Understanding your Annual Accounts

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Introduction

The first time a contractor or freelancer sees his or her accounts, they can definitely be a bit daunting: 10 or so pages of figures and reports in a strange language, and it's tempting, I'm sure, just to sign the accounts off without understanding them and hope for the best.

However, as a company director, you, not your accountant, are responsible for ensuring the accuracy of these accounts, so it's important that you at least have a broad understanding of the accounts. This guide aims to give you this understanding, and in the usual plain English you've come to expect from Broome Affinity.

The format of your annual accounts is set out in the Companies Act. Although there is some leeway as to how the accounts are presented, they must be in a set format. Our clients' accounts will typically contain the following:

- Cover page
- Company information
- Directors' report
- Profit and loss account (statutory)
- Balance sheet
- Notes to the financial statements
- Detailed profit and loss account (non-statutory)

We'll now look at each of the financial pages in turn:

The Profit and Loss Account

UNREAL IT CONSULTING LTD

Profit and Loss Account for the Year Ended 31 December 2015

	Note	2015 £	2014 £
Turnover		113,618	103,124
Administrative expenses		(30,866)	(26,293)
Operating profit	2	82,752	76,831
Profit on ordinary activities before taxation		82,752	76,831
Tax on profit on ordinary activities	4	(16,745)	(15,297)
Profit for the financial year	10	66,007	61,534

For a typical contractor the statutory P&L is normally only six or seven lines long but they are very important lines. It's a summarised version of the detailed Profit & Loss Account we'll discuss later. This version is the set out in a statutory way and cannot be deviated from.

So, what does each line in the accounts represent:

Turnover: this is typically the total of all invoices raised in the period, plus any profit made from the VAT Flat Rate Scheme. Under normal circumstances, invoices will be included here whether or not they have been paid by the year end date.

Administrative expenses: this represents all of the costs of the company that have been classified as expenses. Please note fixed assets will not normally be included here, but your salary will, as will depreciation and expenses which are not allowable for tax. Any dividends paid will not be included here.

Key term: A Fixed asset is an item purchased for use in the business which has an estimated useful life of more than a year. EG, IT equipment

Operating profit / profit on ordinary activities before taxation: Essentially turnover less administrative expenses.

Tax on profit on ordinary activities: This is the corporation tax the company will have to pay on the company profits. Generally, this is 20% of ***taxable*** profits, which, isn't always the same as ***operating*** profit. There are some expenses which will need to be "added back" into the profit as they are not allowable for tax purposes. Such examples are client entertaining or depreciation.

Key term: Capital Allowances is the method used by accountants and HMRC to ensure that tax relief on Fixed Asset purchases is given

If the company has purchased any assets, then the capital allowances will need to be adjusted for in the tax calculation. Your company's corporation tax is typically calculated as follows:

Operating profit	£50,000
Add back:	
Depreciation	£1,000
Disallowable entertainment	£5,000
Less:	
Capital allowances	£2,000

Taxable profit	£54,000
Tax at 20%	£10,800

So, if you're wondering why your corporation tax doesn't equate exactly to 20% of your operating profit, it is likely that you'll have adjustments for disallowable items or capital allowances.

Profit for the financial period: This is the profit left over after the tax has been accounted for.

The Balance Sheet

UNREAL IT CONSULTING LTD
(Registration number: SC123456)
Balance Sheet at 31 December 2015

	Note	2015 £	2014 £
Fixed assets			
Tangible fixed assets	5	523	1,678
Current assets			
Debtors	6	13,400	12,150
Cash at bank and in hand		55,045	47,120
		68,445	59,270
Creditors: Amounts falling due within one year	7	(20,571)	(18,558)
Net current assets		47,874	40,712
Net assets		48,397	42,390
Capital and reserves			
Called up share capital	8	100	100
Profit and loss account	10	48,297	42,290
Shareholders' funds		48,397	42,390

These accounts have been prepared in accordance with the provisions applicable to companies subject to the small companies regime and in accordance with the Financial Reporting Standard for Smaller Entities (effective 2008).

For the year ending 31 December 2015 the company was entitled to exemption under section 477 of the Companies Act 2006 relating to small companies.

The members have not required the company to obtain an audit in accordance with section 476 of the Companies Act 2006.

The director acknowledges his responsibilities for complying with the requirements of the Act with respect to accounting records and the preparation of accounts.

Approved by the director on 4 April 2016

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Broome
Director

The Balance Sheet is essentially the summary of your company's assets, liabilities, obligations, creditors etc at a particular point in time, ie, your year end date.

In simple terms, it shows the "net book value" of your company by adding up all the assets (whether this is PC equipment, trade debtors, cash) and deducting the liabilities (tax due, loans etc)

Key term: Net Book Value is basically the difference between the value of your company's assets and its liabilities

The main sections of the balance sheet are:

- Fixed assets
- Current assets
- Creditors: amounts falling due within one year
- Creditors: amounts falling due after more than one year
- Capital and reserves

Again, the format is defined in the Companies Act so the Balance Sheet must follow a particular format and what is included in each of the sections is also statutorily defined:

Fixed Assets

These are items which are purchased for use in the business which have a estimated useful life exceeding a year, and which exceed the minimum capitalisation value. This would generally be IT equipment or other similar assets. Our minimum capitalisation value is £1,000. Any assets less than £1,000 will be treated as an expense in the P&L.

Key term: Capitalisation only assets costing more than £1,000 will be put on the balance sheet. Less than £1,000 goes to the P&L. The tax relief is the same.

