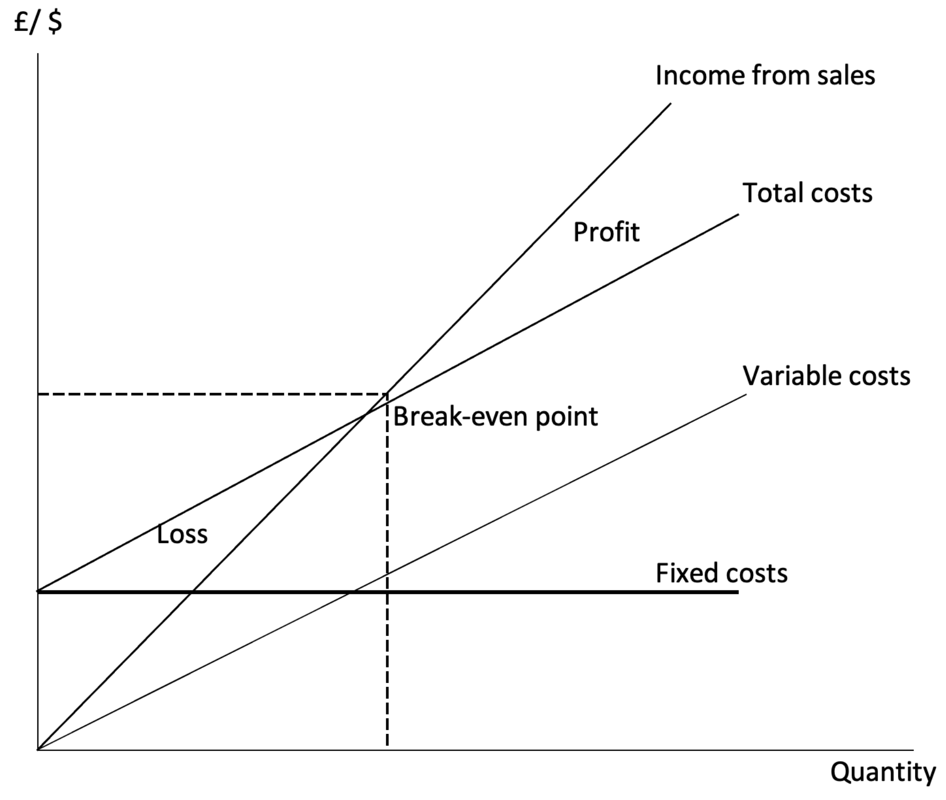
There are lots of different tools accountants use to help businesses improve their bottom-line profit. In this section, I will outline the main costing methods that are used by accountants to help directors and business owners think about what they sell and how to get the most out of their resources.

Fixed and variable costs

One way of looking at accounting information is to look at fixed and variable costs. This is particularly important when setting up a new business or when an existing business is looking to venture into new areas.

Fixed costs are costs that don't change. For example, if a factory is rented, it doesn't matter how many items are sold, the rent will still stay the same. The agreed rent needs to be paid whether the business sells just one item or whether it sells a million items.

Variable costs are costs that change in direct proportion to the number of items bought or produced. For example, if I decide to sell calculators on eBay, the cost of buying the calculators from my supplier will go up in direct proportion to the number of calculators I decide to buy. Eventually, I may be able to negotiate a better unit price for bulk buying, however the cost will still go up if I buy more.



The break-even point is the point at which the money from sales has covered the costs (both the fixed and variable costs) associated with the product or service. If the business sells less than the break-even quantity, the business will make a loss because the total costs are more than the income generated from sales. Once the business reaches the break-even quantity, the business starts to make a profit.

Note in the diagram how the profit increases significantly as more and more items are sold after the break-even point. This makes sense because once a business goes beyond the point where there are no more fixed costs to cover, each additional sale makes a *contribution* to the business's profit.

This sort of analysis is especially useful for businesses that have some sort of spare capacity. For example, if there is a factory that has some unutilised space, the business could look at introducing a new product since it's paying the rent for the whole factory anyway. It might as well use the space to make something, as long as whatever it makes covers the variable cost, it will be worth it.

Direct and indirect costs

Another useful way of looking at costs is to categorise them as direct or indirect costs. A direct cost would be something you would be able to say with certainty that it relates to a particular product or service. For example, carrying on from my earlier example, if I sold laptops as well as calculators on eBay, the cost of buying the calculators is a direct cost associated with the sale of calculators and the cost of buying laptops is a direct cost associated with the sale of laptops.

However, business insurance for example would be an indirect cost and it would be a good idea to find an appropriate way of attributing indirect costs such as insurance to the calculators and laptops. This would help me identify whether or not the items are both making profits and which item is making the most profit. This is known as Activity-Based Costing (or ABC).

Absorption Costing is similar to Activity-Based Costing but focuses more on finding out the cost per unit. Whilst Activity-Based Costing is focused on trying to find out whether the sale of calculators is more profitable compared to the sale of laptops in my business, Absorption Costing is about trying to find out the true cost of each calculator and the true cost of each laptop.

Job Costing is another type of costing which is useful for businesses like painters and decorators or solicitors. Each job a painter and decorator or solicitor takes on is different. For a painter and decorator, the size of each property is different which means the amount of materials and labour will vary from job to job. Similarly, solicitors will find the complexity of each case different and therefore each job will require differing amounts of time and differing levels of expertise at different charge-out rates. Job Costing involves taking all these variables into account and making a reasonable estimate of the costs involved.

Note that none of these costing methodologies are perfect as they all require some element of judgement and estimation. After all, accounting isn’t an exact science. However, they are nevertheless useful tools that accountants use to help businesses make important decisions.

21. Cash flow management

I wanted to include a section in this guide about cash flow management because I think it's one of the most important aspects of business and I don't think it gets enough attention in accountancy books and literature.

Good cash flow management is absolutely crucial for all businesses and organisations.

Here's why.

