Financial Literacy

for Co-operatives

This guide is aimed at anyone who is involved in co-ops – from workers' co-ops, housing co-ops to social centres. The aim is to demystify the world of finance to enable all co-op members to fully participate in financial decision-making. We think it's important that more than just one or two people in the co-op understand what's going on with the finances if we want to be truly democratic in our decision-making and develop successful alternative business models. Unfortunately bookkeeping is full of bewildering terms and concepts, which makes it harder for everyone to have a go.

We'll cover the key concepts, terms and financial reports that a co-op needs to produce, along with explanations of taxes that your co-op may be liable to, such as VAT and corporation tax. At the end you will find a list of resources and co-op friendly bookkeepers and accountants. *This guide is aimed at co-ops in the United Kingdom (but refers mainly to British laws and regulations covering accounting and tax).*

In this briefing:

The importance of bookkeeping

Bookkeeping in the context of a business is simply the recording of financial transactions. Transactions include purchases, sales, payments received and payments made. Bookkeeping enables you to extract financial information about your co-op, including whether your co-op is in good financial health, who owes you money, who you owe money to and whether you are meeting your targets. It also means that if there is any fraud or theft by your fellow co-op members you are able to spot it and track it down.

Good bookkeeping will also help you in preparing your accounts. *Accounts* in this context is a term used to describe both a series of reports outlining the financial health of your business, and also the financial returns (reports that summarise your finances) that you are legally obliged to submit to the government. We will explain what these returns are in more detail later, but here is an overview:

- ★ **Annual Accounts** – for Companies House (companies), Financial Conduct Authority (Co-operative Societies/Industrial and Provident Societies in Britain), or the Registry of Companies, Credit Unions and Industrial and Provident Societies in Northern Ireland; also for your members at your Annual General Meeting, and to HMRC (Her Majesty's Revenue & Customs – the tax office)
- ★ **Corporation tax** – for HMRC (Her Majesty's Revenue and Customs – the tax office)
- ★ **VAT** owed – to HMRC
- ★ **PAYE** (income tax and National Insurance) to be paid for your employees – for HMRC and your employees

The more accurate and up to date your records are the easier it is to put together all your reports and returns at the end of the year. It's much easier (and you're less likely to make mistakes) if you don't wait until the end of the year to do your bookkeeping, but do it on a weekly or monthly basis, depending on the volume of financial transactions in your co-op.

There are a number of different methods of bookkeeping, and which one you choose is up to your personal preference. Nowadays most people use accounting software to do their books. GnuCash is a free/open source programme, downloadable from www.gnucash.org and used by many small co-ops. Quicken, Quick Books and Sage are proprietary bookkeeping programmes used by many businesses, but you have to pay for them. Instead of using software programmes you can also design your own spreadsheet. Alternatively you could go for using the old fashioned method of recording your financial transactions on paper. You can buy bookkeeping books in most stationary shops, or again make your own. Paper books for bookkeeping are called ledgers.

Accounts: where you keep your money

The word *account* has several different meanings in bookkeeping. As we have seen above it can refer to your annual reports. In this section we are going to talk about accounts as a place you keep your money. Later we will talk about accounts in a different bookkeeping sense, and we will explain that in more detail then.

The different places you can keep your money are:

Current or Chequeing Account: an account at a bank or building society where you deposit money for immediate use. Your money can be withdrawn through cheques, cash machines or debit cards. Offers little or no interest rates, and there are often charges to be paid.

Deposit or Saving Account: an account at a bank or building society where you deposit money, but can't withdraw it immediately through the use of cheques or cards. Offers higher interest rates.

Petty Cash (or *cash in hand*): a tin or safe where you keep your cash for immediate use.

Credit Card: an account with a lending organisation. Every transaction on a credit card is in effect a loan with very high interest rates. There is usually a limit on how much you can take out on loan.

For each of these accounts you need to keep a separate record detailing every transaction that happens in that account.

Reconciling Accounts

This term refers to the process of cross-checking and proving that your record for each of these accounts is correct. You need to do this for all your accounts.

Here is how:

Reconciling your bank accounts

Bank reconciliation is the process of checking that your records match your bank's records. To enable you to do this, you should record transactions as they are made on some form of ledger (record sheet) and then enter them into your bookkeeping system on a regular basis, say weekly.

Your bank will send you regular statements, often monthly. You need to check that what your books say matches what the bank statement says. This allows you to spot and correct any errors that you or the bank have made.

Examples of why your records and the bank's records may not match include:

- ★ cheques not cashed;
- ★ bounced cheques;
- ★ bank interest received;
- ★ bank charges made to your account by the bank;
- ★ money received by the co-op during statement period but not received by the bank until after the statement period.

Reconciling your petty cash

Most errors in a small co-op are introduced in your petty cash record system. You should pay extra attention to your petty cash reconciliation. To do this enter all the receipts and paying-in-slips into your books on a daily to weekly basis. Count the cash in the petty cash box regularly and check the amount counted matches the amount your records say you should have. How often you do this depends on your business. In a shop you count the cash at the end of every day. Examples of why the petty cash book and the actual money may not match include:

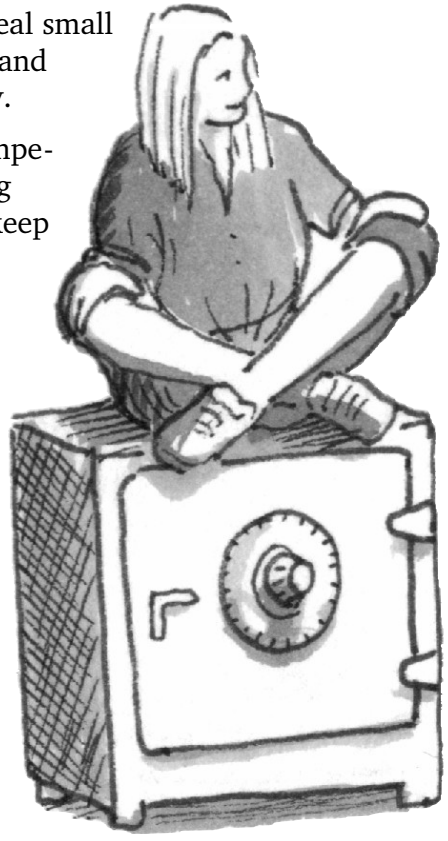
- ★ your co-op members can't add up;
- ★ receipts for expenses have not been kept;
- ★ people pay in money or take out money but don't write it down;
- ★ people take out a note (e.g. £10) to buy something and then forget to put back any change.

If the error is more than one week in the past it's unlikely that people will remember what they did. If you cannot find the error, then you can do something called a *balance adjustment.* This is simply adding a record that there was an error. You enter a transaction, name it *balance adjustment* and add the amount that the account was out by. So if your books say that you should have £134 in your petty cash, but you actually only have £131, then you enter 'Balance adjustment: £3' in the *Cash Out* column. Now your books should show that you only have £131.

(Note: Balance adjustments can also be done for bank accounts, however it should be easier to find and correct errors as the banks will provide you with statements.)

The petty cash box is also the place where it is easiest to steal small amounts of money (as well as the cash register in a shop), and checking it regularly means you will spot any thefts quickly.

The simplest way to avoid errors is to make one or two competent people responsible for the petty cash rather than giving everyone in the co-op access to it. The people responsible keep the records and give other people the cash when presented with receipts. In this case the petty cash reconciliation usually happens when sums of petty cash are paid out.



Budgets and Cash Flow

The importance of cash to a business

Cash in this context doesn't mean the pennies in your pocket, but means ready money that you can use to pay your obligations. Cash pays the bills and allows trading to continue. If you don't have enough cash to pay your suppliers, pay rent, make loan repayments to the bank, etc. then your co-op will be in difficulties very quickly. It's vital that you work out in advance whether you will have enough cash to cover your expenses at any given point in the year.

Even if at the end of the year you make a surplus, there may be weeks or months where you don't actually have the cash to pay the bills. Reasons for this might be:

- ★ a large outlay for stock or raw materials;
- ★ a repair bill;
- ★ a seasonal low in income;
- ★ you are a start up co-op (in which case it can be several months from the start of trading before you make a surplus);
- ★ you have too much unsold stock;
- ★ you are selling your products on credit, e.g. your customers pay for your products 30 days after the actual sale;
- ★ customers not paying on time;
- ★ your business is growing and extending credit to more customers.

Poor cash flow management is one of the most common reasons for business failure. If you run out of cash, then you may find yourself unable to carry on trading, you won't be able to pay yourselves, and your creditors may demand their money without you being able to pay them. It is entirely possible for a thriving business to become *insolvent* – which means an inability to pay your debt, even though the business would have made a surplus by the end of the year. Good cash flow management lets you plan for times when you may need extra cash and avoid slipping into insolvency. It will also help you to plan purchases (e.g. machinery and tools) and to make the best use of your resources.

Making a cash flow forecast

To work out whether you will have enough cash in the future you make a cash flow forecast. This means working out the balance of all the money flowing into and out of your co-op at specific points in the future – either every week or every month. Whether you do it weekly or monthly depends on your type of business and how often you have bills and invoices that are due to be paid. For a shop you would do a weekly forecast as there is a constant stream of takings coming in and payments for goods going out.

The forecast looks at when money actually comes in and goes out (i.e. when cash changes hands), as opposed to what is owed to you or what you owe to someone.

The time period covered by the cash flow forecast is usually a year. For start-ups or if you are taking out a loan or make a major investment you will want to forecast the cash flow for several years ahead, as cash flow problems often only surface later on.

