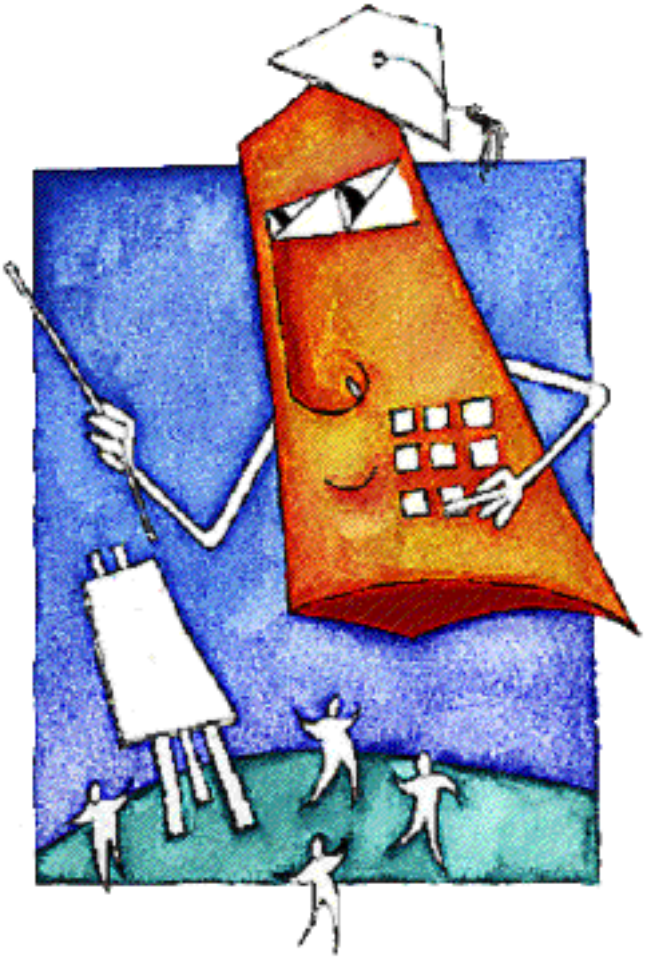
Setting the Scene

1



Introduction

LEARNING A NEW SOFTWARE APPLICATION IS LIKE VISITING A FARAWAY DESTINATION FOR THE FIRST TIME — YOU MAY KNOW WHERE YOU WANT TO GO BUT YOU DO NOT KNOW WHAT TO EXPECT UNTIL YOU ARRIVE.

INTREPID EXPLORERS WILL RELISH THE PROSPECT OF SETTING OFF INTO THE UNKNOWN. THEY THROW A FEW THINGS IN A BAG AND TAKE OFF, RELYING ON THE ODD SIGNPOST AND THEIR OWN SENSE OF DIRECTION TO GET TO WHERE THEY WANT TO BE. THE OCCASIONAL WRONG TURN MERELY ADDS TO THE SENSE OF ADVENTURE…

Others prefer a more cautious approach before venturing into unexplored territory, making a careful study of the route and preparing a full and detailed itinerary. If you like to plan ahead then this chapter is designed with you in mind.

It provides a brief introduction to the world of accounts and how Bottom Line can help you get there.

If you are well versed in the rituals associated with keeping a set of accounts then you will probably want to skip the first section and move on to the next chapter — the uninitiated may prefer to start with some background reading…

First Principles

All businesses, no matter how large or small, rely on one thing — trade. This involves the constant buying or selling of goods or services for cash…

… or, more usually, credit.

As your business grows and the number of transactions soars, it becomes increasingly laborious to keep track of what you owe or are owed.

Even more important, at any given time, you need to be able to stand back and evaluate where all these activities are leading you — on the road to success or simply up the garden path.