One of the biggest problems that companies face is the fact that the market is constantly changing (due to changing consumer habits, advancement in technology etc.). This means companies are continuously looking at the market and adapting. They are only able to adapt by spending (or reinvesting) money that has been made from existing products or services. It is important to make sure that they have the money to enter new markets or develop new products without over stretching themselves.

If they don't have the money to do it, they'll have to consider other options. For example, maybe they can downscale their expansion plans, maybe they can test a portion of a new market or limit themselves to a certain sector, maybe they can enter the market at a slower pace than initially planned. As long as they don't run out of money, they will be ok and good cash flow management will help them to not run out of money.

A company can practice good cash flow management by adopting a number of strategies.

One of the best ways a company can manage its cash is by producing a Cash Flow Forecast. This shows all the expected cash inflows and outflows against a timeline.

A good way of presenting this is by having the dates across the top of an excel spreadsheet and the various income and expenditure items down the side; similar to the Cash Flow Statement shown earlier in Chapter 4 the guide. If there are any large projects in the pipeline, they would be shown as large cash outflows and hopefully, they would be followed by continuous cash inflows after the project finishes to show the extra income being generated as a result of undertaking the project. Managers would be able to look at this and quickly identify if there are any points where the bank balance is projected to go into negative figures. They can then make decisions about what to do such as delay payments to a couple of suppliers, ask the bank for a loan or overdraft or delay the project until they have a bit more cash in reserve.

Also, rather than just looking at its cash position, a company can look at the whole Current Assets and Liabilities section of the Balance Sheet. Customers that owe the company money (Trade Debtors) is an asset because hopefully, at some point it will turn into money. Similarly, things that a company orders but doesn't pay for immediately (Trade Creditors) is a liability because they will cost the company money when it finally pays for them. Looking at Current Assets in proportion to Current Liabilities is known as looking at 'liquidity' and the Liquidity Ratio that I mention in the next section provides an indication of the business's ability to pay the money it owes. The key point is that taking a holistic view of the overall picture is much better than simply looking at the bank balance in isolation.

Another way of improving cash flow is to look at debtor days and creditor days. These show the average number of days customers take to pay and the average number of days it takes the company to pay its suppliers. Clearly, if the company pays suppliers in 30 days on average, but its customers take 60 days on average to pay, there is a discrepancy and the company will be short of cash. It will need to redress the balance by negotiating with its customers and suppliers with a view to bringing these figures into closer alignment.

There are many other ways a company can improve cash flow such as identifying needs vs wants and controlling costs via budgeting which I won't go into detail here. The main thing to take from this guide is the importance of cash flow management in running a business effectively.

22. Key Performance Indicators (KPIs)

Most organisations measure themselves against some sort of KPIs, whether that's in a formal way or informally.

The most common financial KPIs are:

- Gross Profit Margin (Gross Profit expressed as a percentage of Turnover)
- Net Profit Margin (Net Profit expressed as a percentage of Turnover)
- Sales growth % (percentage increase in sales from one year to the next)
- ROCE (Return on Capital Employed (a bit like ROI but for the entire business rather than a single project)
- Debtor days (the average number of days it takes customers to pay)
- Creditor days (the average number of days it takes to pay suppliers)
- Liquidity ratio (Current Assets divided by Current Liabilities)
- Quick Ratio (also known as the Acid-Test ratio: 'Liquid' Assets divided by Current Liabilities)
- Variance to budget (Turnover, Gross Profit and Net Profit)

There are a whole raft of other KPIs that can be measured. The most important thing to consider when it comes to KPIs is to pick the ones that are most relevant to your business.

It is also likely that there are industry specific KPIs relevant to your particular business.

In addition to this, there are non-financial KPIs that are just as important. Examples of non-finance KPIs are:

- Number of complaints
- Staff turnover
- Number of followers on social media
- Social media interactions (number of likes, comments, followers etc.)
- Lead conversion percentage

It's a great idea to collate the most relevant KPIs (financial and non-financial) and report them at regular intervals on a single sheet of paper called a 'Balanced Scorecard'. This forms part of a management information pack and helps managers assess performance and make decisions.

It's often useful to set targets and have budgeted and forecasted KPIs to compare the actual figures to. Also, if the previous years' KPIs are included, you can see a roadmap from the Balanced Scorecard of where you have come from and where you are going to.

23. Project appraisal

Once a business is established, one of things it needs to get good at is project appraisal.

Most businesses recognise they can't stand still. They can't just keep doing the same thing over and over again and expect to continue to make the same level of profits year after year. This is because there are a number of external factors that will affect the business. The business's competitors will be improving all the time, there will be technological advances and consumer needs will change as time goes on. The company directors and business owners will need to stay on top of these things if they want the business to survive and prosper. The changes that take place as a result of these external factors often require planned projects.

In addition to this, there will be all sorts of opportunities that arise to expand and diversify the business. Project appraisal is about identifying the projects that are most profitable or most likely to succeed from a financial perspective.

A company can save itself a lot of time and money by choosing the right things to work on. If it chooses to go down a path and later decides it's the wrong path, it may already have spent a significant amount of money which would all go to waste. That's why it's important to invest some time in making sure the business only spends time and money on projects that are worthwhile.

In this section, I will outline the key project appraisal methods.

Accounting Rate of Return (ARR) - commonly known as Return on Investment (ROI)

This method measures the profit that would be made from a project expressed as a percentage of the initial investment. It's a good method because it's quite easy to compare different projects and decide which one to undertake. It is also good for putting things into perspective.

For example, say the Return on Investment on holding money in a bank is 3%, the Return on Investment on buying rental property is 5% and the Return on Investment on buying stocks and shares is 8%. How does the Return on Investment of a proposed project compare? Is it better than these three options? Or is there anything else the company could do with its money which has a better Return on Investment?

The flaw with this method of project appraisal is that it doesn't take all the factors into account. For example on rental property, the Return on Investment relates to the annual net rents received (after all costs and expenses) expressed as a percentage of the property purchase price. However, it doesn't take into account potential capital appreciation.