The first step to getting to grips with your cash flow is to estimate all your cash flows in and all your cash flows out per week or month as accurately as possible.

A lot of this will be guess work, but try to make the figures as close to reality as you can. Get quotes and look at the income and expenditure of co-ops similar to yours. Use last year's bookkeeping records as a basis.

Cash flows in: shares, loans, sales, grants, donations etc.

Cash flows out: materials, staffing costs, overheads, capital purchases, bank/finance charges, taxation, building repairs, repayments of loans etc.

If you are starting a new business rather than taking over an existing one, factor in that your sales will start low in the first month and then slowly increase over a couple of years to their estimated sustainable level. This also means some of your expenditure (such as raw materials) may start low and then increase.

How selling or buying on credit affects your cash flow

If you sell on credit, i.e. provide a service or give someone something before they pay you, your cash inflow will be delayed. This makes it very important that you have effective 'credit control' – in other words that you chase up anyone who owes you.

On the other hand a co-op that buys on credit and is paid in cash, such as a retailer, has an advantage in cash flow terms. For example, a wholesaler might require payment a month after you place an order, while your customers pay up front when they take things away.

Scenario planning

Once you've set up your cash flow forecast, use it to run through different scenarios. Ask *'What if...'* and see how it affects your cash flow. Examples:

- ★ What if your business really takes off and you do not have enough resources (e.g. staff, materials, vehicles) to cope with demand?
- ★ What if there is a slump in sales?
- ★ What if a major customer doesn't pay up?
- ★ What if essential equipment breaks and you need to replace it?
- ★ What if one or more co-op members fall ill and can't work for one/two/three months?

Work out what your "plan B" is to cover such eventualities. Build in some contingencies for unforeseen costs or emergencies. Show this either as a separate item or build it into the overall figures. You should aim to have sufficient cash to last several months without income from your business.

Plugging gaps in your cash flow

If your balance in the cash flow forecast is a negative figure, this means you don't have the cash to pay for all the expenses due that week/month. Don't panic! This occasionally happens to the healthiest co-ops. It is important to understand why you dip into the red and work out what you can do about it. (It's called *'going into the red'* because bookkeepers like to use that colour to mark a negative balance.) To address this you could:

- ★ save costs – become more efficient;
- ★ take out a loan or issue loanstock (see pg. 17);
- ★ pay for things on a credit card;
- ★ use an agreed overdraft;
- ★ pay wages later;
- ★ invoice your customers in advance for the materials and invoice for the labour after the work has been done – very common in the building trade;
- ★ speak to your suppliers about paying late during that period;
- ★ manage stock levels (looking at whether you have the right amount of stock at any given time – not too much, not too little) – having lots of money tied up in stock can be problematic in terms of cash flow;
- ★ use some of your cash reserves that you have prudently put aside for those difficult time.

Sample Cash Flow Forecast

Cashflow forecast Bakery

	Jan	Feb	Mar	Apr
Seasonal Variation (100% of total anticipated sales split across the months)	10%	12%	8%	8%
Cash In				
Market Sales	£1,023.88	£1,228.66	£819.10	£819.10
Wholesale Sales	£2,080.00	£2,496.00	£1,664.00	£1,664.00
Subscriptions ('Bread Box' scheme)	£6,500.00	£6,500.00	£6,500.00	£6,500.00
Monthly Total Cash In	**£9,603.88**	**£10,224.66**	**£8,983.10**	**£8,983.10**
Seasonal Variation	10%	12%	8%	8%
Cash Out				
Cost of sales (directly related to sale, e.g. ingredients)				
Market Sales	£129.53	£155.44	£103.63	£103.63
Wholesale Sales	£228.80	£274.56	£183.04	£183.04
Subscriptions	£572.00	£572.00	£572.00	£572.00
Total monthly cost of sales	**£930.33**	**£1,002.00**	**£858.67**	**£858.67**
Overheads (ongoing costs, no seasonal variation)				
Wages	£5,266.67	£5,266.67	£5,266.67	£5,266.67
Market Wages	£346.67	£346.67	£346.67	£346.67
Rent	£678.00	£678.00	£678.00	£678.00
Power	£260.00	£260.00	£260.00	£260.00
Internet and phone	£17.33	£17.33	£17.33	£17.33
Insurance	£83.33	£83.33	£83.33	£83.33
Laundry	£43.33	£43.33	£43.33	£43.33
Office	£43.33	£43.33	£43.33	£43.33
Market Expenses	£151.67	£151.67	£151.67	£151.67
Accountancy	£66.67	£66.67	£66.67	£66.67
Vehicle Costs (Insurance, Tax, mot)	£105.83	£105.83	£105.83	£105.83
Vehicle Costs (Fuel)	£216.67	£216.67	£216.67	£216.67
Business Rates	£0.00	£0.00	£0.00	£0.00
Marketing	£43.33	£43.33	£43.33	£43.33
Training	£83.33	£83.33	£83.33	£83.33
Oven replacement				£3,300.00
Loan Repayment	£527.42	£527.42	£527.42	£527.42
Total monthly overheads	**£7,933.59**	**£7,933.59**	**£7,933.59**	**£11,233.59**
Net Movement Of Cash	**£739.96**	**£1,289.07**	**£190.85**	**-£3,109.15**
Opening Balance	**£347.40**	**£1,087.36**	**£2,376.43**	**£2,567.29**
Closing Balance	**£1,087.36**	**£2,376.43**	**£2,567.29**	**-£541.86**
Cash available Including pre arranged bank overdraft of 1k	**£2,087.36**	**£3,376.43**	**£3,567.29**	**£458.14**

This is a cash flow forecast for a small artisan bakery looking at the coming year. Things to note are:

The cash flow forecast factors in that bread is a product with seasonal sales variations. The bakery sells more bread in winter than in summer.

The income for the bakery is split into three sections, wholesale, subscriptions and market sales. This makes it easier to see which of these are the more profitable income streams and also split up costs accordingly.

The bakery is eligible for Small Business Rates relief from their council, meaning they currently don’t have to pay business rates.

The opening balance is carried over from the previous financial year.

The bakery is only just staying afloat. Steps should be taken to increase sales or to increase the money made on each sale.

The bakery has a pre arranged overdraft it can access in those months when there is not enough cash coming in to pay the bills, for example when a bigger expenditure happens, such as having to replace an oven.

May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	**Y1 Total**
8%	8%	6%	6%	8%	8%	8%	10%	**100%**
£819.10	£819.10	£614.33	£614.33	£819.10	£819.10	£819.10	£1,023.88	£10,238.80
£1,664.00	£1,664.00	£1,248.00	£1,248.00	£1,664.00	£1,664.00	£1,664.00	£2,080.00	£20,800.00
£6,500.00	£6,500.00	£6,500.00	£6,500.00	£6,500.00	£6,500.00	£6,500.00	£6,500.00	£78,000.00
£8,983.10	**£8,983.10**	**£8,362.33**	**£8,362.33**	**£8,983.10**	**£8,983.10**	**£8,983.10**	**£9,603.88**	**£109,038.80**

8%	8%	6%	6%	8%	8%	8%	10%	**100%**
£103.63	£103.63	£77.72	£77.72	£103.63	£103.63	£103.63	£129.53	£1,295.32
£183.04	£183.04	£137.28	£137.28	£183.04	£183.04	£183.04	£228.80	£2,288.00
£572.00	£572.00	£572.00	£572.00	£572.00	£572.00	£572.00	£572.00	£6,864.00
£858.67	**£858.67**	**£787.00**	**£787.00**	**£858.67**	**£858.67**	**£858.67**	**£930.33**	**£10,447.32**

								Y1 Total
£5,266.67	£5,266.67	£5,266.67	£5,266.67	£5,266.67	£5,266.67	£5,266.67	£5,266.67	£63,200.00
£346.67	£346.67	£346.67	£346.67	£346.67	£346.67	£346.67	£346.67	£4,160.00
£678.00	£678.00	£678.00	£678.00	£678.00	£678.00	£678.00	£678.00	£8,136.00
£260.00	£260.00	£260.00	£260.00	£260.00	£260.00	£260.00	£260.00	£3,120.00
£17.33	£17.33	£17.33	£17.33	£17.33	£17.33	£17.33	£17.33	£208.00
£83.33	£83.33	£83.33	£83.33	£83.33	£83.33	£83.33	£83.33	£1,000.00
£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£520.00
£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£520.00
£151.67	£151.67	£151.67	£151.67	£151.67	£151.67	£151.67	£151.67	£1,820.00
£66.67	£66.67	£66.67	£66.67	£66.67	£66.67	£66.67	£66.67	£800.00
£105.83	£105.83	£105.83	£105.83	£105.83	£105.83	£105.83	£105.83	£1,270.00
£216.67	£216.67	£216.67	£216.67	£216.67	£216.67	£216.67	£216.67	£2,600.00
£0.00	£0.00	£0.00	£0.00	£0.00	£0.00	£0.00	£0.00	£0.00
£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£43.33	£520.00
£83.33	£83.33	£83.33	£83.33	£83.33	£83.33	£83.33	£83.33	£1,000.00
£527.42	£527.42	£527.42	£527.42	£527.42	£527.42	£527.42	£527.42	£6,329.03
£7,933.59	**£7,933.59**	**£7,933.59**	**£7,933.59**	**£7,933.59**	**£7,933.59**	**£7,933.59**	**£7,933.59**	**£95,203.03**

£190.85	**£190.85**	**-£358.26**	**-£358.26**	**£190.85**	**£190.85**	**£190.85**	**£739.96**	**£88.45**
-£541.86	**-£351.01**	**-£160.16**	**-£518.42**	**-£876.67**	**-£685.82**	**-£494.97**	**-£304.12**	
-£351.01	**-£160.16**	**-£518.42**	**-£876.67**	**-£685.82**	**-£494.97**	**-£304.12**	**£435.85**	
£648.99	**£839.84**	**£481.58**	**£123.33**	**£314.18**	**£505.03**	**£695.88**	**£1,435.85**	

Where to get help

You can get free Income and Expenditure and Cash Flow Forecast spreadsheets from most high street banks and business advice organisations. Bookkeeping co-ops such as Acorn Co-op Support and Catalyst Collective can also help you create your own and will discuss business plans with you or advise you on changes.

