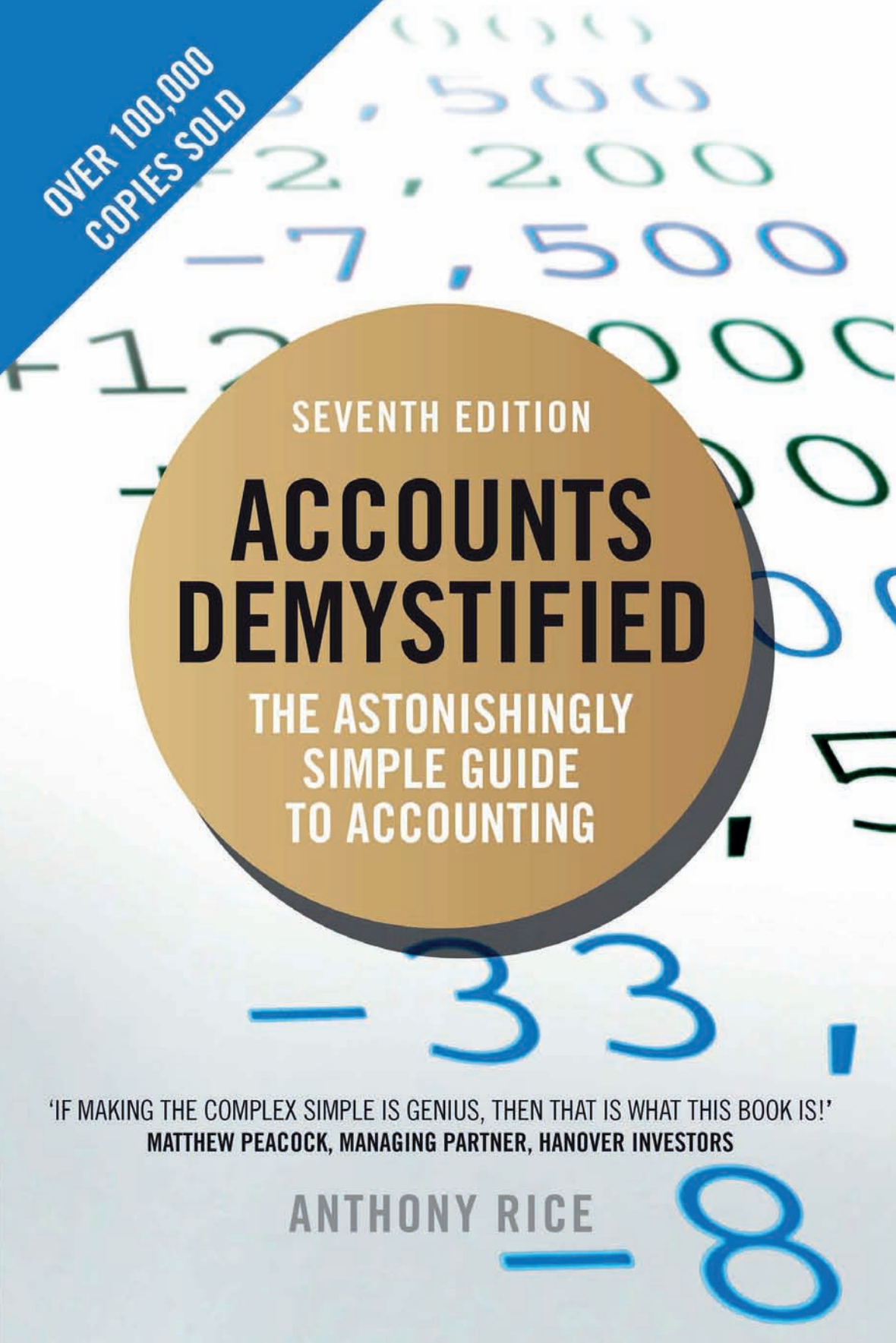
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'IF MAKING THE COMPLEX SIMPLE IS GENIUS, THEN THAT IS WHAT THIS BOOK IS!'
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Matthew Peacock, Managing Partner, Hanover Investors

It is exactly right. What I want you to do now is run through all 17 of SBL's transactions and write down the debits and credits that relate to each. Lay them out as I did the last transaction; i.e. with the debits in a column on the left and the credits on the right. Then check your answers against my list [Table 5.1].

www

Table 5.1 Debits and credits relating to SBL's transactions (1—9)