This is where the art of accounting comes in…

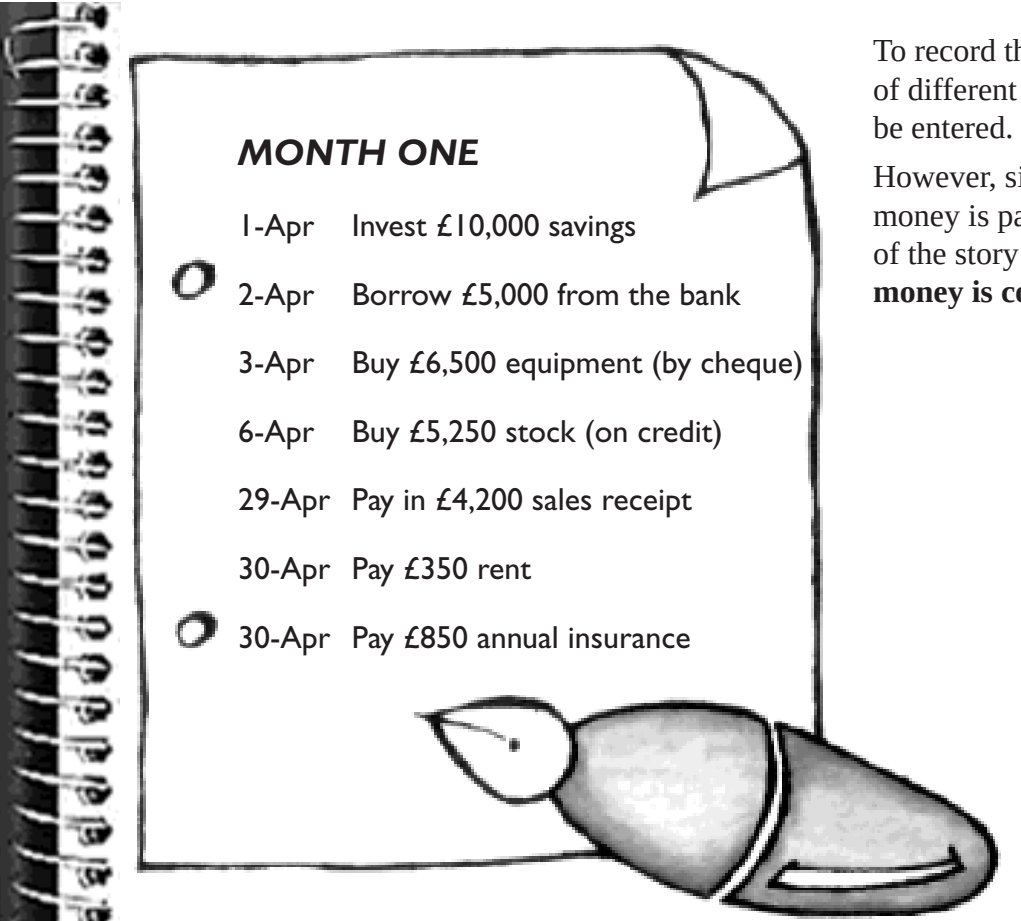
Where do I begin?

The first step towards creating financial order from chaos is to keep a set of **accounting records**. In manual systems, each accounting record is a page of a book onto which the value and date of each transaction is written.

The role of accounting records is best illustrated by an example…

Let's imagine that you are a highly skilled stonemason specialising in architectural restoration work. You have now decided to carve out your own business — Rock Solid — selling both your skills and specialist construction materials.

Imagine also that the trading operations for your first month of business look something like this…



To record these activities, you need to create a number of different accounts into which the relevant details can be entered.

However, simply recording **when** and **how much** money is paid into and out of each account is only part of the story — you also need to consider **where that money is coming from** and **where it is going**…

The Balancing Act

1. Let's look more closely at the first transaction involved in setting up your company — your initial investment of £10,000. In the world of accounting, there are two aspects to this single transaction — you provide £10,000 capital to the business and in return, the business acquires £10,000 to spend.

To reflect this, the first transaction is recorded by two separate accounting records showing £10,000 **debited to** the Cash account and the equivalent amount **credited from** the Capital account — as shown here…

To...

Cash Account	Debit	Credit
1-Apr Share Capital	*10,000.00*	
Current Balance	*10,000.00*	

From...

Capital	Debit	Credit
1-Apr Share Capital		*10,000.00*
Current Balance		*10,000.00*

The accounting terms **Debit** and **Credit** simply specify the direction in which the money has moved from one account to another. Until you get more familiar with these terms, you may find it helpful to think of **Debit** as money going **to** the account — and **Credit** as money coming **from** the account.

The actual process of recording both sides of a transaction is known as **Double Entry** accounting. It is this process which ensures that the total credits and debits always balance and, therefore, that all money coming into and out of the business is accounted for.

2. The second transaction is another injection of cash (£5,000) in the form of a long term bank loan. Once again, the amount would be debited to the Cash account but, this time, the equivalent amount would be credited from a different account — Loans — to identify that it is owed to someone who is not an investor and therefore expects to be repaid…

To…

Cash Account	Debit	Credit
1-Apr Share Capital	*10,000.00*	
2-Apr Bank Loan	*5,000.00*	
Current Balance	*15,000.00*	

From…

Loans	Debit	Credit
2-Apr Bank Loan		*5,000.00*
Current Balance		*5,000.00*

3. With a total of £15,000 in the cash account, you can now invest in the business by purchasing the equipment and machinery you need — stone cutters, masonry drills, hoists and so on. This time, the cash is taken out of the business so £6,500 is credited from the Cash account. However the value of the equipment remains in the business and is debited to Equip/Plant…

To…

Equip / Plant	Debit	Credit
3-Apr Machinery	*6,500.00*	
Current Balance	*6,500.00*	

From…

Cash Account	Debit	Credit
1-Apr Share Capital	*10,000.00*	
2-Apr Bank Loan	*5,000.00*	
3-Apr Machinery		*6,500.00*
Current Balance	*8,500.00*	

Pay now... ... or later

In the previous transaction, you paid for the machinery on delivery by cheque which, for accounting purposes, is deemed to be the same as paying by cash. Cash payments which leave your bank account immediately are different from those payments which are deferred — as when you buy goods on credit.