The depreciation mentioned in the P&L section above comes from this part of the balance sheet as well: Depreciation is the accounting method used for writing down or charging the value of an asset to the company over its useful life. Most IT equipment is written down over three years so it's value will be reduced, or depreciated, by 33% each year.

A note about depreciation and capital allowances: Its worth remembering that because Depreciation is not an allowable expense (see the P&L section above) in order to get tax relief on the cost of fixed assets, we need to claim Capital Allowances. For most asset classes, you can write off 100% if the costs against profit in the year of purchase. This doesn't reduce the tax payable by the cost of the asset, but the taxable profit*. The tax will be reduced by 20% of the cost .*

Current Assets

These are any assets owned by the company which are not fixed assets, and can therefore generally be defined as assets which are cash, or expected to be converted in cash with a year. Typically, a contractor will have two types of current assets: cash at bank, which is self explanatory, and trade debtors (sometimes called trade receivables). Trade debtors are invoices which have been raised but which have not been paid.

Creditors: amounts falling due within one year

These are the company's obligations or liabilities which fall due within a year of the accounting period end. Typically these will be the corporation tax payable on the profit, any VAT due (this would include any VAT returns that have been submitted but not paid, and also any flat rate VAT that has been charged on invoices issued but not yet paid over to HMRC. If you have any Directors' Loans outstanding, or if salaries or expenses have not been paid, the amounts due at the year end will also be shown here.

Capital and reserves

This shows how the top half of the balance sheet has been arrived at. This is normally the capital of the company plus the accumulated profits, less any dividends that have been paid out.

Generally speaking, the assets should always exceed the liabilities. Therefore the final value of the Balance Sheet should be positive. If it's negative (ie, in brackets), then there is a potential problem and it's likely that you have overdrawn your dividends. We would not normally allow the Balance Sheet to get into a negative situation as we will have been monitoring through Freeagent to make sure and will have advised a course of action to avoid this.

Notes to the Accounts

Some notes are statutory, some are optional, but all are there to make your understanding of the accounts that little but easier. The notes will explain what accounting standards and policies the financial statements have been prepared under, and also what a lot of the figures in the accounts make up. For example, there will a Fixed Assets note which will show a breakdown of costs and depreciation of all fixed assets. The Creditors note will tell you how much of the Creditors figure is Corporation Tax, how much is VAT etc.

5 Tangible fixed assets

	Plant and machinery £	Total £
Cost or valuation		
At 1 January 2015	3,500	3,500
Depreciation		
At 1 January 2015	1,822	1,822
Charge for the year	1,155	1,155
At 31 December 2015	2,977	2,977
Net book value		
At 31 December 2015	523	523
At 31 December 2014	1,678	1,678

7 Creditors: Amounts falling due within one year

	2015 £	2014 £
Corporation tax	16,745	15,297
Other taxes and social security	3,826	3,261
	20,571	18,558

10 Reserves

	Profit and loss account £	Total £
At 1 January 2015	42,290	42,290
Profit for the year	66,007	66,007
Dividends	(60,000)	(60,000)
At 31 December 2015	48,297	48,297

Detailed Profit & Loss Account

UNREAL IT CONSULTING LTD
Detailed Profit and Loss Account for the Year Ended 31 December 2015

	2015 £	2015 £	2014 £	2014 £
Turnover (analysed below)		113,618		103,124
Gross profit (%)		100.00%		100.00%
Administrative expenses				
Employment costs (analysed below)	(17,060)		(15,560)	
Establishment costs (analysed below)	(686)		(637)	
General administrative expenses (analysed below)	(11,965)		(8,941)	
Depreciation costs (analysed below)	(1,155)		(1,155)	
		(30,866)		(26,293)
Profit on ordinary activities before taxation		82,752		76,831

UNREAL IT CONSULTING LTD
Detailed Profit and Loss Account for the Year Ended 31 December 2015

	2015 £	2014 £
Turnover		
Sales, UK	110,000	100,000
VAT flat rate profit	3,618	3,124
	113,618	103,124
Employment costs		
Directors remuneration	8,060	8,060
Directors' pensions	9,000	7,500
	17,060	15,560
Establishment costs		
Insurance	686	637
General administrative expenses		
Telephone and communication	994	937
Sundry expenses	467	415
Accountancy fees	1,188	1,198
Travel and subsistence	9,316	6,391
	11,965	8,941
Depreciation costs		
Depreciation	1,155	1,155

This non-statutory page (or to be accurate 2 pages) provides more detail to the statutory P&L explained above. The P&L is shown over 2 pages – the first shows the headline figures, the second shows the detail.

Turnover will be broken down into UK Sales, Overseas Sales if appropriate, and VAT Flat Rate Profit.

Costs will be broken down into their various components, such as Salaries, Office Costs, Travelling expenses, Insurance, Accountancy fees etc. This is where you can get a good handle everything you've spent over the year.

Remember, if you're a Freeagent user (and if you're not you should be), the information in the year end accounts should mirror the information in Freeagent. This is not always the case as sometimes post-year end adjustments are required, but your account manager should be able to explain any differences adequately.

If you have any questions at all about your annual accounts, please call or email. Your Accountant will be able to explain anything that isn't clear to you.

Find out more

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About the Author

Alan Broome founded the contractor accounting firm Broome Affinity in 2007. He has been specialising in accounting and tax planning for contractors, freelancers and interim consultants ever since. Alan and his team provide focussed services delivered using market leading technology in a friendly and informal way.