Net Present Value (NPV)

NPV is a popular project appraisal methodology which involves looking at all the cash inflows and outflows involved in a particular project over many years. It then uses something which is called a discount factor to try and find the value today of future cash flows.

The idea here is that the value of cash in the future is different to the value of cash right now due to things like inflation and the fact that investing the money in this project today takes away the opportunity of investing the money elsewhere at a different rate of return at some point in the future. The NPV method takes these factors into account and derives what it believes to be a true current valuation of the project.

This methodology states that as long as the NPV is positive, the project should go ahead.

Internal Rate of Return (IRR)

This methodology is similar to the NPV but it involves using trial and error to find the rate at which the values of future cash inflows match the initial investment. In other words, what is the percentage point at which the NPV is zero? That is the Internal Rate of Return.

The business would normally have a predetermined minimum rate of return which it would deem acceptable for its projects. If the Internal Rate of Return is equal to, or higher than the business's minimum acceptable rate, the project can go ahead. If not, the project would be rejected.

Payback period

This method involves looking at the amount of time it would take for future cash inflows to cover the initial investment. There is no discount factor applied in this method so it's quite an easy method to calculate. When comparing two or more potential projects, the business can simply look at which one pays for itself faster and use that as a basis for deciding which one to go with.

There is also another version of this method called the discounted payback period method which does introduce the concept of applying a discount factor to future cash flows.

Profitability Index (PI)

This method is similar to the NPV but expresses the present value of future cash flows as a percentage of the initial investment. This methodology states that as long as the PI is positive, the project should go ahead.

Which one should you use?

They all have good and bad points. I would recommend using more than one method to get a better feel for which project is the best one to pursue. It also depends on the type of project and what the company wants to achieve. For example, the Return on Investment method didn't take into account capital appreciation and therefore it won't give the whole picture for every project. NPV involves some element of judgement on what discount factor to use and there a few different ways of determining the discount factor. There is also no defined period of time for future cash flows to look at when calculating the NPV. The payback period doesn't tell you how profitable a project will be, it only tells you how quickly the money is recovered.

Therefore, I would be inclined to choose a couple of methods, maybe even three and then decide which way to go.

24. Business valuations

There are lots of ways in which a business can be valued and there are many factors which come into play such as potential for future profits, the industry in which the business operates, a strong team, the value of assets and so on.

In some senses, PLCs are the easiest to value because their shares are available to buy on the stock exchange and it's simply a matter of multiplying the current share value with the total number of shares. This is assuming the market value of the shares is correct and how much people are prepared to pay for something is often a good indicator of how much something is worth. The problem comes when there is imperfect information and the amount people are prepared to pay is wrong because they don't have all the information or the information is incorrect. Hopefully, audited accounts which have been discussed earlier in this guide help mitigate this risk.

Another way of identifying the value of a business is to look at the assets it owns i.e. the book value. If you look at the Net Assets on the Balance Sheet, this is an indicator of the net financial position and worth. However, this method doesn't account for things that can't be seen but are worth something (intangible assets) such as brand value, experience of the management team, potential for future profits, how lucrative is the industry in which the business operates etc. These factors can only accounted for when a business has been sold.

Other ways of valuing businesses are:

- To use a multiple of Net Profits e.g. Net Profits x 3, 4 or 5 (the multiple depends on the industry)
- To use a multiple of Turnover e.g. Turnover x 1
- To compare with similar businesses in the same industry that have been sold recently
- To use the NPV method mentioned earlier in the book
- To identify how much it would cost to set-up a new business from scratch and reach this point again
- To use an industry specific method

Whichever method is used, it will most likely involve some level of estimation as this is not an exact science. A professional valuation can be obtained and small businesses can often negotiate on the price if they are looking to sell their business.

25. Tax

Most people dislike paying tax and wish they could pay less.

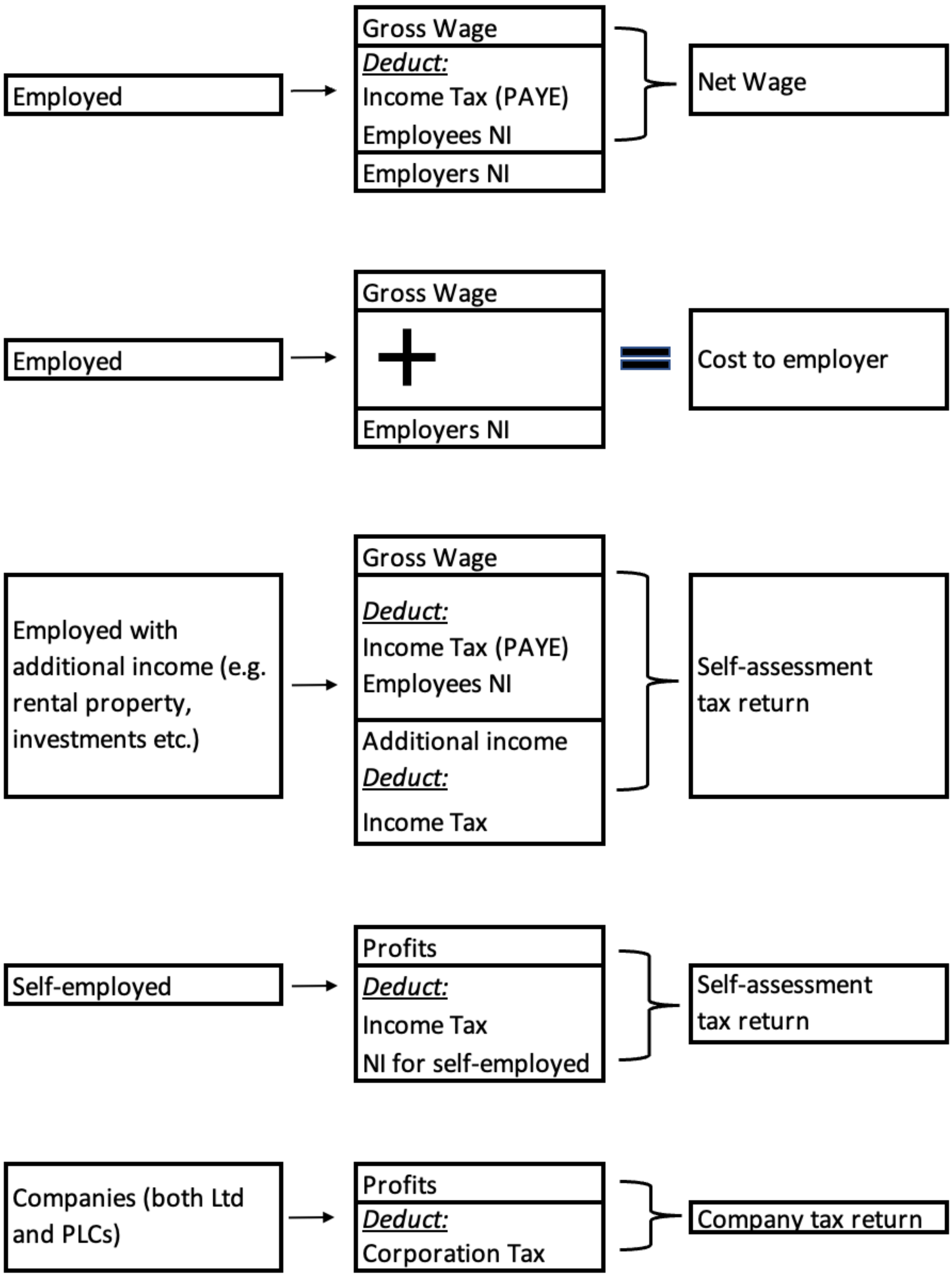
However, tax is a means by which the government runs the country and most people don't realise the amount of money it takes to run a country. Here are just some of the things the government pays for using money collected from taxes: the National Health Service (doctors wages, nurses wages, ambulance drivers, the ambulances themselves, hospitals, hospital beds, hospital cleaners), the police service, the fire service, the army, waste collection services, building motorways, keeping our streets clean, streetlights and the list goes on and on. This costs billions of pounds per year and it's all paid from money collected from taxes.