At this point, you have just won your first restoration contract requiring marble and stone to undertake the work. This means buying stock and your suppliers are willing to offer you 30 days credit before expecting you to pay. Now! Even though money has not yet changed hands there are still two sides to this transaction — you acquire the materials you need in exchange for the promise to pay your suppliers in 30 days time.

To...

Stock	Debit	Credit
6-Apr Buy Stock	*5,250.00*	
Current Balance	*5,250.00*	

From...

Trade Creditors	Debit	Credit
6-Apr Buy Stock		*5,250.00*
Current Balance		*5,250.00*

Creditors & Debtors

Trade Creditors are the suppliers to whom you owe money…

…and **Trade Debtors** are the customers who owe money to you.

When keeping a set of accounts, it usual to keep an individual account for each customer in a separate book called a **Sales Ledger** and an individual account for each supplier in the **Purchase Ledger** as described later in this chapter.

One final point, when you come to pay your creditors in 30 days time, you will need to credit £5,250 from the Cash account. The corresponding debit to the Trade Creditors account reduces the balance to zero thereby clearing the debt owed to your supplier.

Three weeks later and your client is ready to pay your first invoice of £4,200 to cover the materials you have supplied so far. However, as fast as money goes into your account, some has to leave so that two immediate bills can be settled. These remaining transactions can be summarised as follows…

			to…	from…
29-Apr	Pay in sales receipt	£4,200	Cash account	Sales
30-Apr	Pay rent	£ 350	Rent	Cash account
30-Apr	Pay annual insurance	£ 850	Insurance	Cash account

From balanced accounts to the Balance Sheet

What effect have all these activities had on the business as a whole and, more significantly, has it been worthwhile?

To answer that question, we now consider how these transactions can be translated into a more meaningful form which can be readily evaluated by you and by anyone else who may have more than a fleeting interest in your business.

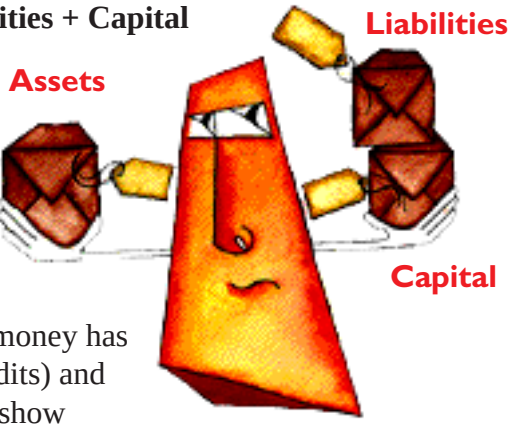
This is where the **Balance Sheet** enters the picture…

The Balance Sheet is a statement detailing the financial worth of your business on a particular date. It does this by summarising the effect of each transaction on three elements — **Assets, Liabilities** and **Capital** — where…

- **Assets** represent what the company owns (such as buildings, equipment, cash) or what the company is owed (usually by its customers).
- **Liabilities** represent what the company owes to its creditors.
- **Capital** refers to the internal debt to its owner and other investors.

The Balance Sheet is arranged so that the company's assets always equal the external and internal claims to those assets like this…

Assets = Liabilities + Capital



A way of looking at this is that **Liabilities** and **Capital** accounts show where the company's money has come from (credits) and **Asset** accounts show where it has gone (debits).

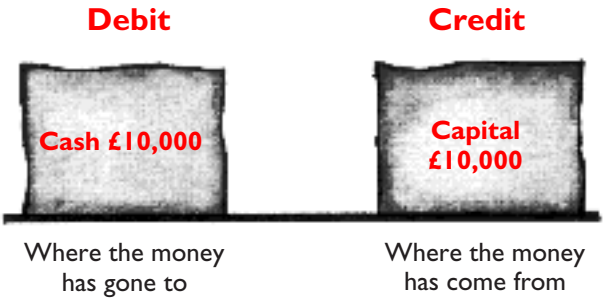
The two sides of the equation are established by assigning Asset records as Debit type accounts — while Liabilities and Capital accounts become Credit type accounts. In a balanced set of books, the total debits must equal the total credits.

With the above equation firmly etched on your mind, let's go back to that list of transactions and look at their effect on the three Balance Sheet elements…

1. Invest £10,000 savings

Your first transaction is investment of £10,000 of savings. This results in the business acquiring £10,000 of Assets (into the Cash account) and, in return, your stake in the business is acknowledged by issuing £10,000 of Share Capital (recorded in the Capital account).