For contact details see the *Resources* section at the end.

Understanding accounting terms and concepts

You will find that some basic accounting knowledge will prove to be invaluable as you work on the finances of your co-op. This section goes through the most important and commonly used terms and concepts. For further information we recommend you get a bookkeeping manual.

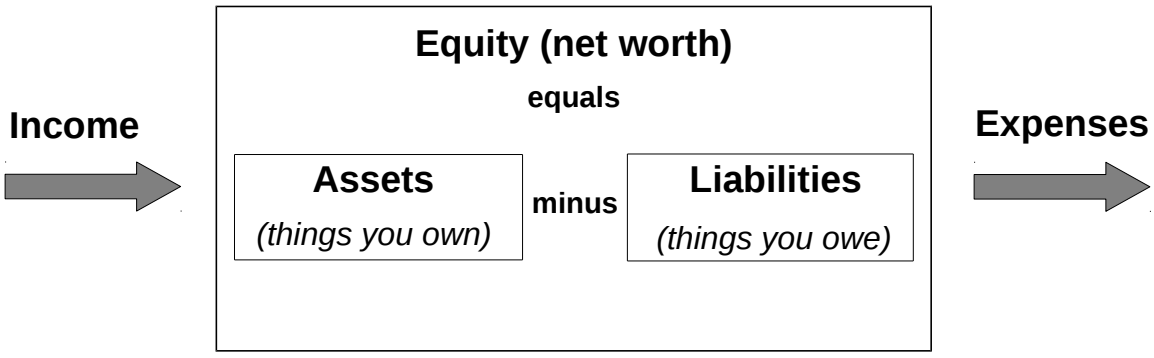
The five fundamental types of accounts in bookkeeping

When you hear the word account, you probably first of all think of bank accounts. However, as we've already seen, in the bookkeeping world the word account has a much wider meaning and is used in lots of different contexts. When bookkeepers say account, they mean simply a group of similar transactions bundled together.

In accounting all finance related things can be grouped into five fundamental types of accounts. That is, everything that accounting deals with can be placed into one of the following categories:

1. **Assets:** are things you own (e.g. the money in your bank account).
2. **Liabilities:** are things that you owe (e.g. a mortgage).
3. **Equity:** is what you are worth (overall net worth, it equals all your assets minus all your liabilities).
4. **Income:** all inflows into your co-op that increase your equity (what you are worth). These are things that weren't yours but become yours, e.g. the profit you make on your sales. This is different from cash you receive. Not all money you receive increases your worth – e.g. if you sell something for the same price as you bought it, this does not increase your worth and therefore does not count towards income.
5. **Expenses:** all outflows from your business that decrease your equity (what you are worth). Things that were yours but become someone else's, e.g. money for rent, wages. This is different from cash you spend because not all money you spend decreases your worth – e.g. if you buy a van, you spend money on it, but in return you now own something that is worth the money you bought it for. Your overall worth is the same, so this does not count as an expense.

How the five different accounts relate to each other



The term *Equity* refers to your net worth at a specific point in time. Your Equity is calculated by subtracting your *Liabilities* at that specific point in time from your *Assets* at that specific point in time:

Equity = Assets – Liabilities

Furthermore, you can increase your *Equity* through *Income*, and decrease *Equity* through *Expenses*. This makes sense of course: when you receive a payment you become "richer" and when you pay a bill you become "poorer".

This is expressed mathematically in what is known as the Accounting Equation:

Assets – Liabilities = Equity + (Income – Expenses)

Note that the left hand side of the equation *Assets – Liabilities* refers to how much you are worth at a specific point in time. The right hand side of the equation reflects a change in what you are worth over a period of time. This allows you to group together all of the income and expenses over that period and see how it has affected your equity over that time.

So for example if you want to look at how your equity has changed over the last year you can use the formula as follows:

Your Equity at this point in time = Equity at the same date last year + This Year's Income – This Year's Expenses

And because ***Equity = Assets – Liabilities***, you can arrive at this formula:

Your (Assets – Liabilities) at this point in time = Equity at the same date last year + This Year's Income – This Year's Expenses

So you can now check that you've got your bookkeeping right. The equation must always be balanced (so the amount must be the same on both sides). For every change in value of one account in the Accounting Equation, there must be a balancing change in another. This concept is known as the *Principle of Balance*.

This is important to remember when you do you bookkeeping, as for each transaction you need to make an entry on both sides of the equation. If you record income you must also record an equal increase in your assets. If you record an expense, you must also record a decrease to your assets.

You could also have an increase in assets if you have a parallel increase in liabilities, for example if you take out a loan it both increases your assets and your liabilities, and overall does not increase your worth.

If you use accounting software, the programme will automatically show you options to choose for this or just do it for you. We will deal with this again when we look at balance sheets.

Balance sheet transactions and transfers between accounts

There are some transactions that are neither an income nor an expenditure (they do not increase or decrease your net worth). These are called *balance sheet transactions* or transfers between accounts. So for example if you use some of your cash to buy a tractor, this is a balance sheet transaction. When you take cash out to buy your tractor you reduce the amount of cash assets you have. However you are not losing that money – you are just swapping it for a tractor, which is also an asset. Overall your co-op is worth the same amount as before. It is a balance sheet transaction.

Similarly if you move money from your current account to your saving accounts, this is neither an income nor an expenditure – you still have the same amount of money overall. Such transactions are called transfers between accounts.

Examples of balance sheet transactions, income and expenditure.

Balance sheet transactions	Income	Expenditure
Buying tools and machinery	Selling products – for the extra amount you get after covering your costs	Paying rent
Buying solar panels	Feed in tariff from solar panels	Paying for the labour to have solar panels installed
Buying stock	Grants	Paying wages
Collecting and paying VAT	Donations	Paying utilities
Buying a building	Interest from the bank	Paying for building repairs
Receiving a loan or mortgage	Selling services	Paying interest on loans and mortgages
Paying back a loan or mortgage (the 'capital' part, not the interest)	Interest from investments	Legal and professional fees
	Receiving rent	Depreciation

Chocolate buttons and the different types of transactions

In a world where the currency is chocolate buttons a group of three people form a wholefood co-op and set up a shop.

They receive a start-up donation of 10 chocolate buttons from a kindly aunt. This means they have an asset of 10 chocolate buttons. They don't have to pay back the chocolate buttons, as it was a donation. Their overall worth is 10 chocolate buttons.

They now use their 10 chocolate buttons to buy a packet of liquorice bears.

- *Is this an expenditure or a balance sheet transaction?*

To answer this question we must ask ourselves whether this transaction has decreased what the co-op is worth?

So let's work it out: At the beginning the co-op was worth 10 chocolate buttons. Now they are worth 1 packet of liquorice bears, which has the same value as 10 chocolate buttons. They have exchanged one form of asset (chocolate buttons) for another asset (liquorice bears). There is no change in what they are worth. This means that this transaction is not an expenditure but a balance sheet transaction.

They then go on to sell their packet of liquorice bears for 20 chocolate buttons.

- *Is this an income and if so how much is the income?*

So again to answer this question we must ask ourselves whether this transaction has increased what they are worth? They were worth a packet of liquorice bears (or 10 chocolate buttons), but are now worth 20 chocolate buttons.

This means their worth has increased by ten chocolate buttons, so they have had an income of 10 chocolate buttons.

- *So what kind of transactions are the following?*

They have to pay 1 chocolate button to the landlord for rent, 1 chocolate button to the the utility company for electricity, 1 chocolate button to the insurance company for product liability insurance and 1 button to each of the members as wages.

Well let's look again at what they are worth. They were worth 20 chocolate buttons and now have 14 chocolate buttons. They do not have any other assets. So they went from 20 chocolate buttons to 14 chocolate buttons, and had an expense of 6 chocolate buttons.

- *What is their equity (net worth) and how much profit have they made?*

Overall throughout the whole process they have gone from being worth 10 chocolate buttons to being worth 14 chocolate buttons, a net income or profit of 4 chocolate buttons.

This is what it would look like expressed as an equation. You can see both sides balance.

Assets	– Liabilities	= Your worth before the transactions	+ Income	– Expenses
14 buttons	– 0 buttons	= 10 buttons	+ 10 buttons	– 6 buttons

More on assets and liabilities

As we've already seen assets are simply things you own. You will often see them divided up into the following sub accounts:

- ★ **Liquid assets:** things you own that can be converted into cash in a short time (usually 30 days) with little or no reduction in value *(e.g. cash, money owed to you)*.
- ★ **Current assets:** things that can be converted into cash usually within the next accounting period with little or no reduction in value *(e.g. stock, short term investments, money owed to you)*.
- ★ **Fixed assets:** things that you don't want to or can't easily turn into cash *(e.g. premises, your printing press, your bike repair tools, your computer)*.

