Chapter 7: Business Accounting

What are accounts an why are they necessary?

Accounts are **financial records** of a firm's **transactions** that is kept up to date by the **accountants**, who are qualified professionals responsible for keeping accurate accounts and producing the final accounts.

Every end of the year, a **final accounts** must be produced which gives details of:

- Profits and losses made.
- Current value of the business.
- Other financial results.

Limited companies are bound by law to publish these accounts, but not other businesses.

Financial documents involved in buying and selling.

Accountants use various documents that are used for buying and selling over the year for their final accounts. They can help the accountant to:

- keep records of what the firm bought and from which supplier.
- keep records of what the firm sold and to which customer.

These documents are:

- **Purchase orders**: requests for buying products. It contains the quantity, type and total cost of goods. Here is an example.
- **Delivery notes:** These are sent by the firm when it has received its goods. It must be signed when the goods are delivered.
- **Invoices:** These are sent by the supplier to request for payment from the firm.
- **Credit notes:** Only issued if a mistake has been made. It states what kind of mistake has been made.
- **Statements of account:** Issued by the supplier to his customers which contains the value of deliveries made each month, value of anycredit notes issued and any payments made by the customer. Here is an example.
- **Remittance advice slips:** usually sent with the statement of accounts. It indicates which invoices the firm is paying for so that the supplier will not make a mistake about payments.
- **Receipts:** Issued after an invoice has been paid. It is **proof** that the firm has paid for their goods.

Methods of making payment

There are several ways goods can be paid for:

- **Cash**: The traditional payment method. However, many businesses do not prefer to use cash for a number of **security reasons**. When cash is paid, a **petty cash voucher** is issued by the person in charge of the firm's money who also signs it to authorise the payment. The person making the purchase signs it too to show that the money has been recieved.

- **Cheque**: It is an instruction to the bank to transfer money from a bank account to a named person. In order to do this the bank needs a **cheque guarantee card**, saying that they have enough money in their account to support this payment.
- **Credit card**: Lets the consumer obtain their goods now and **pay later**. If the payment is delayed over a set period then the consumer will have to pay **interest**.
- **Debit card**: **Transfers money directly** from user's **account** to that of the seller.

Recording accounting transactions

Businesses usually use computers to store their transactions so that they can be easily accessed, calculated and printed quickly.

Who uses the financial accounts of a business?

- **Shareholders:** They will want to know about the profit or losses made during the year and whether the business is worth more at the end of the year or not.
- **Creditors:** They want to see whether the company can afford to pay their loans back or not.
- **Government:** Again, they want to check to see if correct taxes are paid. They also want to see how well the business is doing so that it can keep employing people.
- **Other companies:** Other companies want to compare their performance with a business or see if it is a good idea to take it over.

What do final accounts contain?

The trading account

This account shows how the **gross profit** of a business is calculated. Obviously, it will contain this formula:

Gross profit = Sales revenue - Cost of goods sold

Note that:

- Gross profit does **not** take to account **overheads**.
- **Only** calculate the **cost of goods sold**, and forget the **inventory**.
- In a **manufacturing business**, **direct labour and manufacturing costs** are also deducted to obtain gross profit.

The profit and loss account

The profit and loss account shows how **net profit** is calculated. It starts off with gross profit acquired from the trading account and by deducting all other costs it comes up with net profit.

Depreciation is the fall in value of a fixed asset over time. It is also counted as an indirect cost to businesses.

As for **limited companies**, there are a few differences with the normal profits and loss account:

- **Profits tax** will be shown.

- It needs to have an **appropriation account** at the end of the profits and loss account. This shows what the company has done with its net profits, in other words, how much **retained profit** has been put back into the company.
- Results form the **previous year** are also included.

Balance sheet

The balance sheet shows you a business's assets and liabilities at a particular time. The balance sheet records the **value** of a business at the end of the financial year. This is what it contains:

- **Fixed assets:** land, vehicles, buildings that are likely to be with the business for more than one year. They **depreciate** over time.
- **Current assets:** stocks, inventory, ash and debtors that are only there for a short time.
- **Long-term liabilities:** long-term borrowings that does not have to be paid in one year.
- **Short-term liabilities:** short-term borrowings that has to be paid in less than one year.

If your **total assets** are **higher** than your **total liabilities**, then you are said to own **wealth**. In a normal business, wealth belongs to the **owners**, while in a limited company, it belongs to the **shareholders**. Hence the equation:

Total assets - total liabilities = Owners'/Shareholders' wealth

Here are some terms found in balance sheets:

- **Working capital:** is used to pay short-term debts and known as **net current assets**. If a business do not have enough working capital then it might be forced to go out of business. The formula:

  Working capital = Current assets - Current liabilities
- **Net assets:** Shows the net value of all assets owned by the company. These assets must be paid for or finance by **shareholders' funds** or**long term liabilities**. The formula:

  Net assets = Fixed assets + Working capital
- **Shareholders' funds:** The total sum invested into the business by its owners. This money is invested in two ways:

  - **Share capital:** Money from newly issued shares.
  - **Profit and loss reserves:** Profit that is owned by shareholders but not distributed to them but kept as part of shareholders' funds.
- **Capital employed:** Long-term and permanent capital of a business that has been used to pay for all the assets. Therefore:

  Capital employed = net assets
  Capital employed = Shareholders' funds + long-term liabilities

Analysis of published accounts

Without analysis, financial accounts tell us next to nothing about the performance and financial strength of a company. In order to do this we need to compare **two figures** with each other. This is called **ratio analysis**.

Ratio analysis of accounts

The most common ratios used are for comparing the **performance** and **liquidity**of a business. Here are five of the most commonly used ratios.

Ratios used for analysing <u>performance</u>:

- **Return on capital employed:** This result could show the efficiency of a business. If the result rises, the managers are becoming more successful.

<u>*Return on capital employed (%) = Operating profit/Capital employed * 100*</u>

- **Gross profit margin:** If this rises, it could mean that either they are increasing added value or costs have fallen.

<u>*Gross profit margin = Gross profit/Sales revenue * 100*</u>

- **Net profit margin:** The higher the result, the more successful the managers are. This could be compared with other businesses too.

<u>*Net profit margin = Net profit before tax/Sales revenue * 100*</u>

Note: Net profit does **not** include tax.

Ratios used for analysing liquidity: This is too see how much cash a business has to pay off all of its short-term debts.

- **Current ratio:** This ratio assumes that all current assets could be converted into cash quickly, but this is not always true since**stock/inventory** could not be all sold in a short time. Generally, a result of 1.5 to 2 would be preferable, so that a business could pay all of its short-term debts and still have half of its money left.

<u>*Current ratio = Current assets/Current liabilities*</u>

- **Acid test** or **liquid ratio:** This type of analysis neglects stocks, but it is similar to the current ratio analysis.

<u>*Acid test ratio = (Current assets - Stocks)/Current liabilites*</u>

These ratios can be used to:

- Compare with other years.
- Compare with other businesses.

It must be remembered that a ratio on its own will give you nothing, but when it is compared with ratios from the past and other businesses it will tell you a lot of things.

However, there are still some **disadvantages** of ratio analysis:

- Only shows past results, does **not** show anything about the **future**.
- Comparisons between years may be **misleading** because of **inflation**.
- Comparisons between businesses could be **difficult** since each has its**own accounting methods**.