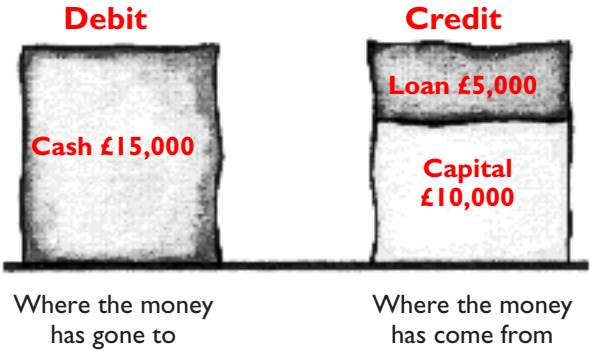
The effect of this transaction on the two sides of the Balance Sheet can be illustrated like this…



2. Borrow £5,000 from the bank

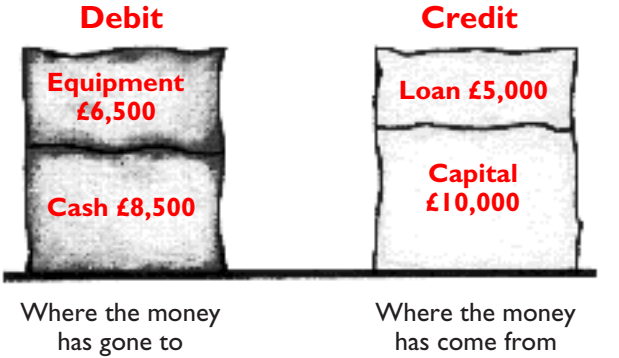
A second injection of cash, as a long term bank loan, increases the company's Assets by £5,000 but, in doing so, the company acquires a Liability to repay the debt…

…eventually.



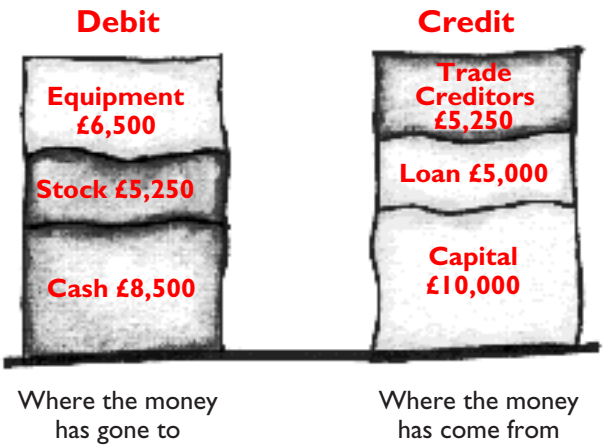
3. Buy £6,500 equipment (by cheque)

By contrast, this transaction does not change the overall worth of the company, it simply shows one asset (£6,500 in cash) being exchanged for another asset (£6,500 worth of equipment).



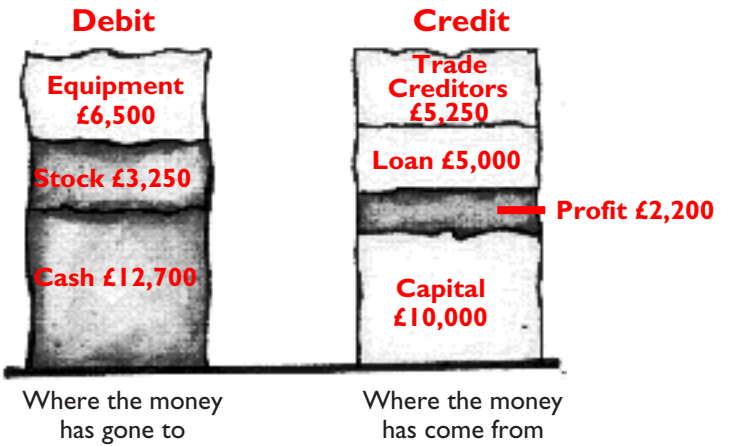
4. Buy £5,250 stock (on credit)

By now, you will be getting the idea, in this transaction you acquire stock (more assets) on 30 days credit. This raises the value of the company by £5,250 but you have to repay the debt and another liability rears its head.