Liabilities are things you owe to other people. You will often see them divided up into the following sub-accounts:

- ★ **Current liabilities:** things you will need to pay, usually within the next accounting period. The time period covered must be the same as current assets *(e.g. unpaid bills, loan repayments due in the next year, tax and VAT due)*.
- ★ **Long term liabilities:** things you need to pay after the next accounting period *(e.g. loanstock due after the end of the year, the rest of your mortgage)*.

Using asset and liability accounts to forecast your cash flow

The reason why assets and liabilities are divided up into these sub-categories is to enable you to identify problems with short term cash flow. If your current liabilities are greater than your current assets and your liquid assets taken together, you know that you will potentially have a problem with cash flow this year. This does not mean that you necessarily will have a problem with cash flow as you can trade your way out, but it does mean that if there was no change in your current position you would not be able to meet all your obligations. It is an early warning signal and once identified you should develop a plan to make sure you can meet all your obligations. This will probably require you to do a full cash flow forecast, as explained in the previous section on cash flow forecasting.

Grant income as a liability

Grant income is a special case: in most cases the money is not actually yours until you have delivered the work that the grant is for and handed in your report. If the funder is not satisfied, you may have to pay back the grant. This makes it a liability. It is not technically yours yet, even though it is in your bank account. To deal with this you enter the grant income as an inflow into your bank account and you also record it in a *liability account.* The *liability account* is not another bank account, but a category in your accounting system. Once you have done the work and actually earned the grant, you then transfer it from your liability account to your income account (i.e. decrease the amount in the liability account and increase the income account by the same amount). This has the advantage that if you have not spent a grant before the end of a financial year*, it will not count towards your overall income, and therefore will also not count towards *corporation tax* (Page 25).

* The terms Accounting Period and Financial Year are often used interchangably. For the sake of clarity we've used the term Accounting Period for your co-op's financial year (that is, whatever period you draw up your accounts for), and the term Financial Year for the Fiscal year, i.e. April to March.

Accounts Receivable and Payable

Accounts Receivable and *Accounts Payable* are special types of assets and liabilities.

Accounts Receivable: an account where you record amounts of money you have invoiced someone for until they actually pay you (e.g. the money is transferred into your account or you receive the cash). It is basically the value of all your unpaid invoices (how much money people owe you). This account is also called **'debtors'**. The reason why you do this is because technically the money is yours but you've not actually received it yet. So when you want to work out what your co-op is worth you can now count this towards the worth, even though you don't have the cash sitting in your bank account yet.

Accounts Payable: an account where you record the amount of money someone invoices you for until you actually pay it (e.g. the amount is deducted from your current account). It is basically how much money you owe for goods or services received. It does not include money owed for loans or on shares. This account is also called **'creditors'.** Again you park these invoices in a separate record so that when you work out how much your co-op is worth you can deduct these – even though you have not paid the invoices yet, the money technically is yours no longer. It belongs to the person or company that you bought stuff from.

Negative equity and insolvency

As discussed above equity tells you what your co-op is actually worth. It equals all your assets less all your liabilities:

Equity = assets – liabilities

Negative Equity is when your liabilities are greater than your assets. This means if you sold everything and got all the money owed to you, you still couldn't pay back everyone you owe money to. It means you are technically *insolvent.*

If you have negative equity you are legally obliged to have a plan for getting out of it. It is illegal to trade otherwise. If your co-op is registered with limited liability (which means that directors are only responsible for the debts of the co-op up to the amount of money they personally put in, either as guarantees or shares), then your personal liability becomes unlimited unless you are acting to get the business solvent again. Part of this is to consider at every meeting of your co-op whether it is in the best interest of your creditors to keep trading. Specifically you must consider whether your creditors are more likely to get their money back if you keep trading than if you declare your co-op insolvent. If you think this is the case, then you need to pass a resolution stating this and you can then carry on trading. If you don't think so, then you must stop trading and wind up the co-op.

Useful accounting terms

Here are some other accounting terms that you are likely to come across:

Depreciation: a way of accounting for the fact that things you own (such as vans, computers, machinery – but not houses!) can lose their value over time. For example, if you buy a new van or new computer then next year it will be worth significantly less than when you bought it. Generally you reduce the value of your assets to zero over a number of years. There are two main types of depreciation, straight line and curved, for more details see www.hmrc.gov.uk .

Credit: refers to money or value leaving an account. *(Note: this might seem confusing as in your bank statement credit is money that enters your account. This is because bank statements are written from the point of view of the bank: if you have money in a bank account then the bank owes you.)*

Debit: refers to money or value entering an account.

End of Year Accounts (Annual Accounts)

All companies, Limited Liability Partnerships (LLPs) and Co-operative Societies legally have to create and *file* (i.e. send in) *annual accounts*. These accounts are a snapshot of the company's finances at the end of an accounting period. With a little bit of patience most co-ops should be able to produce their own accounts. You can also employ an accountant to do this although it can be expensive for a small co-op and it's not a legal requirement to use one.

Annual accounts are useful for you to see how your co-op is doing financially. You must also send them to HMRC and to either Companies House (companies and LLPs) or to the Financial Conduct Authority (Co-operative Societies (old IPSs) in Britain or the Registry of Companies, Credit Unions and Industrial and Provident Societies in Northern Ireland. Lenders and funders may also want to see them. There are set rules about what the accounts need to contain at a minimum. The booklet *How to Set up a Workers' Co-op* explains this in more detail, you can download it from the Seeds for Change website for free (see *Resources* below).

End of year accounts consist of two parts:

- ★ the **Profit and Loss Account:** a summary of the year's income and expenditure;
- ★ the **Balance Sheet:** a calculation of the current balance of the value of all the assets (e.g. money, equipment, buildings, loans, stock, payments due to you) and liabilities (e.g. loans and other money owed by you, unspent grants).

The year-end accounts must be agreed by the directors (or possibly all members, depending on your constitution). Smaller companies can choose to provide an *abbreviated balance sheet* which is shorter and simpler than a full set of accounts. Examples of annual accounts are at the end of this guide.

The Profit and Loss Account

This calculation shows you how much profit or loss you have made over the last accounting period.

Profit = Income – Expenditure

Co-ops and charities often call this an *income and expenditure account* and call the profit shown at the bottom of this account *surplus* instead of profit. If the figure is negative, then it is called a loss.

The Profit and Loss Account separately lists your income and your expenditure.

Income includes items such as such as:

- ★ your total sales minus the cost of those sales;
- ★ any grants or donations you have received;
- ★ any rental income from sub-letting;
- ★ interest on any money you have invested or in bank accounts.

On the **expenditure** side it shows the expenditure such as:

- ★ wages and salaries, National Insurance and PAYE contributions;
- ★ staff training;
- ★ other overheads such as rent, phone bills, utilities, insurance, stationery, advertising, bank charges;
- ★ taxes such as business rates;
- ★ legal and professional fees such as paying an accountant;
- ★ leasing or buying machinery and equipment;
- ★ repairs and maintenance;
- ★ insurance.

Working out your profit or loss

There are two different methods for working out your profit or loss: the simple profit calculation and the turnover based calculation. Which of these two you choose depends on the type of your business. We explain both below.

Simple profit calculation

This is the easiest way. All you have to do is list all your income and all your expenses. You then subtract the total expenses from your total income and you have your profit for that year.

Income – Expenses = Profit

Note that in this method most people include all of the sales as income and all costs associated with those sales (such as buying in stock or materials) as expenses. This can be a bit confusing as it contradicts the definitions of income and expenses we have given above. This is because this method is most appropriate for co-ops whose trade does not rely on buying in materials, e.g. businesses whose trade is consultancy, research, training, bookkeeping and agency type businesses like taxi-drivers, actors, musicians. The costs in these businesses are mostly *fixed*, that is they are costs that arise independently of how much or how little you sell. It is also the method most commonly used by grant dependent co-ops.

Turnover based Profit calculation

This is slightly more complicated but very useful for businesses that manufacture or sell goods. It is useful if you have a mix of *fixed* (arising independently of how much you sell) and *variable* costs (something that changes depending on how much you sell, e.g. raw materials)

1. Work out your **Turnover**. Turnover is the amount of money received for all sales after removing any sales tax (e.g. VAT), but before deducting the cost of those sales. Also called *revenue*.
2. Now you work out the **Cost of Sales.** This is the amount of money you spent making those sales (*variable costs*). Cost of Sales only refers to the costs that you can directly relate to the sale of that item. So for example buying in the stock, packaging each item, and (if it is possible to calculate) the amount of wages directly related to the sale, e.g. time spent on manufacturing each item.
3. Work out your **Gross Profit.** *Gross Profit is your Turnover minus the Cost of Sales*.
4. Now work out your **Overheads.** These are expenses that are required to run your co-op, that can't be directly connected with the products or services you do. They are *fixed costs*. They are also called **operating expenses** or **revenue costs** and include rent, utilities, any wages that were not included in cost of sales, (e.g. wages for administration and advertising) and depreciation.
5. Now work out your **Net Profit (surplus).** This is your Gross Profit minus Overheads. (So that makes it: **Net Profit = Turnover – Cost of Sales – Overheads**)

Note that companies have *profit*, while non-profits and societies have *surplus* – different names for the same thing.

Working out corporation tax due

Most co-ops are liable to corporation tax which is a tax on the taxable profits (or surplus) of limited companies and other organisations. For the purposes of your Annual Accounts you must next work out whether and how much corporation tax you owe on your net profit. We explain how to do this in more detail in the section on corporation tax (pg. 25).