	TRANSACTION	DEBIT	CREDIT
1	**Issue shares**		
	Increase **Cash**	10,000	
	Increase **Share capital**		10,000
2	**Loan from parents**		
	Increase **Cash**	10,000	
	Increase **Long-term loans**		10,000
3	**Buy car**		
	Decrease **Cash**		9,000
	Increase **Fixed assets**	9,000	
4	**Buy stock for cash**		
	Decrease **Cash**		8,000
	Increase **Stock**	8,000	
5	**Buy stock on credit**		
	Increase **Stock**	20,000	
	Increase **Trade creditors**		20,000
6	**Sell stock for cash**		
	Increase **Cash**	12,000	
	Decrease **Stock**		6,000
	Increase **Retained profit**		6,000
7	**Sell stock on credit**		
	Decrease **Stock**		12,000
	Increase **Trade debtors**	30,000	
	Increase **Retained profit**		18,000
8	**Equipment rental, etc.**		
	Increase **Trade creditors**		2,000
	Decrease **Retained profit**	2,000	
9	**Car expenses**		
	Decrease **Cash**		4,000
	Decrease **Retained profit**	4,000	

Table 5.1 Continued (Transactions 10–17)

	TRANSACTION	DEBIT	CREDIT
10	**Loan interest**		
	Decrease **Cash**		1,000
	Decrease **Retained profit**	1,000	
11	**Collect cash from debtors**		
	Increase **Cash**	15,000	
	Decrease **Trade debtors**		15,000
12	**Pay creditors**		
	Decrease **Cash**		10,000
	Decrease **Trade creditors**	10,000	
13	**Prepayment**		
	Decrease **Cash**		8,000
	Increase **Prepayments**	8,000	
14	**Pay dividend**		
	Decrease **Cash**		3,000
	Decrease **Retained profit**	3,000	
15	**Telephone accrual**		
	Increase **Accruals**		2,000
	Decrease **Retained profit**	2,000	
16	**Depreciation**		
	Decrease **Fixed assets**		3,000
	Decrease **Retained profit**	3,000	
17	**Accrue tax liability**		
	Increase **Tax liability**		4,000
	Decrease **Retained profit**	4,000	

Trial balance

The **trial balance** (or **TB** for short) is just a list of all the nominal accounts in the nominal ledger showing the balance in each (i.e. the height of the box) at a point in time. For the avoidance of doubt, each balance takes into account *every* transaction and adjustment the company has *ever* made up to that point in time that affects that nominal account. In other words, it is like a very detailed balance sheet, albeit laid out differently.

The TB is actually a major milestone in the accounting process, in that:

- It is the end of the process of getting all our transactions and adjustments into the accounting system.
- It is the starting point for the process of producing our balance sheet, P&L etc., all of which are derived from the TB.

Which brings us to the chart of accounts or layout of accounts.

Chart of accounts (layout of accounts)

The **chart of accounts** is little more than a template. It determines how each nominal account should be treated for the purposes of producing the balance sheet and the P&L. So it identifies:

- which of the nominal accounts are part of retained profit, so the software can add them together to get net retained profit for the balance sheet;
- which nominal accounts should be listed under each of the categories on the balance sheet, such as fixed assets, current assets, current liabilities, shareholders equity, etc.;
- which of the nominal accounts that make up retained profit should be listed under which category on the P&L, such as sales, cost of sales, **overheads**, etc.

You can usually set up more than one chart of accounts that will produce balance sheets and P&Ls that are laid out differently, but which are based on the same underlying TB. For example, you might want a very detailed balance sheet and/or P&L for your own checking purposes, but less detailed ones for presentation to your fellow directors. A chart of accounts allows you to summarise your data by grouping nominal accounts together and presenting them as just one figure. As ever, it's just simple arithmetic.

OK, so the nominal account balances are the cumulative effect of every transaction that's ever been carried out by the company. That means, for example, that the sales nominal account will show all the sales ever made by the company. But don't I want to see the sales for the most recent month or the financial year up to date?

You do, of course. But this is easily done. If your year end is, say, 31 March and you are doing your accounts for, say, August, the accounting system simply has to take the balance of the sales nominal account at the end of August and

subtract the balance in that nominal account as it was at the end of July. The difference *must* be the sum of the entries made in August, which is therefore your August sales. Likewise, the system can subtract the balances at the end of March from the end of August balances to get the financial year to date.