Tax is one of the most complicated areas associated with accounting due to the thousands of pages of tax legislation in the UK. It's not much different in other countries across the world.

In this section, I will outline the main taxes that are applicable in the UK. The USA and most countries in the western world have similar tax systems and although the rates and the specific rules may vary, the principles are generally the same.

Note that any percentages and figures mentioned in this section are for illustrative purposes only and will likely change over time. I will attempt to outline the key principles of each tax rather than provide detailed examples and descriptions of how the taxes are calculated. If you are interested in the detail, the best place to look is the government's website; www.gov.uk and search for the relevant tax in the search box, for example search 'income tax rates and thresholds'. Alternatively, speak to an accountant or a tax specialist.

Like accountants, tax specialists also have a professional qualification which is issued by the Chartered Institute of Taxation (CIOT). Once qualified, tax accountants can use the letters CTA after their name which stands for Chartered Tax Adviser.



Income Tax and National Insurance (NI)

Employed people pay Income Tax on their wages. It is referred to as PAYE which stands for Pay As You Earn. The tax is deducted from their wages by their employers and paid to the government.

They also pay National Insurance (NI) which is deducted from their wages together with Income Tax and paid to the government.

Essentially, employers are simply collecting the tax and NI and paying it over to the government. They don't incur the cost of PAYE and Employees NI.

However, employers do have to pay Employers NI for each employee. This means that the cost of employing someone is the Gross Wage plus Employers NI.

If an employed person earns any other income such as income from rental property, or income from investments (dividends) or interest for example, they need to declare this additional income to the tax authorities and pay tax on this additional income. This is done by completing a self-assessment tax return.

Self-employed people pay Income Tax and NI too. However, they don't receive wage slips and the tax and NI isn't deducted on a weekly or monthly basis like it is for employed people.

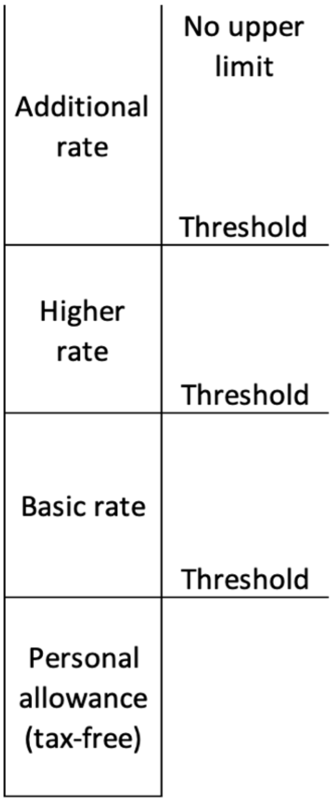
Self-employed people pay Income Tax and NI on profits (not wages). The Income Tax and NI is calculated at the end of each tax year as part of the self-assessment tax return process. They pay their tax and NI in one or two lump sums.

For self-employed people, Income Tax is calculated in the same way as Income Tax for employed people. However, it's calculated on profit rather than wages.

There is a separate NI rate and calculation for self-employed people which is different to the one for employed people.

Sole Traders and Partnerships are classed as self-employed.

Income Tax tiers



Income Tax is calculated based on total earnings.
The amount of tax an individual pays depends on how much they earn.

For example, if an individual earns £70,000 in the year, they will pay 0% tax on some of their income (due to the tax-fee personal allowance), they will pay the basic rate tax percentage on some of their income and they will pay higher rate tax on some of their income. The fact that their wage falls within the higher rate tier doesn't mean ***all*** their wage is taxed at higher rate. It's only the portion that is over the basic rate threshold that is taxed at the higher rate.

Some people won't pay the higher rate of tax at all if their income is below the higher rate threshold. They will pay 0% on a portion and the basic rate of tax on the remainder.

People that earn a very high wage will pay some tax at basic rate, some at higher rate and some at additional rate.