Members' dividends and corporation tax

There is an important difference to highlight between Companies and Co-operative Societies (previously called IPS, along with other types of societies) with regards to dividends and corporation tax. Dividends are payments made to the members of a co-op out of the profits of that year. Not many small co-ops actually do this, but it is worth pointing out the following:

Co-operative society (ex-IPS): for these types of co-ops, HMRC considers members' dividends to be a legitimate business expense. This means you pay out dividends as an expense. Then you work out your net profit and how much corporation tax you pay on that. So for Co-operative Societies paying out members' dividends reduces the surplus and therefore the corporation tax bill. N.B. members may need to declare their dividends for income tax purposes.

Companies: for co-ops registered as companies HMRC does not allow you to deduct members' dividends from the profits before calculating corporation tax. Members dividends are paid out of profits left after corporation tax has been paid.

Donations and Bursaries

Once you've dealt with corporation tax and Dividends you then decide whether you want to make any donations or bursaries out of your profits. Enter these into your Income and Expenditure sheets.

Your profit/surplus

Once you've done all that you arrive at your profit or surplus for this year: *Profit (Surplus) Brought Forward* and *Profit (Surplus) Carried Forward***.** The final calculation is working out how much profit (or *reserves*) your co-op has accumulated over the years. You do this by taking your profit from this year after all deductions, (such as Tax and Dividends) and adding it to the *Profit Brought Forward* from the previous year. The figure you arrive at is called *Profit Carried Forward* and is the same as your Net Worth or Equity.

The Balance Sheet

The Balance Sheet is a snapshot of a business' financial condition at a specific moment in time, usually at the close of an accounting period. You can find an example Balance Sheet at the end of this guide.

It shows the *assets* (e.g. money, equipment, buildings, stock, payments due to you) and *liabilities* (loans and money owed by you) of the business. From this we calculate the *net worth* (aka equity) of the organisation at that particular moment in time.

A standard company balance sheet has three parts: assets, liabilities and equity. The main categories of assets are usually listed first, and typically in order of liquidity. Liquidity means how easily you can access these funds – e.g. cash in hand is the most liquid. Assets are usually split up into Liquid Assets (cash), Current Assets (short term savings accounts, stock) and Fixed Assets (such as buildings, machinery). Assets are followed by the liabilities, which are split up into current liabilities (things you have to pay over the next accounting period) and long-term liabilities (things you have to pay in the long run). The difference between the assets and the liabilities is known as equity or the net assets or the net worth or capital of the company.

According to the accounting equation, net worth must equal assets minus liabilities. Another way to look at the same equation is that assets equals liabilities plus equity. This is often used as a different way of laying out the same information.

In case you were wondering, the reason *balance sheet transactions* are called that is because they affect the things on this sheet and don't affect the profit and loss sheet.

What is a Balance Sheet used for?

The Balance Sheet lets us compare the organisation's financial health year on year. And it shows us how the money is tied up and distributed between the different types of assets and liabilities. It lets us assess questions such as: is the business in a position to expand? Can the business easily handle the normal financial ebbs and flows of revenues and expenses? It also shows up whether a business should take steps to bolster cash reserves.

Balance sheets can identify and analyse trends, particularly in the area of Accounts Receivable (Debtors) and Accounts Payable (Creditors). Is some debt non-collectable? Has the business been delaying paying it's creditors to forestall an inevitable cash shortage?

It is also a way of checking that your accounts are correct. This is because your net worth, or equity, should match the profit (surplus) carried forward from your income and expenditure sheet. The two totals 'balance' each other. For an explanation of the term profit (surplus) carried forward see page 15.

Balance sheets, along with Income and Expenditure Accounts, are the most basic elements in providing financial reporting to potential lenders such as banks, investors, and vendors.

Loans and bookkeeping

This section explains how to account for loans. Receiving a loan is the most likely scenario for new co-ops, however the same principles apply when making a loan or buying an investment. We won't go into much detail about the different types of loans because this is outside the scope of this briefing. Loans and loanstock are covered in more detail in the booklet *How to Set Up a Workers' Co-op* (see *Resources* below).

Types of loans

You may need a long-term loan for start-up costs and to buy equipment. There may also be times when your balance goes into the red (your cash runs out temporarily) and you need a short-term loan to see you through until your income grows. There are many different places you can get a loan from: banks, private individuals and other co-ops to mention just a few. Overdraft facilities are a type of short-term loan with high interest rates. These are good for short term cash flow problems. Longer term loans and mortgages are useful for buying buildings and equipment and have lower interest rates.

Loans should only be used to deal with cash flow issues or to provide you with capital. They should never be used if you have no way of generating the money to pay them back.

Many co-ops have a type of loan called loanstock. This is a direct investment in the co-op by individuals or organisations, over a fixed term (often 5 years), with an interest rate agreed between the co-op and the lender. With this type of loan the interest is due to the lender at the end of every year. It can either be paid at the end of each year, or added on to the money already owed. The interest does not have to be paid in money, e.g. the Leeds Bread Co-op pay interest in bread (and are calling their loanstock *bread bonds*). The loanstock is repaid in a lump sum at the end of the term of the loan.

Another way of raising money for a co-op is to issue withdrawable shares or community shares. This is a type of investment from your members (if your rules allow). For accounting purposes these are not loans and are treated differently – we have just included them so you are aware of another potential source of capital.

Accounting for loans

So how do you deal with loans in your accounts? Receiving a loan does not class as income because it increases both your assets (cash value of the loan) and your liabilities (the fact that you have to pay it back) by the same amount. It therefore doesn't alter your net worth, and so is not an income and does not get written down in your income account. It is called a balance sheet transaction and gets dealt with in the balance sheet.

Accounting for paying back a loan is slightly more complex. Paying back a loan consists of two parts – the original loan amount (the *principal* or *capital*) and the *interest* charged on that loan amount. Paying back the principal decreases both your assets (cash used to pay back the loan) and your liabilities (you no longer have to pay it back) by the same amount. Paying back the principal therefore doesn't alter your net worth and so it is not an expense.

However paying interest on a loan is an expense. Paying back the interest on a loan decreases your assets (cash required to pay interest), but leaves your liabilities unaltered (it has nothing to do with the original loan). It therefore decreases your net worth and so is an expense.

Receiving or paying back a loan in itself does not change the basic profitability of the business. However if you also have to pay back interest this classes as an expense and therefore a loan with interest decreases the profitability of the co-operative – it actually costs you money.

Measuring your co-op's profitability

Now you've got your co-op's accounts you can use them to work out how well your co-op is doing. There are lots of ways of doing this and which of these measures is most useful depends on your particular type of co-op. This section introduces some commonly used measures and some indications of how to interpret them. For more information we recommend getting a book on business finance (see *Resources* below).

The Profit Margin

The profit margin is a measure of how profitable your co-op is. Profit margin is the percentage of turnover or of selling price that is turned into profit/surplus.

It is calculated by finding the net profit as a percentage of the turnover (or revenue).

First of all work out your net profit:

$$Net\ Profit = Turnover - Cost$$

Then calculate your profit margin:

$$\text{Profit margin} = \frac{Net\ Profit}{Turnover\ (\text{or}\ revenue)}\ x\ 100$$

Example

Suppose a vegetable shop buys in vegetables for £20,000 and then sells them for £30,000. It also pays out wages and rent to the sum of £9,000.

First of all work out the net profit:

Net profit = selling price (or turnover, or revenue) – cost of sales – overheads.

The selling price is 30,000.

Cost of sales (costs directly related to the sale of a product) is £20,000 (buying in the veg).

Overheads in this case is £9,000 (running a shop and paying staff).

Therefore net profit = £30,000 - £20,000 - £9,000 = £1,000 Now you can work out the profit margin

$$\frac{£1000}{£30{,}000}\ x\ 100 = 3.33\,\%$$

What is the profit margin used for?

The profit margin is mostly used for internal comparison. It is difficult to accurately compare it for different businesses, because operating and financing arrangements vary so much. But a low profit margin indicates a low margin of safety and a higher risk that a decline in sales will erase profits and result in a *net loss*, also known as a *negative margin*. Profit margin can be an indicator of a company's pricing strategies and how well it controls costs.

Most co-ops have a very low profit margin, as in the example above. This is because they exist to provide mutual benefits to their members rather than to make a profit. For example in a workers' co-op the aim is to provide a pleasant work place and decent wages for workers – any potential surplus is often used to increase wages or lower prices to benefit the community. In a consumer co-op the aim is generally to provide products cheaply to members, so the profit margin should be low! Capitalist businesses on the other hand aim for a high profit margin because they want to generate a profit for their owner or share holders, rather than paying

decent wages to the workers or keeping prices as low as possible for consumers.

Having said that, co-ops should make at least some profit to build up their reserves. It is very important to have enough reserves to see you through difficult times. Aim to have a reasonable profit margin. (But only you can decide what is reasonable.)

The Operating Margin

This is another measure of your co-op's profitability. It is similar to profit margin, but presents a more accurate picture because it doesn't use the net profit but the operating profit. The operating profit is your profit before you deduct any interest, taxes and depreciation. This is because a good accountant can change how profitable your business looks by playing with the length of time over which you depreciate something, or make your business look less profitable so you don't pay as much corporation tax. This measure of profitability removes the possibility of distorting the figures. This is a useful figure to know if you want to raise investment in your co-op – most investors will ask for it.

$$\frac{Operating\ Profit}{Turnover\ (or\ Revenue)}\ x\ 100$$

The Break Even Point

The break even point is the point at which cost (or expenses) and turnover (or revenue) are equal. If there is no net loss or gain then you have broken even and a profit or a loss has not been made. Anything you sell above the break-even point generates a profit.

It is usually measured in unit sales. This is the number of units you need to sell before you break even.