5. Pay in £4,200 sales receipts

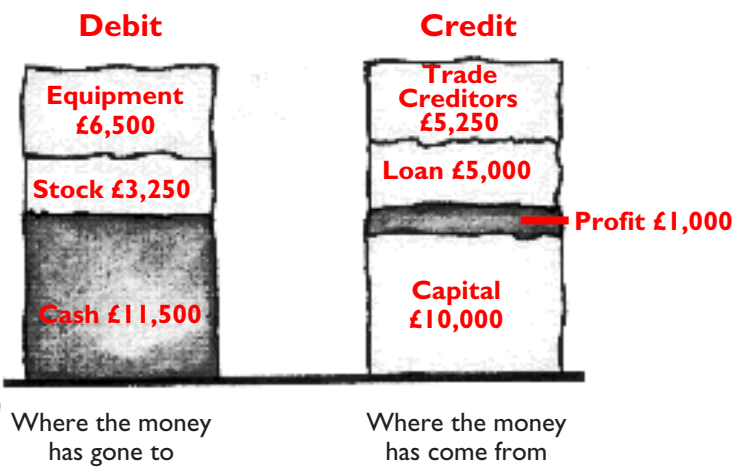
Now for the fun bit! Your customer pays you £4,200 to add to your cash assets — in return for supplying, let's say, £2,000 worth of materials which now reduces your stock…



Notice that something quite interesting has just materialised — Profit. This has resulted from the sale of one asset (stock worth £2,000) for a much larger asset (£4,200 cash). Your capital interest in the business grows by £2,200. In other words, you are £2,200 richer, congratulations!

6. Pay £350 rent and £850 insurance

Unfortunately! Materials were not your only cost — you also have to pay one month's rent (£350) and the annual insurance premium (£850). These costs both reduce your cash assets by £1,200 and, you've guessed it, your profit by the same amount!



We have now arrived at a Balance Sheet which shows where the company stands at the end of the first month. This information is normally presented, not as blocks, but as a table of monetary values. The balance of debit against credit is taken for granted but there is another equation which must also hold true:

Assets - Liabilities = Capital

Our Balance Sheet may therefore look like the example over leaf…

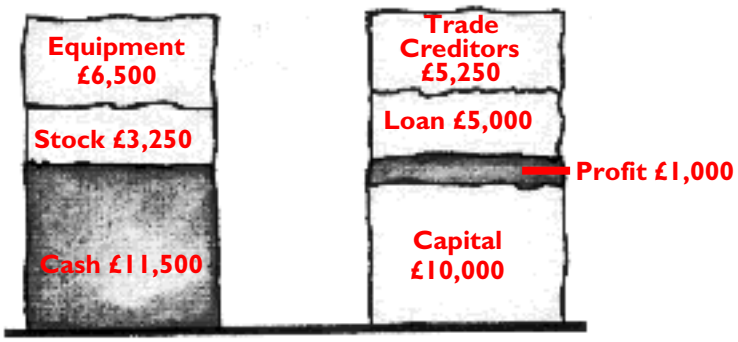
Notice that in the conventional Balance Sheet, the company's Assets are listed in increasing order of liquidity (or how easily they can be realised as cash) where…

Fixed Assets refers to those items — such as property, company vehicles, office furniture — which you intend to use rather than sell.

Current Assets refers to assets which are already in the form of cash or those assets (stock, work in progress) which are destined to be sold for cash, usually within 1 year.

Current Liabilities refers to short term debts which are due to be settled inside 1 year.

At this point, you might think it strange that Current Liabilities appear under the **Assets** banner, rather than Liabilities. There is a good reason for this since another role of the Balance Sheet is to establish how much of the Current Assets are available to fund future expansion… …once all the bills have been paid.



This is derived by deducting the total Current Liabilities from the total Current Assets to arrive at the **Net Current Assets**. Monitoring the changes in this figure provides an important indicator of the ongoing financial stability and security of your business.

One final point, the Balance Sheet provides a snapshot of how the money is distributed within the company at a particular moment. It changes with each transaction entered.

Rock Solid

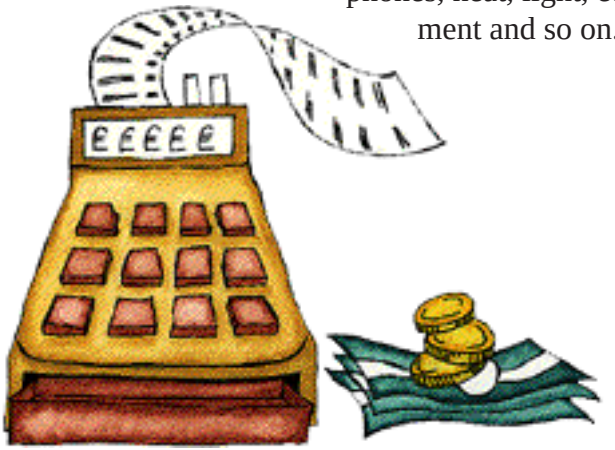
BALANCE SHEET Date: 30-April

ASSETS		
Fixed Assets		
Tangible Assets	6,500.00	
TOTAL FIXED ASSETS		6,500.00
Current Assets		
Stocks	3,250.00	
Cash	11,500.00	
TOTAL CURRENT ASSETS	14,750.00	
Current Liabilities		
Creditors due in 1 year	5,250.00	
NET CURRENT ASSETS		9,500.00
TOTAL ASSETS LESS CURRENT LIABILITIES		16,000.00
LIABILITIES		
Creditors due over 1 year	5,000.00	
TOTAL LONG TERM LIABILITIES		(5,000.00)
NET ASSETS		11,000.00
CAPITAL AND RESERVES		
Share Capital	10,000.00	
Profit or Loss	1,000.00	
TOTAL CAPITAL		11,000.00