The same principle applies to the calculation of National Insurance (and this is true for both Employees and Employers NI). However, NI doesn't have as many tiers. There is a 0% threshold for NI as well. This is called the 'Primary Threshold' for Employees NI and the 'Secondary Threshold' for Employers NI.

Corporation Tax

Corporation Tax is just like Income Tax but for Limited Companies and PLCs. It's a tax on profits not turnover. There is no tax-free allowance. It is calculated by multiplying the company's profit by the applicable Corporation Tax rates. The profit may need to be adjusted for things like depreciation and disallowed expenses which I will elaborate on in the next couple of sections.

Allowable expenses

Businesses (Sole Traders, Partnerships, Limited Companies and PLCs) are able to claim business costs as 'allowable' expenses in calculating their tax.

This means a business should deduct its expenses from its income to arrive at a profit figure which is subject to tax. For Sole Traders and Partnerships, it is Income Tax and NI. For Limited Companies and PLCs, it is Corporation Tax.

A business expense should be wholly and exclusively for business purposes for it to be allowable. For example, someone can't go on holiday to Dubai, have a short meeting with a business acquaintance and claim the whole trip as a business expense.

Most items that are genuine purchases for the business are allowed. However, there are some expenses that are not allowed such as customer entertainment and fines.

Capital Allowances

Capital Allowances are a form of tax relief (in other words tax benefit) introduced by the government to incentivise directors and business owners to invest in their businesses and grow.

For example, if a business invests in a large piece of equipment, as long as the criteria for Capital Allowances is met, the government says the whole amount can be deducted from the business's income to arrive at the profit to be taxed. This large purchase reduces the business's taxable profits significantly and the business will pay less tax as a result of this purchase.

Without Capital Allowances, this purchase would be seen as an investment and it would benefit the business over many years. Its value would depreciate slowly over time and the accounts reflect this. However, the tax treatment of this investment is different to the accounting treatment.

In fact, another way of seeing Capital Allowances is that it's the government's version of depreciation. In the accounts, the depreciation is something that involves making estimates which means that each business comes up with a different answer. The government achieves consistency and fairness by making all businesses adhere to Capital

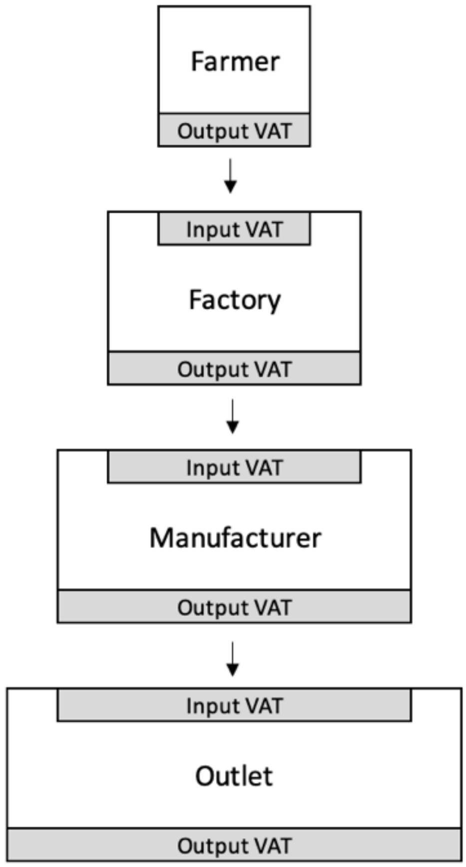
Allowances rules rather than using their own estimates of depreciation. It also uses Capital Allowances to grant tax incentives.

Value Added Tax (VAT)

VAT is a tax which is collected by the government on goods and services that are sold by UK businesses.

It works in a similar fashion to PAYE and NI whereby the business collects the VAT on behalf of the government and pays it over to the government. The difference is that PAYE and NI are in relation to wages whilst VAT is in relation to goods and services.

Businesses are obligated to register for VAT once they reach a certain size. Smaller businesses can choose to register for VAT voluntarily. For this example, I will assume that all the businesses are registered for VAT.



VAT is added to sales. This is known as output VAT. The best way to remember this is that it is money flowing *out* of the business because it is paid to the government (outflow of cash = output VAT).

VAT on purchases is known as input VAT. It is reclaimed from the government and therefore is money flowing *into* the business (inflow of cash = input VAT).

In this example, the farmer sells wool to the factory. The farmer adds VAT to his or her sales. The factory isn't bothered by this increase in price because it can claim it back as input VAT. The farmer's sale is the factory's purchase.

The factory buys the wool from the farmer and turns it into a form that can be knitted. It sells this onto the manufacturer and adds VAT.

The manufacturer isn't bothered that the factory has added VAT because it can reclaim the VAT on its purchase of wool.

The manufacturer knits jumpers from this wool and sells it to the outlet after adding VAT.

Again, the outlet claims back the VAT on its purchase of knitted jumpers. It adds VAT and sells the jumpers onto the general public who eventually pay the VAT but don't reclaim anything back. As far as the final customer is concerned, they just assume the VAT is part of the price.

Note how the VAT figure is getting larger as it goes further into the chain. This is because each part of the chain adds some value and incorporates the cost of their work (together with a profit margin) into the price. For example the manufacturer charges the outlet for the fact that it put the wool through a process and turned the wool into nice knitted jumpers. Similarly, the outlet will charge the final customer for bringing the product to the customer's attention by holding it on the shop floor or on their website.