Sometimes it is expressed as volume of sales instead, which is the amount of cash you need to generate through sales before you break even.

$$\frac{Total\ Fixed\ Costs}{Unit\ Sale\ Price - Unit\ Variable\ Cost} = Unit\ Sales$$

Fixed and variable costs

Fixed costs are costs that stay the same no matter how much you sell, e.g. rent, utilities, sometimes wages). Variable costs are costs that go up or down depending on how much you sell, they are directly linked to your sales, for example buying materials or stock.

Example

A bakery has fixed costs of £5000 (premises and staff) per month. It sells each loaf for £2. The variable costs of producing each loaf is 50p (ingredients, electricity and packaging).

Once the bakery has sold 3333 loaves in a month, it starts to make a profit on each loaf of £1.50.

$$\frac{5000}{£2 - 50\text{p}} = 3333\ Loaves$$

The Margin of Safety

The margin of safety tells you how far output or sales levels can fall before a business reaches its break even point. It is the amount of sales you could lose before you start making a loss. The greater the margin of safety, the more secure you are.

$$Margin\ of\ safety = current\ sales - break\ even\ sales$$

If the bakery sells 4000 loaves then the margin of safety is: 4000 – 3333 = 667 loaves.

The margin of safety is sometimes expressed as a percentage:

$$\frac{Current\ Sales - Break\ Even\ Sales}{Current\ Sales}\ x100$$

In the case of our bakery that gives us a percentage margin of 16.68% – which is not bad!

The Average Mark-up

Mark-up is the difference between the cost of a good or service and its selling price. A mark-up is added on to the total cost incurred by the producer of goods or services in order to create a profit. The total cost reflects the total amount of both fixed and variable costs to produce and distribute a product. Mark-up can be expressed as a fixed amount or as a percentage of the total cost or selling price.

$$\frac{Total\ Sales}{Cost\ of\ Sales} = Aveage\ Markup \qquad \frac{£\,4200}{£\,3000} = 1.4$$

Generally speaking the higher your mark-up the more money you make on each sale. Some types of products require a higher input of labour or have higher wastage, so they need to have a higher mark-up to cover that. For example mark-ups for wholefood products in wholefood co-ops are usually between 1.25 and 1.4, but vegetables are often around 1.5. This is to allow for wastage from vegetables going off.

The Retail Mark-up

There is a slightly different measure used in the retail sector called retail mark-up, which is commonly calculated as the difference between wholesale price and retail price, as a percentage of wholesale. This is often used by shops and other retail businesses. There are standard figures for different sectors and retailers that businesses aim for.

Understanding VAT and bookkeeping

This is a basic introduction to VAT – Value Added Tax. There are lots of little rules and exemptions, which we won't go into here. The HMRC website (www.hmrc.gov.uk) has a really detailed section on VAT. There is also a very helpful helpline about VAT (0845 010 9000).

Value Added Tax is both very simple and very complex. It is a tax on sales of most goods and other supplies (e.g. providing a service) you make to either another business or end consumers. It is collected by businesses and passed on to HMRC.

You have to register for VAT and collect VAT from your customers if your annual VATable turnover goes over a certain threshold. For the 2013/14 tax year this threshold is £77,000. This is a bit confusing because £77,000 isn't necessarily the same as your total turnover and we explain this in more detail below.

Once registered you can only de-register if your turnover is less than £75,000. Once registered for VAT you must collect VAT on all your VATable turnover, not just that above the threshold.

VATable turnover and the different VAT rates explained

VATable turnover is all your turnover from supplying goods or services within the three VAT rates of (currently in 2013) 20%, 5% and 0%. The table below gives some examples for the different rates, exemptions and non-business activities. This is not a complete list. Check www.hmrc.gov.uk for more detail.

When working out your VATable turnover you leave out VAT exempt business activities and non-business activities.

Count towards VATable Turnover			**Do not count towards VATable turnover**	
Standard VAT rate 20%	**Reduced VAT rate 5%**	**Zero VAT rate 0%**	**VAT exempt business activities**	**Non-business activities**
Most goods and services, e.g. • selling new and used goods • providing a service such as hairdressing or training • charging an admission price into buildings Also: a self-employed person providing services	For example: • fuel and power used in the home and by charities • women's sanitary products • installation of energy-saving materials	For example: • most food (but not meals in restaurants/ cafés or hot takeaway) • books • newspapers • young children's clothing • most prescriptions • most public transport services	For example: • most rent • betting, gambling and lotteries • providing credit • the services of doctors and dentists • some services provided by undertakers	For example: • receiving income from purely voluntary donations where nothing is given in return • receiving grant funding • activities where your organisation doesn't make a charge

Example 1 – Do we have to charge VAT on bike maintenance training?

It depends! If you offer a course on bike maintenance and charge people to attend, then this would be liable to VAT at a rate of 20%. If you get a grant to provide bike maintenance training to the public and you don't charge people to attend, then this is outside of the scope of VAT. If your funder requires you to also charge people to attend, so they are attending a subsidised course, then this would be a business activity and the entry fees you get (but not the grant) would count towards your VATable income.

Example 2: VATable turnover is below the threshold for VAT registration.

This table illustrates how a worker's co-op selling bikes and running training courses has worked out that they are below the threshold for VAT registration. The income from grants is classed as a non-business activity and not counted towards the VAT threshold.

Turnover	**VAT rate**	**Amount**	**VATable turnover**	**VAT charged to the customer**
Sales of bikes	20%	60,000	60,000	0
Fees for bike training	20%	5,000	5,000	0
Grants for delivering free bike training	non-business	15,000		0
Total		**80,000**	**65,000**	**0**

Example 3: VATable turnover is above the threshold for VAT registration.

In this example the worker's co-op is also selling books in addition to bike training and bike sales. Books sales count towards the VATable turnover, even though they are 0% rated and no VAT is charged on them. This means that the workers' co-op is now over the threshold and has to start charging VAT at the appropriate rate to the customer.

Turnover	**VAT rate**	**Amount**	**VATable turnover**	**VAT charged to customer**
Sales of bikes	20%	60,000	60,000	12,000
Fees for bike training	20%	5,000	5,000	1,000
Sales of books	0%	15,000	15,000	0
Total		**80,000**	**80,000**	**13,000**

How VAT works – charging VAT and reclaiming VAT

Once registered you must charge the appropriate VAT on all goods and services you sell, e.g. for standard rate goods, you must sell at *the price of the goods + 20%*.

VAT is a tax on the end customer not on the business. It gets passed along the supply chain. This means that if you are registered for VAT and are charging your customers VAT (known as **output VAT**), you can claim back VAT on most goods and services that you buy (known as **input VAT**).

If you are VAT registered, then every quarter you have to fill in VAT returns and pass any VAT you have collected on to HMRC.

To work out how much VAT you owe to HMRC you must:

1. Calculate how much VAT you have paid ***(input tax)*** and how much VAT you have received ***(output tax)***.
2. Then work out how much VAT you owe to HMRC

VAT received **(output tax)** *– VAT paid* **(input tax)** *= VAT owed to HMRC*

What happens if the figure of VAT owed is negative?

In this case HMRC pay you money back. This can happen if your business mainly charges reduced rate VAT (e.g. domestic renewable energy or energy efficiency services) or zero rate VAT (e.g. on food or printing) and you mainly purchase standard rated products (e.g. solar

panels or electrical parts, paper and ink, building work to your shop, petrol for your deliveries), especially if you only make a small profit.

VAT received on goods sold – VAT paid on goods bought = VAT owed to HMRC

For example:

£0 (£500 of books sold at 0%) – £60 (£300 materials bought for printing at 20% VAT) = – £60

You can also reclaim any VAT related to overheads related directly to the VATable goods you are selling (e.g. in the case of a printing business: VAT on electricity, paper, waste removal). You can find the rules for working this out on the HMRC website.

Note: if you are mostly selling goods at 20% rate, but you still get VAT back from HMRC this may be a sign that you are losing money! This could be because you are buying in lots of stock but not selling it on.

As part of the VAT return you also have to supply the following information to HMRC:

★ total of goods sold;
★ total of VAT received on goods sold;
★ total of goods purchased;
★ total of VAT spent on goods purchased.

Accounting software will calculate this automatically. If you use a spreadsheet or book based version, you need to include a column for VAT spent and VAT received so as to be able to add it up easily.

Registering for VAT voluntarily

As we have seen above in some cases it can be worth registering for VAT voluntarily even if your VATable turnover is below the threshold. This will allow you to claim back VAT you have paid from HMRC. You should look at voluntary registration if:

A) **Customers are themselves mostly VAT registered businesses** – your customers themselves will be able to claim back the tax you charge them, and you will be able to save money on the things you purchase.

B) **The goods you sell fall mostly within the 0% or 5% rate for VAT.** This is because the amount of VAT you can claim back on the price of goods you bought may exceed the amount of VAT that you owe to HMRC for goods you sold. You may therefore receive money back from HMRC.

C) If you know you will end up registering for VAT anyway, it may be worth voluntarily registering early, particularly if you have large capital purchases to make. This means you will be able to reclaim the VAT on these outlays.

Example – benefits of registering for VAT

A bakery only sells bread which falls within the 0% rate. The bakery has to pay VAT at 20% on its electricity, water, telephone and rent.

It therefore owes no VAT to HMRC. However if registered for VAT, then the bakery can reclaim all the VAT it pays on electricity, water, telephone and rent. This amounts to about £1200 a year.

In addition, at the point of setting up the business, the bakery also bought an oven, baking trays, scales etc – all of which had VAT on them. The bakery can reclaim an additional £3000 of VAT on these set-up purchases.