Profit and Loss Account

We have seen that you can produce a Balance Sheet identifying that you made a £1,000 profit in the first month. In our little example it is easy to see how that profit was generated because we only have four transactions which directly affect profitability.

However, making a profit is what business is all about. The generation of profit allows further investment such as advertising which (hopefully) generates more business which means buying more materials and, eventually, employing people — and employees inevitably mean more costs and overheads in the form of wages, phones, heat, light, equipment and so on.



This escalation of business means that you will soon find it impossible to pinpoint exactly how the profit was generated…

…and understanding how you have made a profit (or loss) is vital!

Clearly, the Profit (or Loss) element of the Balance Sheet merits closer scrutiny and this is done by breaking down the Profit (or Loss) component into two further categories…

• **Revenue** which represents the income earned.

• **Expenditure** representing the costs incurred in running the business.

Revenue accounts have **credit balances** (representing where money has come from) and the Expenditure accounts have **debit balances** (showing where the money has gone).

Yet another equation:

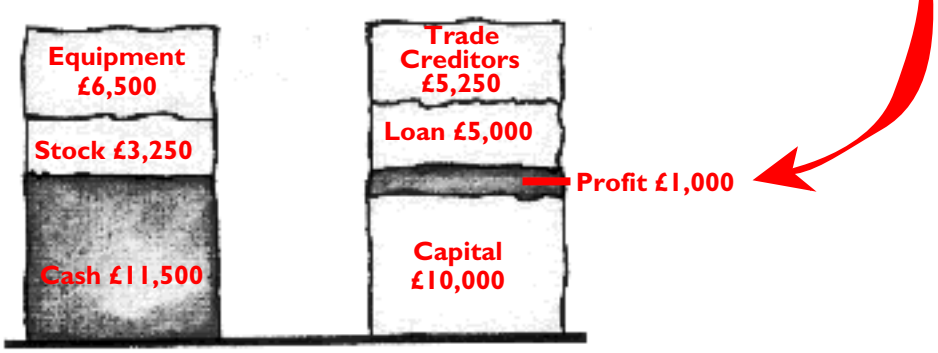
Revenue - Expenditure = Profit

allows us to arrive at the Profit (or Loss) figure which appears in the Balance Sheet. The details of Revenue and Expenditure form the Profit and Loss Account…

Rock Solid

PROFIT & LOSS ACCOUNT Date: 30-April

REVENUES	
Sales	4,200.00
Other Income	0.00
TOTAL INCOME	4,200.00
Cost of Sales	
Materials	2,000.00
Direct Expenses	0.00
Direct Labour Costs	0.00
TOTAL DIRECT COSTS	2,000.00
GROSS PROFITS	2,200.00
EXPENSES	
Productive Overheads	0.00
Administrative Overheads	850.00
Establishment Costs	350.00
TOTAL OVERHEADS	1,200.00
OPERATING PROFIT	1,000.00
RETAINED PROFIT FOR YEAR	1,000.00



More about the Profit & Loss Report on the previous page…

In this report, it is usual to show the **Total Revenues** (or turnover) immediately followed by the **Direct Costs** incurred in generating those revenues.

The difference between the total revenues and total direct costs produces the **Gross Profit** which has to cover all the other expenses (or overheads) which are associated with the company's operation as a whole. These expenses may include…

- **Productive overheads** (such as motor running costs, marketing)
- **Administrative overheads** (printing, postage, business insurance, telephones)
- **Establishment costs** (rent, rates, heating and more).

The figures in our example are rather sparse but, with a little imagination, you should get the picture.

Now! By deducting the Total Overheads from the Gross Profit we arrive at the **Operating Profit** which tells you whether you are winning or losing the battle.

Once any tax and dividend payments have been deducted from the Operating Profit, you are left with the **Retained Profit** and it is this figure which passes to the **Capital** component on the Balance Sheet.

Statutory accounts only require a Profit & Loss Account, together with the Balance Sheet it relates to, at the end of each financial year. However, for closer control and management of your business, it is usual to prepare these and other reports at more frequent intervals — usually 4 weekly or monthly. The interval between preparing one set of financial reports and the next is called an **accounting period**.

