# Annual Accounts and HM Revenue & Customs

**How your accounts are prepared.
What they mean to you, your creditors
and the HM Revenue & Customs**

# AAS TRAINING LTD
# Annual Accounts and
# HM Revenue and Customs

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Section 1

# Introduction

Have you ever wondered:

- Do my annual accounts actually tell me anything that I don't already know?
- Why are the accountant's bills so high? Can we do anything to keep them down?
- What does the accountant do for his money? How can he take so long to produce the accounts?
- What is an audit? Do I really need one?
- Why does *my* estimated profit look nothing like the figure calculated by the accountant?
- How is my tax calculated? Is it complicated or just common sense? How much does the accountant tell HM Revenue & Customs (HMRC)?
- What are HMRC looking for when they check my accounts?

If these and similar questions have ever concerned you, then you are going to find this book beneficial.

This book won't make you into an accountant. However, it will give you a good introduction to the annual financial accounts prepared by your accountant each year.

By the end of the book, you will have a better understanding of accounting terms. You will develop an appreciation of how profit and loss accounts and balance sheets are structured. This will enable you to have more meaningful discussions with your bank manager, accountant or any other financial adviser you decide to use.

You will also have a better understanding of how your accounts are presented to the Revenue & Customs and what the Inspector of Taxes is looking for when he checks your accounts.

We will assume that you keep your accounts in the kind of analysed cashbook format recommended in the 'Simple Practical Book-keeping' book in this series.

We are about to focus on your annual financial accounts. The profit and loss account tells you how much profit you have earned in the previous year. The balance sheet sets out how much your business is worth.

The annual accounts are useful to:

***You*** - for example, if you wish to move house and require a mortgage, the lender will want to see your annual accounts to confirm your income.

***Your bank*** - especially if you plan to borrow money.

***HM Revenue & Customs***- who will base their tax demand on your profit and loss account.

***Others*** - who may have an interest in your business like creditors, HP companies etc.

The annual accounts are definitely *not useful* for controlling the business because:

- by the time they are prepared they are historical. Annual accounts are not sufficiently up to date to allow you to control your business.

- there is not enough *detail* for management control. To manage your business, you need monthly accounts. These focus on controllable items of income and expenditure like sales, wages, materials, stocks etc. Management accounting is covered in another book in this series .

Although the annual financial accounts are no substitute for monthly management accounts, they do represent an annual milestone. This can serve as a trigger for an in-depth review of your business performance, perhaps helped by your accountant or other adviser.

At the end of this book, you will feel more comfortable with accounting words and terminology. Next year, when the accountant asks you to 'sign off' your accounts, you will have a better understanding of what you are signing! The next section helps you to understand the nature of 'profit'.

Section 2

# What is a Profit?

In this section, we introduce the idea of 'profit'. In the next section, we look at some practical examples. You need to read both sections to develop your understanding. Let's begin with a question.

**Question**

If you subtracted the amount of cash spent by your business in a year from the amount of cash received by your business in that year, would the difference represent your profit for the year? In other words does:

| | |
|---|---|
| | Cash Received |
| *less* | Cash Spent |
| *equal* | Profit? |

The answer is a definite '**No**'. The difference between the amount of cash spent and the amount of cash received is your cash surplus (or cash deficit). *This is not the same as profit.*

We need to make a variety of adjustments in order to convert a cash surplus into a profit figure. These adjustments include:

- Allowance for credit given
- Allowance for credit taken
- Changes in stock levels
- Depreciation
- Payments made in one year for goods/services received in another year.

Here are some examples of the adjustments that you have to make to your analysed cashbook. More explanation follows in the next section.

## Credit Given

This adjustment only applies where the business gives its customers credit.

At the end of every trading year, the business will be owed money from customers who bought goods or services during the year but who have not yet paid their bills. Legally, the transaction took place within the old trading year so the income is deemed to belong to that trading year. This means that we have to adjust the 'cash received from sales' figure at the end of every accounting year *to include debtors outstanding at the end of the year.*

By the same token, some of the cash that we receive during this accounting year will be for goods and services sold in the previous year. We need to *deduct this cash* from the year's 'cash received from sales' figure because the income belonged to the previous trading year. Don't worry if this sounds complicated. An example of this adjustment is shown on page 8 in the next section which will make it clear.