Audit trail

An **audit trail** is a listing kept by most accounting systems of everything you do on the system. Even if you reverse (i.e. cancel) a transaction, the audit trail will not actually delete the cancelled transaction. It will instead maintain the original transaction and add an additional transaction that exactly cancels out the original one. This means you can always track what has been done (and by whom, if you have different users with different logins to the system).

VAT (Value Added Tax)

Sadly, we can't talk about accounting without understanding a bit about VAT.

Before you go into VAT, can you tell me what 'value added' means?

Yes. A company buys in raw materials, equipment, services; these are the company's **inputs**. The company's employees then do things to or with these inputs in order to make products or provide services. The products and/or services are then sold; these are the company's **outputs**. **Value added** is the difference between the outputs and the inputs; in other words, it's the amount of value that the employees add to the inputs.

So what is VAT?

VAT is exactly what it says: a tax on the value added in products and services. The rules can be very complex but, in general terms, it works as follows.

Most products and services are subject to VAT, although some are classified as **exempt** or **zero-rated**, in which case VAT is not charged. Companies fall into one of two groups as far as VAT is concerned: those that are **VAT registered** and those that aren't. You register for VAT if your annual sales are more than a certain figure (the figure changes every year, but it is of the order of £80,000). If you are registered, you have to add VAT to the amount you charge for your products or services (your outputs) and then pass that VAT on to Her Majesty's Revenue and Customs ('HMRC'). Thus a company that is registered

for VAT does not actually *pay* any VAT, it merely collects it for HMRC. You can, however, if you are registered, reclaim from HMRC the VAT you pay on most of your purchases (your inputs). The net amount that HMRC gets in from you is therefore the VAT on the difference between your inputs and your outputs, which is therefore VAT on the value added. Hence the name.

So who does pay the tax?

You, me and the other 60 million people in the country. We are charged VAT by the shops when we buy things. Since we are not VAT registered, we cannot reclaim the VAT.

So how does this work with your double-entry system?

Very neatly, as it happens. Let's look at a simple example. The rate of VAT is changed every once in a while (and can be different rates on different categories of products or services), but we will assume it is 20 per cent. Let's say you sell some consulting work that you want £1,000 for. You would have to add 20 per cent VAT to that, making a total charge to the customer of £1,200. The accounting entries would be as follows:

	Which bar?	**Debit**	**Credit**
Increase **Debtors**	Assets bar	1,200	
Increase **VAT liability**	Claims bar		200
Increase **Retained profit**	Claims bar		1,000

As you can see, the VAT does not affect retained profit at all. The customer owes you the VAT, but you immediately increase the liability to HMRC on your balance sheet by the amount of the VAT.

When you make purchases, you will be charged VAT. The VAT element of each purchase *reduces* your liability to HMRC and does not affect retained profit.

Every three months (or every month if you are a big company), the balance in the 'VAT liability' box is paid to HMRC. If, as happens in a number of circumstances, the VAT on your purchases is greater than the VAT on your sales, then HMRC will pay you instead.

The last point to note is that, while the sales figure that appears on a company's P&L (the £1,000) doesn't include the VAT, the debtors figure on the balance sheet (the £1,200) does. We have to remember this when we come to analyse the accounts later.

Setting up your software

When you first start using your accounting system, there are *lots* of set-up tasks you *could* do and the system may encourage you to do. There are only two you *really* need to do, at least in principle, before you can get going. The rest of them you can do as you go along or when you are more familiar with the system.

Financial year

You have to tell your accounting system the start and end dates of your financial year. This is so it knows how to calculate your year to date figures. Normally you would specify simply the start or end date of your financial year and the system would assume your year is 12 months long.

Opening balances

This is the only thing that really requires any explanation. As we now know, the balance sheet is the definitive statement of a company's situation at any point in time. It has to reflect *every* transaction the company has *ever* made up to that point in time. If your company has been trading for a while before you start using an accounting system (or if you are swapping from one system to another) and you are not planning to enter every individual transaction since the company started, then somehow you have to allow for this fact.

We deal with this by entering 'opening balances'. What this means is taking the balance sheet of the company (perhaps from your accountant) at midnight on the day before the day from which you want to start entering transactions and entering the relevant balance for every nominal account that makes up that balance sheet. When you start entering your transactions, they will 'add' to the historic balances, so your TB and hence your balance sheet in the accounting system will reflect the balances from every transaction the company has ever made. So:

- Let's suppose your year end is 31 March.
- However, you want to start entering transactions with effect from 1 July.