Here's what happens when I put numbers to this example:

	Purchases			**Sales**		
	Net	**VAT**	**Gross**	**Net**	**VAT**	**Gross**
Farmer	0	0	0	10	2	12
Factory	10	2	12	15	3	18
Manufacturer	15	3	18	25	5	30
Outlet	25	5	30	40	8	48

- The sales values go up the further up the chain you go
- The VAT values also go up
- The sales figure for one business is the purchase figure for the next business in the chain
- The output VAT figure on sales for one business is the input VAT figure on purchases for the next business in the chain

The following table shows the figures on each business's VAT Return (note that they are the same figures as above but just the VAT part):

VAT

	Reclaims	Collected	Collected minus reclaimed
Farmer	0	2	2
Factory	2	3	1
Manufacturer	3	5	2
Outlet	5	8	3
Total amount received by the government			**8**

- Each business will pay some VAT to the government
- It pays the difference between the amount collected and the amount it can reclaim on purchases
- Normally it will result in a net outflow of cash because hopefully its sales will be larger than its purchases. If sales are less than purchases, the business would be loss-making.

The following table shows the profit made by each business:

Profit

	Net Sales	Net Purchases	Profit
Farmer	10	0	10
Factory	15	10	5
Manufacturer	25	15	10
Outlet	40	25	15

- The VAT does not affect Profit Margins
- It's simply a process of collecting VAT and passing it over the government
- The figures without VAT show the true value of sales and cost of purchases

Although the VAT doesn't affect the Profit Margin, it does affect cashflow because the businesses need to be aware that they have collected cash for the government and have some money in their bank account that doesn't technically belong to them.

There are different VAT rates for different types of products and services. The main ones are standard-rated, zero-rated, reduced-rate and exempt. It's useful to check on the government website to see what VAT rate applies.

Most goods and services fall into the standard-rated category.

An example of a zero-rated good is baby clothes because government doesn't want to collect tax and increase the price to the final customer for this type of item. It's great for businesses that are zero rated because they can reclaim VAT at standard rate for purchases but don't have to add VAT to sales.

Gas and electric are examples of reduced-rate goods. Stamps are an example of exempt goods. There are also transactions that are outside the scope of VAT such as wages and loan payments.

VAT schemes

There are a number of different VAT schemes which are mainly for smaller businesses to simplify the record-keeping process. For example the 'Flat Rate scheme' allows businesses to add VAT on their sales invoices at the normal rate. However, they don't need to reclaim VAT. They simply pay a pre-determined flat percentage of their sales to the government depending on their industry.

The 'Cash Accounting scheme' is based on cash transactions rather than invoices. It allows businesses to only pay the VAT once they have collected the payment from customers. Similarly, they can only reclaim VAT when they have paid their suppliers.

The 'Second-hand Margin scheme' allows businesses to pay VAT on the profit margin of each item rather than the sales value. The 'Global scheme' is a variation of the Second-hand Margin scheme and allows businesses to pay VAT on the total profit margin in the year rather than each individual sale.

All of these schemes have strict eligibility criteria which needs to be checked to see if a business is allowed to use the scheme.

Dividends

Dividends received from a person's own company or for shares held as investments are subject to Income Tax mentioned above. The thresholds are the same, however the rates are different compared to income from wages.

Capital Gains Tax (CGT)

Capital Gains Tax is the tax paid on profit made from selling large or expensive items, usually assets you own that are worth a lot.

Everyone is entitled to an annual amount that is exempt from CGT. This is in addition to the tax-free amount on Income Tax. Only profits over and above the annual exemption are subject to CGT.

The main house you live in is not subject to CGT.

In everyday life, most things people sell either make no profit or a small profit which is well below the annual exemption.

As with dividends, the Income Tax thresholds are used to determine the tax percentage that is applicable and although the thresholds are the same, the rates are different to those used for Income Tax calculations.

If companies sell large items, they pay Corporation Tax on Capital Gains. There is no tax-free amount for companies.

Tax reliefs

There are a few different types of tax reliefs businesses can claim and the main ones relate to instances where the business has made a loss or has closed down.

For example, a business can 'carry back' losses which means it can deduct losses made in the current year from previous years' profits and reduce the tax bill.

Similarly, it can 'carry forward' losses which means it can deduct this year's losses from profits in future years to reduce the tax bill of future years.

There is also something called 'sideways loss relief' which is about deducting losses from profitable income streams or other businesses that are profitable within the same year.

Business Asset Disposal Relief was previously known as Entrepreneur's Relief and this is about paying reduced Capital Gains Tax on the sale or closure of a business.

With all these tax reliefs it is important to look at the specific eligibility criteria to see if they apply.

Business Rates

Business Rates are a bit like Council Tax but for businesses. They are normally calculated on the amount of space that a business's property takes up.

Import and Export duty

This is charged by governments on goods that are brought into and sent outside the country. You will have heard of duty-free shops at airports. Technically, these shops are not in the country and the goods sold in them are not subject to Import duty. Items will be purchased and taken out of the country and consumed abroad. Goods that are under certain allowances don't need to be declared at Customs and Excise.

Most businesses will need to consider Import and Export duties if they buy and sell abroad.

Stamp Duty Land Tax (SDLT)

This is a tax on the purchase of property. There is a large tax-free allowance so I would recommend that you check the government website for the latest rates and allowances.

Inheritance Tax (IHT)

This is the tax on the estate of someone who passes away. As with SDLT, there is a significant tax-free allowance and I would recommend that you check the government's website for the latest rates and allowances.

There are also specific rules such as the fact that there is no Inheritance Tax on assets that are passed between spouses and there are tax reliefs for transferring assets within certain timeframes before death. It is worth looking into this and perhaps seeking professional advice if you have a large amount of assets that will be passed onto family and friends after you pass away.

Tax avoidance vs tax evasion

Tax avoidance is when a person or a business arranges their financial affairs in such a way so as to minimise the amount of tax they pay. This is completely legal.

For example, if a business owner sets up a Limited Company because he or she feels that less tax will be payable than if they remained a Sole Trader, that's completely fine. Or if your parents own a significant amount of assets and they transfer these to your name well before they die to avoid Inheritance Tax, that's completely fine too. This is just good tax planning.

On the other hand, tax evasion is illegal. This is manipulating the figures and lying in order to pay less tax. A good example of this is a tradesman or woman that quotes you a lower fee for doing some work at your house if you pay cash in hand. If a painter and decorator quotes you £1,000 for painting your entire house but offers you a price of £800 if you pay in cash, it normally means they are not going to declare the income to the tax authorities. This is because there is no evidence of the work having taken place if you pay them in cash whereas if you paid them electronically, or if they issued an invoice, they would have to declare the income since they have left an audit trail of their work.