Reasons not to voluntarily register for VAT

If the co-op sells to individuals then it's usually best to register only once you are required to. It is generally cheaper for your customers if you are not VAT registered, as you won't have to add VAT to your goods and services, so the end price of the product will be less and it will give you a competitive advantage. NB the competitive advantage won't be 20% (or appropriate VAT level) of the price of your goods, but the VAT on the price difference between what you buy in and the product you sell on (the value you are adding to product). Bear in mind that if you pay VAT on the raw materials, goods and resources you buy in, you can't reclaim this VAT unless you are registered.

Not registering also means less work as you won't have to fill in VAT returns every quarter!

Systems of VAT accounting

There are a number of different systems of VAT accounting. To work out which one is best for you call HMRC's VAT helpline, but here's an overview of the options.

The two main systems are:

Accrual: This system accounts for VAT at the point of invoice or bill. It matches how your accounting in general is done, and tracks VAT owed as it is accounted for in your end of year accounts.

Cash: This system accounts for VAT at the point of payment. It can help with your cash flow as you do not pay VAT on goods sold until your customers pay you. However you can't claim back VAT on goods purchased until you have paid for them.

Other systems include:

Annual Accounting Scheme: You only make one return a year. However you make nine monthly payments throughout the year based on what you paid last year. At the end of the year you either make a balancing payment or receive money back. This system is not advised for people who reclaim VAT regularly or have a fluctuating VAT balance.

Flat Rate Scheme: You do not record VAT transactions but instead pay a percentage of your turnover as VAT. The percentage depends on what your main business is. Your turnover includes your profit (the value you add) and HMRC will make an assumption of how much profit you make as part of your turnover. The main advantage is it reduces paperwork and the need to track VAT. The big disadvantage is you will probably pay more than you would under one of the other schemes as HMRC assumes a greater profit than small worker co-ops tend to actually have. You also can't claim VAT against your purchases or claim VAT back if purchases are greater than sales. It's designed for very small businesses that have no time to to work out VAT and don't want to employ a bookkeeper to do it for them.

Retail Schemes: There a lots of these and they are quite complicated. They are intended for business that sell large quantities of relatively inexpensive items to the public. They are designed so you don't need to track VAT on every transaction, but can calculate it based on a period of sales (often a day) using a variety of different methods of apportioning rates to your turnover. For example, catering companies, chemists and florists all have special rules.

Corporation tax

Corporation tax is levied on the taxable profits (or surplus) of limited companies, Co-operative Societies and other organisations including clubs, associations and other unincorporated bodies.

Taxable profits for corporation tax include:

- ★ **profits** from taxable income such as trading profits and investment profits (except dividend income which is taxed differently);
- ★ **capital gains** – known as 'chargeable gains' for corporation tax purposes (chargeable gains arise when you sell or dispose of an asset for more than it cost you. Asset in this case doesn't mean your trading stock, but things like buildings and shares your co-op owns).

Co-ops registered as Companies and Co-operative Societies (previously called IPSs) are liable to pay corporation tax if they carry out a trade that generates a profit (or surplus). However some trading activities are exempt from corporation tax – see below.

To check which bits of your income count as taxable have a look at the HMRC website www.hmrc.gov.uk/ct/, which provides lots of helpful guides on the rules and exemptions.

Co-ops registered as LLPs (Limited Liability Partnerships) are not affected by corporation tax. This is because LLPs are not classed as corporations for tax purposes. Instead of corporation tax, tax on profits is deducted directly from the members of the LLP in the form of income tax.

Your responsibilities

You are responsible for working out whether and how much corporation tax you have to pay on a yearly basis. You have to tell HMRC that your co-op is liable for corporation tax, and then pay the right amount of corporation tax and file your corporation tax return (Form CT600) on time. Virtually all companies and organisations must file their Company Tax Returns **online**. Additionally your tax calculations and, with very few exceptions, the accounts that form part of your Company Tax Return, must be filed online. You must also pay any corporation tax that's due electronically (bank transfer).

You must also normally keep your co-op's business and accounting records for at least six years from the end of your corporation tax accounting period. For example, if your accounting period ends on 31 March 2009, you'll need to keep the records for that period until at least 31 March 2015. This is because HMRC do spot checks on some businesses and may want to see the records you used to work out your corporation tax.

Below we summarise the main points to remember when working out your corporation tax. **More detailed guidance is available on the HMRC website.**

Working out how much corporation tax you have to pay

Corporation tax rates

The Chancellor sets out the rates of corporation tax and various allowances, reliefs and credits in the Budget each year. There are currently two rates of corporation tax, depending on the company or organisation's taxable profits:

- ★ the lower rate – known as the 'small profits' rate
- ★ the upper rate – known as the 'full' rate or 'main' rate

There is also a sliding scale between the lower and upper rates known as 'Marginal Relief'.

If your taxable profits are less than £300,000 the rate of corporation tax is 20% of your profits. From 2015 there will only be one rate of corporation tax, at 20%.

Corporation tax accounting period

For corporation tax, the tax year is called the 'financial year' or 'fiscal year' and runs from 1 April to 31 March. If your co-op's accounting period doesn't run from 1 April to 31 March and spans two corporation tax financial years, you'll need to apportion your company's taxable profits between the two financial years on a time basis.

For example, if your company's corporation tax accounting period runs from 1 July 2013 to 30 June 2014:

- ★ the first nine months (274 days) fall into corporation tax financial year 2013 (from 1 April 2013 to 31 March 2014). So you'll pay tax on 274/365ths of your taxable profit at the financial year 2013 tax rates;
- ★ the remaining three months (91 days) fall into the financial year 2014 (from 1 April 2014 to 31 March 2015). So you'll pay tax on 91/365ths of your taxable profit at the financial year 2013 tax rates.

Deadlines

Generally you must:

- ★ **pay within 9 months and one day** after the end of your company or organisation's corporation tax accounting period;
- ★ **file your corporation tax return within 12 months** after the end of your company's or organisation's corporation tax accounting period.

If you don't meet those deadlines, your company or organisation may be charged interest and penalties. However, in the spirit of fairness, if you pay earlier than due HMRC will pay interest to you.

Working out your net trading profit or loss

Corporation tax is due on your net trading profit. This is the profit you make for the purposes of corporation tax, this may be a different figure from the one in your annual accounts, because some of your income may not be taxable, and some of your expenditure may not be tax deductible. See below for adjustments to make when working out your net trading profit for corporation tax.

Remember that you have to stick to the accounting reference period set by HMRC (1 April – 31 March).

- ★ Replace any Depreciation you used on assets (see page 12 for an explanation of Depreciation) with Capital Allowances. These are a tax relief that lets you write off the cost of certain of your assets against your taxable profits. They take the place of the depreciation shown in the financial (commercial) accounts, which isn't allowable for corporation tax purposes. Capital Allowances decrease your profit. There are different types of capital allowances. For each allowance, there are special rules to calculate how much, if any, relief you can claim. You have to follow these rules, rather than the method used in your accounts for calculating depreciation. Check www.hmrc.gov.uk/ct/ for current rules.
- ★ Remember that for co-ops registered with the Financial Services Authority as Co-operative Societies (previously called IPS) HMRC considers members' dividends to be a legitimate business expense. This means you pay out dividends as an expense before working out the net profit and then working out how much corporation tax you owe (however members may need to declare their dividends for income tax purposes). For co-ops registered as companies with Companies House, HMRC does not allow you to deduct members' dividends from the profits before calculating corporation tax. Members dividends are paid out of the profits left after corporation tax has been paid.

★ Housing co-ops do not have to pay corporation tax on income from rent from members.

★ Include any balancing charges – these may arise when you sell, give away or stop using a capital item in your business and you have claimed capital allowances on them. If the value you received for the item plus the amount of capital allowances claimed is greater than the amount you paid for the item, then the difference is your balancing charge and is added to your taxable profits.

★ Do not include any losses or gains that might be made on the sale or disposal of assets, this is already covered in the balancing charges.

What do to if you made a loss

If you make a loss in one year, then you can carry that loss forward to the next year and offset it against any profits (surplus) made in the future. You don't have to make any claim for this to happen – it's done automatically if you fill in your Company Tax Return correctly. Or you may be able to carry it back to earlier accounting periods – check the HMRC website for details.

"Active" and "dormant" status for corporation tax

HMRC considers your co-op to be ***active*** for corporation tax purposes when it is, for example:

★ carrying on a business activity such as a trade or professional activity;
★ buying and selling goods with a view to making a profit or surplus;
★ providing services;
★ earning interest;
★ managing investments;
★ receiving any other income.

However, there are some circumstances where HMRC does not consider a company or organisation to be active for corporation tax purposes. In this case, your company or organisation is considered to be ***dormant*** and you are not liable to corporation tax. Examples of being dormant include:

★ a new company that has not started trading yet (you can carry out pre-trading activities, e.g. writing a business plan or negotiating contracts, and incur pre-trading expenditure before you officially open your business without HMRC deeming that you have started trading);
★ a company that will never be trading because it has been formed to own assets such as land or intellectual property;
★ an existing company that has been – but is not currently trading;
★ a company that is no longer trading and destined to be removed from the Companies Register.

PAYE and NI

Once you start paying wages or salaries you need to register as an employer for PAYE (Pay As You Earn income tax) and National Insurance contributions and collect both of these and pass them on to HMRC. Once registered you will receive lots of help from the PAYE office, so we won't go into it here. Most small workers' co-ops deal with it themselves rather than employing an outside bookkeeper to do it for them, as it's realtively straightforward.