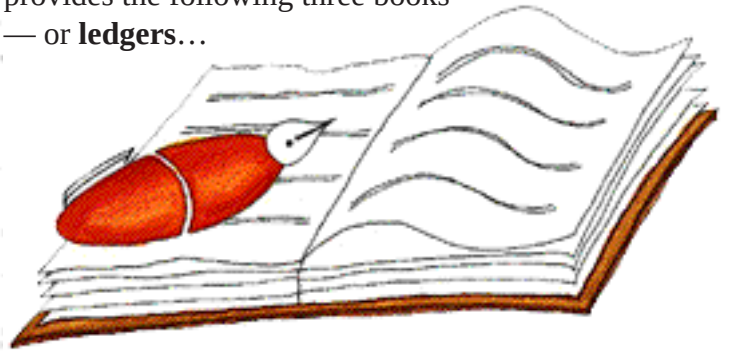
Introducing Bottom Line

Having concentrated on the theory of accounts, it is now time to turn our attention to the practice.

Bottom Line is a fully integrated accounting application which is designed to help you…

- Rapidly create a permanent and accurate record of all your financial transactions for internal and external scrutiny…
- Analyse their combined effect on the profitability and value of your business.

The starting point in Bottom Line is the set of individual accounting records which record all your business transactions. To help you organise these records in a structured and logical way, Bottom Line provides the following three books — or **ledgers**…



Sales Ledger

The Sales Ledger is designed to maintain and manage your customer accounts. It enables you to generate sales invoices and collect payments on time. It also provides a full breakdown of sales and, if appropriate, the VAT amounts due.

Purchase Ledger

Whatever income your business brings in on one hand, it usually manages to spend with the other. The Purchase Ledger enables you to maintain your database of suppliers, keep track of what you owe them and when they must be paid. It also includes the facility to analyse your expenditure and maintain VAT records.

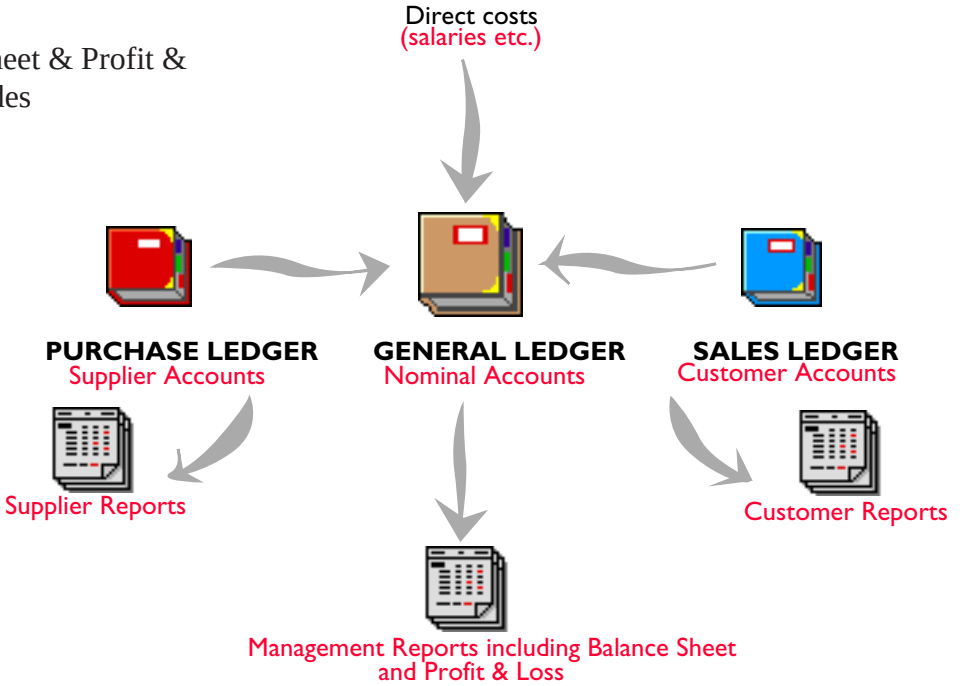
General Ledger

The General Ledger is the nerve centre of the Bottom Line accounting system. It houses all the accounts records — for each type of Asset, Liability, Capital, Revenue and Expenditure — and processes the transactions which ultimately reflect the value and profitability of your business.

In addition to maintaining the Balance Sheet & Profit & Loss accounts, the General Ledger provides Reconciliation and Reporting facilities. Financial transactions can also be entered directly into the General Ledger accounts.

To complete the picture, the Sales and Purchase Ledgers are able to pass details of all their transactions to the General Ledger to create a fully integrated system…

…the General Ledger produces the information you need to manage and control your business finances while the other two ledgers maintain your customer and supplier accounts.