Aggressive tax avoidance schemes are a grey area as well. This is where wealthy companies and individuals hire tax specialists to find loopholes in the tax laws. This means that technically they are acting within the law, but essentially not paying a fair amount of tax. When governments become aware of these schemes, they clamp down on them and close the loopholes. A good example of this is the offshore tax avoidance schemes. There were a number of these schemes which allowed wealthy individuals and companies to set up their residence in low tax countries known as 'tax havens'. This resulted in them paying lower taxes as compared to the higher taxes they would have had to pay in the countries in which they were operating or living.

26. Software

Software plays a crucial role in the world of accounting. One organisation could easily have six or seven pieces of accounting software to help deal with all the different aspects of accounting and finance.

The main piece of software is accounting and bookkeeping software. This records each and every transaction, whether it's a bank transaction, a sales invoice or an employee expense. It's all recorded in accounting software.

Payroll is sometimes processed in a separate piece of software, especially for large organisations with hundreds, if not thousands of employees.

Additional software is sometimes required to produce management accounts and reports such as Profit and Loss Accounts and Balance Sheets.

For small businesses, activities like payroll and reporting are all incorporated into the one piece of cloud-based software. However, for larger organisations, the number of transactions for multinational organisations could run into thousands per day. To deal with this amount of data, the software requirements are much more sophisticated and robust and that's why there may be a need for add-ons to pull out raw data and arrange it in a meaningful way.

Budgets and forecasts may also be prepared with their own software. Sales departments may have their own software for providing quotes and monitoring prices. Most stock control systems include costs as well as quantities. I haven't mentioned Excel yet. The list goes on.

The introduction of cloud-based accounting solutions has made a huge impact over the last decade and technology is improving all the time. This has resulted in some tasks that were previously completed manually being automated.

It is often suggested that accountants will become redundant in the future because their work will be entirely carried out by computers. However, the more likely outcome is that accountants' roles will evolve over time. They will spend less time producing and checking accounts and more time interpreting them and communicating them in a meaningful way. Technology also provides the opportunity for accountants to offer value-added services and business advice.

27. Bookkeeping

What’s the difference between accounting and bookkeeping?

Bookkeepers are involved mainly in the recording and processing of accounting transactions whilst accountants compile it in accordance with the rules and regulations and offer professional advice on it. Accountants will often have a deeper understanding of the more technical aspects of accountancy and tax.

The best analogy I can think of is doctors and nurses. Both have some medical knowledge. While doctors take the overall responsibility and make the key decisions, nurses are there to administer the medicines and give injections etc. so they are just as important but have a different role.

28. Bank reconciliations

Bank reconciliations or 'bank recs' for short are one of the most important areas for accountants in preparing accounts.

In accounting, a reconciliation is referred to as the process of identifying the reasons why certain balances don't match. For example, a bank rec is a statement showing the difference between the balance on the bank statement on a particular date and the balance shown in the accounts. In an ideal world, what's in the business's bank account should be the same as the total income a business has made minus all its costs but in reality, this is sometimes not the case. There may be timing differences. For example, the business may have sent a cheque that has been recorded in the accounts, but the cheque hasn't cleared the bank yet because it takes a few days to clear.

The reconciliation explains this difference and any other similar differences.

The introduction of cloud-based software with bank feeds directly transferring all banking information relating to each and every transaction into the software has changed things. The bank rec is now more about making sure that every bank transaction is explained rather than identifying differences. Every transaction is either matched to an invoice (which could be a purchase invoice for things bought or a sales invoices for things sold) or the transaction could be something that is just coded directly into the accounts (such as a bank fee or a tax payment for example, these are items for which there is no invoice).

As long as everything is explained, a set of accounts can be produced from the software including the Balance Sheet and Profit and Loss Account.

29. Payroll and pensions

Payroll is an important sub-section of accounting. There are lots of in-depth rules in relation to payroll which is why most large organisations appoint a payroll manager.

The rules cover all sorts of things like expenses, redundancy, bonuses, overtime, minimum wages and so on.

There are additional tax consequences of rewarding employees through ‘benefits in kind’. This means employees sometimes receive things instead (‘in lieu’) of wages such as company cars, private healthcare, gym memberships etc. and they need to pay tax on these perks that are paid for by the company.

The government has made it compulsory for all businesses that employ staff to have a pension scheme in place. This initiative was introduced to encourage everyone to save more for their retirement. If employees earn over a certain amount, they are automatically enrolled into the company’s chosen pension scheme. However, the employees can opt-out if they want to.

Note that there are three contributors to the pension scheme. The employee makes a contribution and this is taken out of their wage in the same way as PAYE and National Insurance. The employer makes a contribution and this is added to the cost of employing staff in the same way as Employer’s National Insurance. The third contributor is the government.

30. Governing bodies

The governing body for accountants in the UK is the Financial Reporting Council (FRC) and there are various international governing bodies such as the IFRS Foundation Monitoring Board and the International Federation of Accountants (IFAC). Each country has its own governing body and there are different governing bodies for the different areas of accounting. For example, there is an International Auditing and Assurance Standards Board (IAASB) and an International Ethics Standards Board for Accountants (IESBA).

The other regulatory bodies in the UK you have probably heard of are HMRC and Companies House.

HMRC stands for Her Majesty's Revenue and Customs. It was formed in 2005 and replaced the Inland Revenue. It also replaced Customs and Excise as the two areas were merged. HMRC is in charge of all matters relating to UK tax. The USA equivalent is the IRS (The Internal Revenue Service).

In the UK, there is also Companies House which is in charge of Limited Company registrations and closures. Companies House holds important information about every company for the public to view such as directors' names, company addresses and the latest published accounts.