These adjustments are particularly important if you rely on manual accounting via an analysed cashbook. If you have a computerised accounting system, you will find that the 'sales ledger' program automatically calculates the correct sales figure for you based on the date that the invoice was raised.

## Credit Taken

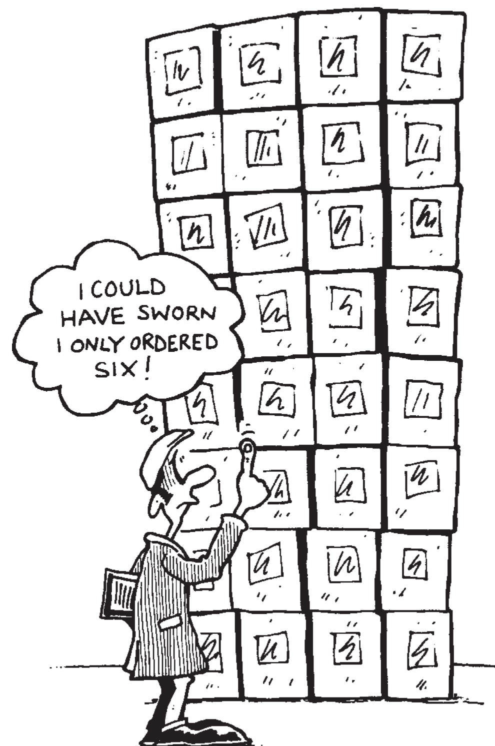
Most businesses receive credit from their suppliers. This means that they get their goods and services before they pay the bill. Legally, however, the transaction takes place at the time when the goods or services are accepted, not on the date that payment is made. Items bought by the business are charged to the profit and loss account *at the time when they are accepted, not the time they are paid for.*

This means that we need to make an adjustment to the 'cash out' figure in our analysed cashbook to reflect the effects of credit. The adjustment is similar in nature to the adjustment for sales discussed above. Don't worry about the detail now, the example on page 10 in the next section will make this clear.

Remember that these adjustments are important if you rely on manual accounting using a cashbook. If you run a computerised accounting system, the 'purchase ledger' is based on transaction dates, not on payment dates. This means that the computer automatically supplies the 'correct' figure for purchases received.

## Stock Changes

If you sell items from stock which you bought in a previous trading year, you will artificially inflate your profit for this year. This is because you will be showing income this year and expenditure in the previous year. This causes a misleading profit fluctuation. To eliminate profit fluctuations caused by changing stock levels, we need to know two things:




- How much stock did we have at the beginning of the trading year?
- How much stock did we have at the end of the trading year?

From these two figures, we can work out the stock change during the year. This is then used to adjust the profit (we will see an example of this on page 11).

Work-in-progress is a special type of 'stock' which mainly affects the manufacturing and construction industries. People who manufacture goods will hold stocks of part-finished work. Once again we need to know:

- the amount of work-in-progress at the beginning of the period, and
- work-in-progress at the end of the trading period.

This enables you to adjust the profit figure for work-in-progress distortions (an example of this is given on page 12).

## Depreciation

Your cashbook will show money spent on the purchase of capital items like cars, vans, office equipment, machinery, premises etc.

However, the *profit* calculation does not charge the whole cost of the asset in the year of purchase. Instead, the cost is shared out over the life of the equipment. For example, a car with a seven year life may have one seventh of its purchase price charged against each of the seven profit and loss accounts drawn up whilst the car is in use.

*Fully Depreciated?*

## Summary

These examples illustrate a very important distinction in accounting. If you log all your sources of 'cash in' and all your sources of 'cash out', you will have a very valuable document called a cash flow statement (this important document is examined closely in other books in the series).

*However, the difference between 'cash in' and 'cash out' is not profit*. Profit is a notional surplus arising from trading. It is notional because it does not just take cash into account, it makes adjustments for non cash items like depreciation, stock change, credit given and credit taken etc. The profit and loss account also apportions bills which span two accounting periods so that each period bears a fair share of the cost.

The next section looks at the profit and loss account in more detail and shows you how to calculate the figures.