The Bottom Line Approach

The following chapters describe the operation of Bottom Line in detail — in a nutshell, this involves…

1. Designing and setting up your set of accounts

First you set up a data file to store the business accounts. Following that you move on to designing and assembling the structure of your General Ledger accounts. Basic templates (or stationery files) are available to start you off on this path.

2. Setting up the Sales & Purchase Ledgers

Create your databases of customers and suppliers.

The Sales and Purchase Ledgers also require certain standard information about the General Ledger coding system as well as simple codes to analyse Sales and Purchases and to link transactions to the General Ledger.

3. Transferring opening balances

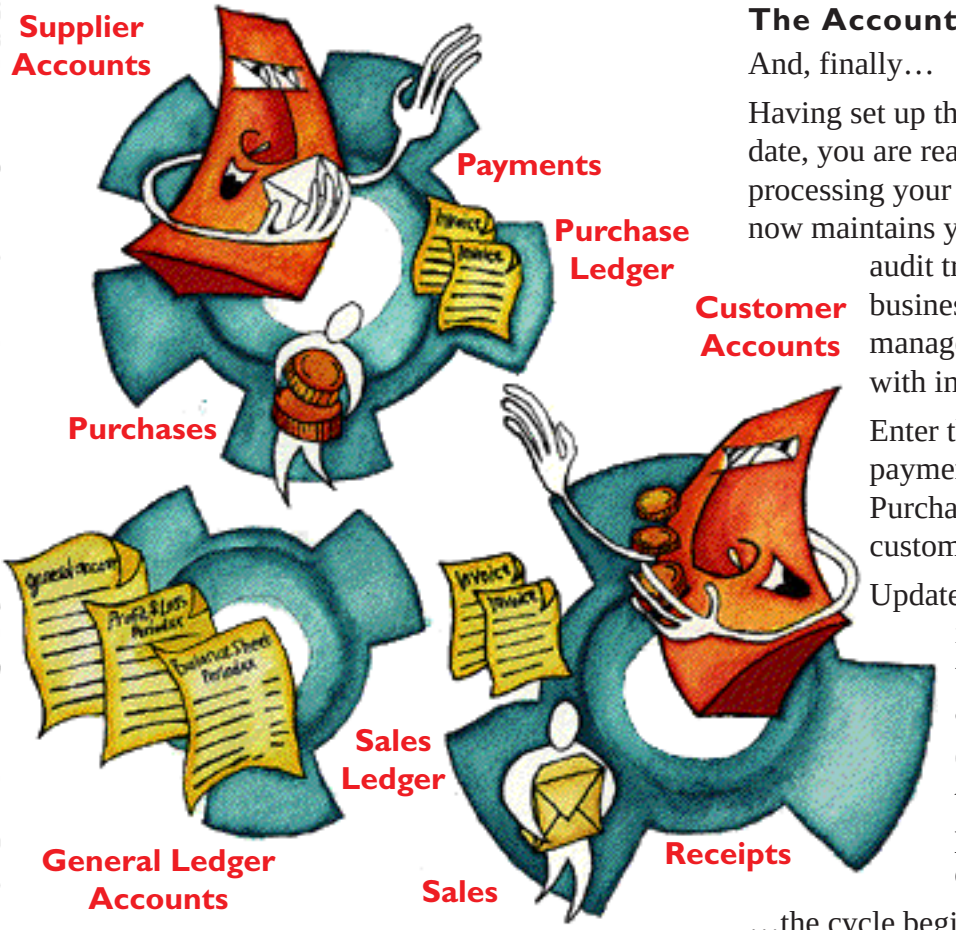
Enter all open items for the relevant customer and supplier accounts, (uncleared invoices, credit notes, payments and refunds). After posting all open items from the Sales and Purchase Ledgers, update the opening balances for each General Ledger account.

You may also wish to create the opening balances for Bank and other reconciliations. If you are VAT registered you will also set up the opening values for your VAT Input and Output figures

4. Finalising the figures

Having transferred the opening balances to the General Ledger, you may want to enter the historical account balances for previous periods.

Go through the flow chart which forms Appendix 1, Opening Moves. This will provide you with a blow by blow guide to setting up your accounts for the first time.



The Accounting Cycle

And, finally…

Having set up the three ledgers and brought them up-to-date, you are ready to begin the periodic cycle of processing your business transactions. Bottom Line now maintains your accounts, providing the necessary audit trails and reports required to run your business and to keep your auditors, bank manager and statutory authorities supplied with information.

Enter the transactions — invoices, credit notes, payments and refunds — into the Sales and Purchase Ledgers to constantly update your customer and supplier accounts.

Update the General Ledger accounts by posting the sales and purchase transactions then use the Journal facility to enter any additional business.

Once you have finished entering the transactions for the current period and printed all the reports that you require, close the current period and…

…the cycle begins all over again.

next chapter