Sample Accounts

TRUST US Bookkeeping Collective Limited
FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 SEPTEMBER 2011

COMPANY INFORMATION The Company was incorporated on 21 July 1992 under the Companies Act 1985 as a Company Limited by Guarantee and not having a share capital. Its Articles of Association establish it as a workers' co-operative. The business of the Company is managed by its Members, who are also the Directors and whose names are shown below.

DIRECTORS	Ernest Stavro Blofeldt Moll Flanders Ronnie Biggs Al Capone	REGISTERED OFFICE	HMP Wandsworth Heathfield Road Wandsworth London SW 18 3HR
SECRETARY	Al Capone	REGISTRATION No.	1122334 (England & Wales)
		BANKERS	The Monopoly Bank plc

REPORT OF THE DIRECTORS The Members present their annual report with the financial statements of the company for the above year.

PRINCIPAL ACTIVITIES The principal activities of the co-operative are:

- to improve the quality of life for humans, animals and the Earth generally;
- to promote and distribute information about tax scams
- to run protection rackets
- to tackle social and environmental problems with innovative ideas;
- to support and encourage the growth of the co-operative movement, and to promote co-operative principles, enterprises and activities.
- bookkeeping of organisations run in line with the above.

RESULTS FOR THE YEAR The results for the year, and the state of affairs of the co-operative at the year end, are set out in the accounts on pages 3 to 6 of the accounts.

MEMBERS The Member Directors who served during the year were as shown on page one.

DIRECTORS' RESPONSIBILITIES Company law requires the directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the company as at the end of the financial year, and of the profit or loss of the company for that period. In preparing those accounts, the directors are required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- Follow applicable accounting standards, subject to any material departures disclosed and explained in the accounts;
- Prepare the accounts on the going concern basis, unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for maintaining proper accounting records which disclose with reasonable accuracy at any time the financial position of the company, and enable them to ensure that the accounts comply with the Companies Act. They are also responsible for safeguarding the assets of the company, and hence for taking reasonable steps for the prevention and detection of fraud and irregularities.

EXEMPTIONS In preparing the above report the directors have taken advantage of the special exemptions applicable to small companies.

Approved by and signed on behalf of the Member/Directors:

.....

Company Secretary

Dated: .....

Year Ended 30 September 2010
DETAILED PROFIT & LOSS ACCOUNT

	notes	**2011**	2010
TRADING INCOME:			
Protection Payments		**6750.00**	3362.00
Finance contracts		**5093.20**	5518.20
Book-keeping fees		**2056.65**	890.00
Miscellaneous Sales & Services		**800.00**	1576.27
		14699.85	11346.47
OTHER INCOME:			
Grants received			
Bank & Building Society Interest Received			
TOTAL INCOME		**14699.85**	11346.47
EXPENSES:			
Office rent		**600.00**	512.00
Salary		**5040.00**	5040.00
Contract Services		**500.00**	1410.29
Legal/Professional Fees		**581.66**	4.00
Memberships		**204.00**	202.38
Wigs, false mustaches and make-up		**20.00**	0.00
Postage		**153.37**	99.96
Office costs		**822.60**	884.90
Telephone & internet		**502.85**	542.77
Website		**25.61**	425.00
Travel & Subsistence		**830.15**	1033.00
Bribes and backhanders		**1635.19**	564.24
Training costs		**0.00**	0.00
Conference Attendance		**157.40**	0.00
get away vehicles		**0.00**	0.00
Income Tax and NI		**0.00**	0.00
Depreciation		**86.75**	86.75
Corrections to Corporation Tax		**0.03**	0.00
Total Expenses		**11463.61**	10805.29
NET PROFIT		**3236.24**	541.18
Depreciation disregarded		**86.75**	
(LOSS)/PROFIT BEFORE TAXATION		**3322.99**	541.18
Corporation Tax at 20%	2	**697.83**	113.65
Donation to the Ex Cons Widows, Widowers and Orphans' Fund		**520.00**	520.00
Previous year Corporation Tax		**0.03**	9.13
(ABSORBED LOSS)/RETAINED PROFIT FOR YEAR		**2018.38**	-101.60
Accumulated profit brought forward		**1318.42**	1420.02
Accumulated profit carried forward		**3336.80**	1318.42

Company Secretary Dated:

....

TRUST US Book Keeping Collective Limited
Year Ended 30 September 2011

BALANCE SHEET	notes	**2011**		2010	

FIXED ASSETS:					
Tangible Assets	3	**86.75**		173.50	
Investment	4	**50.00**		50.00	
CURRENT ASSETS:					
Debtors	5	891.65		0.00	
Cash at Bank & in Hand		**4691.75**		2226.57	
CREDITORS:					
Falling due within one year	6	**2383.35**		1131.65	
NET ASSETS			3336.80		1318.42
TOTAL ASSETS LESS CURRENT LIABILITIES			**3336.80**		1318.42
RESERVES:					
Profit and Loss Account			**3336.80**		1318.42

DIRECTORS' STATEMENT

For the year ending 30/09/2010 the company was entitled to exemption from audit under section 477 of the Companies Act 2006 relating to small companies.

Director's responsibilities;

The members have not required the company to obtain an audit of its accounts

for the year in question in accordance with section 476,

The directors acknowledge their responsibilities for complying with the requirements of the Act with respect to accounting records and the preparation of accounts

These accounts have been prepared in accordance with the provisions

applicable to companies subject to the small companies regime.

.....

Dated: .....

TRUST US Book Keeping Collective Limited
Year Ended 30 September 2010
NOTES TO THE ACCOUNTS

1) ACCOUNTING POLICIES

(A) Basis of accounting
The accounts have been prepared under the historical costs convention and on a going concern basis.
(B) Turnover
Turnover represents sales and services provided and expenses reimbursed.
(C) Tangible Fixed Assets
Depreciation is provided at the following annual rates in order to write off each asset over its estimated useful life:
Computer Equipment:
(D) Cash flow statement
The Company has taken advantage of the exemption in Financial Reporting Standard no 1 from producing a cash flow statement on the grounds that it is a small company.

2) TAXATION

The tax charge for the period was as follows.

UK Corporation Tax at prevailing small company rates:	
due on interest received	
due on trading profit	697.83

3) TANGIBLE FIXED ASSETS

	Purchase pric	Depreciation	NBV
Printer	347	260.25	86.75

4) INVESTMENT

Shares in Rootstock Ltd
(Industrial & Provident Society)

5) DEBTORS

Trade debtors	891.65

6) CREDITORS: Amounts falling due within one year

Outstanding cheques	1185.52
Directors' loan accounts	500.00
Other loans	
Corporation Tax	697.83
Suspense Account	
	2383.35

Loans from Directors and supporters are interest free with no fixed dates for repayment.

7) CONTINGENCIES AND COMMITMENTS

There were none at 30 September 2010 or 30 September 2011.

8) MEMBERS

Members, of which there were three at the end of the period, have guaranteed to contribute u
To £1 each in the event of the company being wound up whilst they are members, or within one year of ceasing to be a member.

Resources

Her Majesty's Revenue & Customs (HMRC) – the tax office **www.hmrc.gov.uk**
The tax office has loads of useful info and online calculators on their website. They also run free courses around the country on all aspects of PAYE, corporation tax, VAT registration, etc. and will send out a 'New Employer' pack to help you get started. They are extremely helpful and friendly, so long as they think you're trying to do the right thing.

Accounting software

Quicken – proprietary software
GNUcash – free open source software. Download from www.gnucash.org

Recommended reading

How to set up a Workers' Co-op Handbook – download free copy from www.seedsforchange.org.uk or buy for £5 from Radical Routes www.radicalroutes.org.uk/publications-and-resources.html
Lots of info on how to prepare a financial plan, different forms of raising money and sample accounts.

Understanding Business Accounting for Dummies (UK edition) and **Bookkeeping For Dummies (3rd Revised edition, UK edition) –** Really good easy books covering everything you need to know. Get it from the library or buy it – it will be money well spent.

Friendly bookkeepers and accountants

Acorn Co-op Support Ltd

[t] 01524 381780
[e] contact@acorncoopsupport.org.uk
[w] www.acorncoopsupport.org.uk
Finance training, business planning advice and bookkeeping services for co-ops. Experienced in working with housing co-ops, workers' co-ops and social centre co-ops. Offer bookkeeping, end of year accounting, PAYE, VAT and more.

Catalyst Collective Ltd

[t] 0845 223 5254
[e] hayley@catalystcollective.org
[w] www.catalystcollective.org
Accounting services and financial planning advice for co-ops.

Slade & Cooper

[t] 0161 831 0100 [e] office@sladecooper.co.uk
[w] www.sladecooper.co.uk
Auditors and accountants who specialise in co-ops.

Somerset Co-operative Services

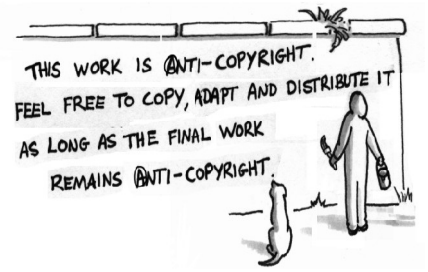
[t] 0300 4562265 [e] alex@somerset.coop
[w] www.somerset.coop
Financial services from bookkeeping, pay roll to year end accounts.

The Accountancy Co-operative

[t] 01202 621622 [e] office@accountancy
[w]www.accountancy.coop
Accountants specialising in co-operatives and other small businesses.

For more briefings and training workshops see:
www.seedsforchange.org.uk

For finance training, advice and bookkeeping services
www.acorncoopsupport.org.uk



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