31. International Financial Reporting Standards (IFRSs)

In the UK, the accounting rules and regulations are known as the Financial Reporting Standards (FRSs). These rules cover everything from how to account for transactions to the layout in which accounts are presented.

Over the last few decades, with companies trading internationally and especially with the emergence of the internet, it has been recognised that there is a need to have a consistent approach across the world. This will help both users and preparers of accounts. Users will be able to easily understand and more accurately compare accounts from different companies across the globe. Preparers will be able to account for transactions consistently for multinational organisations.

That’s the main reason for IFRSs being introduced. Most of the key accounting principles are the same. The main differences are in the layout of the accounts and some of the terminology. In fact the UK standards are somewhat influenced by the terminology and layout of IFRSs and I have included some examples in the following table. Note that the FRSs are not completely redundant and are still used, particularly by smaller companies in the UK.

Traditional description	**Referred to as**
Profit and Loss Account	Income Statement *or* Income and Expenditure Statement
Balance Sheet	Statement of Financial Position
Stock	Inventories
Debtors	Receivables
Creditors	Payables

32. Professional ethics

It is useful to know that qualified accountants must abide by a code of professional ethics which covers issues such as integrity, confidentiality and competence.

It means accountants should act honestly and not disclose confidential information to anyone they shouldn't. They need to be competent, act professionally and show a duty of care when carrying out their work. If they don't abide by this code of ethics, they can face disciplinary action by their professional body.

If you feel that an accountant has not acted properly, you can report it to their professional body so the matter can be investigated.

33. Money laundering

Money laundering is about identifying money that is obtained through criminal activity or money that is being held to fund criminal or terrorist activities.

This is seen to be ‘dirty’ money and criminals or terrorists will try to clean (or ‘launder’) the money so they can get it into the normal banking system. This is often done by disguising the ‘dirty’ money and mixing it with ‘clean’ money through complex or legitimate business structures.

For example, a restaurant or a car dealer or nail bar that does very little business could claim to have done lots of business, all in cash, and could put that money in the bank ‘legitimately’ – when actually it was really the proceeds of crime e.g. drug dealing or computer crime.

Accountants are required by their professional bodies to take an active role in complying with Anti-Money Laundering (AML) regulations. They are required to undertake risk assessments for all clients and if they come across anything suspicious while carrying out any of their work, they must report it without ‘tipping-off’ i.e. they can’t let the client know they are suspicious and are going to report it.

34. Final word

As you have read in this guide, accountancy and finance is a vast and wide-ranging subject with lots of different strands. Its importance should not be underestimated by companies and organisations because the finances underpin everything they want to achieve.

Accountancy and finance is ultimately about ensuring businesses have the resources they need to achieve their goals and objectives.

Inevitably companies that employ staff with an understanding of how the finances work will have a greater chance of success.

I believe this guide will help business owners, directors, managers, budget holders and staff to better understand accountancy and finance as it gives them the tools and knowledge to improve the business's bottom line.

Please keep it as a reference point so when you come across an accountancy term in a meeting and you can't remember what it means, or you want to remind yourself about something in particular, you can just dig out this guide and look it up in the glossary.

I'll finish with a story about a documentary I saw on TV a couple of years ago where a business owner had hired an accountant to take care of all his business's accounting and bookkeeping needs. However, the accountant turned out to be a fraudster who had been creating bogus suppliers with his own bank details on the invoices. It turns out he had paid himself hundreds of thousands of pounds over the course of a couple years. The company inevitably folded and I felt so sorry for this guy who had worked hard to build up a great business. If only he, or a member of his staff had read this guide or been on one of my training courses, they would have known about segregation of duties. He may also have been able to detect that something was not quite right if he was regularly reviewing management accounts. Or maybe he would have known about checking the accountant's qualifications and he would have been aware of professional ethics as soon as he suspected any foul play. I'm sure there would be something in this guide which triggered a thought that would have helped him and he could have saved the business.

And with that, I'd like to take this opportunity to wish you every success and hope to meet you at a training course in person or virtually sometime soon. Also feel free to connect with me on LinkedIn and check out my YouTube channel where I regularly post useful content.

Good luck and best wishes.

Naeem Anwar

35. Acronyms

AAT	Associate Accounting Technician
ABC	Activity-Based Costing
ACA	Associate Chartered Accountant
ACCA	Associate Certified Chartered Accountant
AGM	Annual General Meeting
AML	Anti-Money Laundering
ARR	Accounting Rate of Return
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGT	Capital Gains Tax
CIMA	Chartered Institute of Management Accountants
CIOT	Chartered Institute of Tax
CIPFA	Chartered Institute of Public Finance and Accounting
COS	Cost of Sales
CPD	Continued Professional Development
CTA	Chartered Tax Adviser
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before, Interest, Tax, Depreciation and Amortisation
FCA	Fellow Chartered Accountant
FCCA	Fellow Certified Chartered Accountant
FD	Finance Director
FRC	Financial Reporting Council
FRS	Financial Reporting Standards
HMRC	Her Majesty's Revenue and Customs
IAASB	International Auditing and Assurance Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IHT	Inheritance Tax
IRR	Internal Rate of Return
IRS	Internal Revenue Service
KPIs	Key Performance Indicators
Ltd	Private Limited Company
MD	Managing Director
NI	National Insurance
NPV	Net Present Value
P/E Ratio	Price Earnings Ratio
P&L	Profit and Loss Account
PAYE	Pay As You Earn
PI	Profitability Index
PLC	Public Limited Company
QBE	Qualified by Experience
ROCE	Return on Capital Employed
ROI	Return on Investment
SDLT	Stamp Duty Land Tax

Glossary (continued)

SMEs	Small – Medium sized Enterprises
VAT	Value Added Tax

36. Glossary

Glossary (continued)

Page

Glossary (continued)

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Naeem Anwar is a Chartered Accountant, corporate trainer and finance coach based in the Northwest of England.

He specialises in running a range of training courses for people who are not accountants or finance professionals but need to know about accounting and finance for their current or future job roles.

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