Introduction to Accounts & How to use them

By the CILA Business Interruption SIG

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Introduction

This paper is designed to give a quick overview of the sort of accounts that may be available to an adjuster when dealing with commercial claims together with an introduction to some of the terminology that may be encountered – especially regarding different costing methods. It is very brief and not intended to be anything other than the briefest of introductions to accounts.

What are accounts?

Accounts are summaries of a business’s detailed records.

- Accounts usually refers to the formal profit and loss account and balance sheet together with accompanying notes
- Internal accounts are often referred to as “management accounts” and are prepared monthly
- Published accounts also include the Directors’ Report and the Auditor’s Report.
Basic principles - costings

Every business needs to have some kind of costing system - although many smaller businesses may not. Without one, management can have no idea of whether an individual product is making a profit or a loss. When dealing with claims we find a wide variety of costing systems, however the basic principles are always there.

Costs incurred by a business may be categorised as variable or fixed, or direct and indirect, or in various groupings by natural functions such as “manufacturing”, “distribution”, “sales and marketing”, “finance”, “administration” etc.

From an insurance perspective we are principally concerned with understanding which costs are fixed and which are variable as this impacts both any business interruption claim calculation but also can influence material damage settlements (e.g. where stock is damaged, or internal labour costs are claimed). There is also a third category – costs which are semi-variable, where for instance a fixed monthly or annual contract fee is supplemented by a variable usage charge.

**Variable:** Cost varies directly with the number of units produced. If one more unit is manufactured, the cost increases proportionally.

**Semi-variable:** Cost varies directly but the measurement of how it varies needs to be considered in the light of specific circumstances (rather than just, for instance, applying a historical percentage of sales to a reduction in sales).

**Fixed:** Cost remains the same irrespective of the number of units produced, assuming the business continues.

NB although costs are also frequently categorised as direct – those that are directly attributable to a unit of production, or indirect – those that cannot be attributed specifically to a unit of production, this does not necessarily mean that direct costs will be truly variable. Each specific cost should be reviewed to see what its relationship to production levels truly is.
Standard Cost: To allow a manufacturing business to budget for and control costs during the year, many businesses operate a standard costing system. This sets quantities, materials and labour that will be required to produce a single unit and costs them at the rate incurred at a particular point in time. Labour and variable costs can readily be allocated to each unit of production but the allocation of fixed costs is more difficult. It is usual to estimate the number of parts that will be produced in the year and allocate the total expected annual costs over these units. Obviously, the allocation per unit will be incorrect if the number of units produced differs from the expected level. For example, if an extra unit is manufactured, then the total rent paid for the year will not increase. The allocation of fixed costs can be very detailed. For example, a company may allocate the fixed costs for each department separately over only those units which pass through that department.

While the Insured's accountants will spend a great deal of time working out these costs, standard costs can vary from actual for the following reasons:

<table>
<thead>
<tr>
<th>Material costs:</th>
<th>More or less material actually used than the standard quantity</th>
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<tbody>
<tr>
<td></td>
<td>Cost price of materials changes</td>
</tr>
<tr>
<td>Production labour:</td>
<td>More or less time actually taken to produce unit than the standard time allowed</td>
</tr>
<tr>
<td></td>
<td>Hourly cost of labour different from standard</td>
</tr>
<tr>
<td>Fixed costs:</td>
<td>Variation in actual costs from initial annual estimate</td>
</tr>
<tr>
<td></td>
<td>Variation in the number of units produced</td>
</tr>
</tbody>
</table>

At the end of the month or possibly quarter, the Management Accountants will produce what is known as a variance analysis which compare the actual costs incurred against the standard cost. If costs incurred are greater than the standard then the variance is described as adverse, whilst if the cost is less than standard then the variance is described as favourable.

When we are dealing with a manufacturing business and discussing their costing system, we must always check whether it is a standard costing system and, if it is, ask to review the variance analysis. If variances are substantial, then we will need to adjust the standard cost to allow for this when making a payment.
It is critical to remember that "standard cost", or even "standard cost" amended to “actual” by incorporating variances, is unlikely to be “variable” cost, and therefore may not be appropriate either for the purposes of a material damage stock claim or for calculation of the rate of gross profit in a business interruption claim.

**Budgeted cost:** Many businesses, even the smaller ones, will produce budgets or projections and will seek to base their claim on these. A budget or projection is no more than the businesses' best guess of what will happen in the forthcoming year. Budgets would normally include projected sales levels together with costs expected to be incurred to produce that revenue.

When presented with a budget, it is important to consider the following:

1. When was the budget prepared? - Before the loss?
2. Why was the budget prepared? - For the bank, or as the target for salesmen?
3. Review past actual performance against budget - Is it likely that this budget would have been achieved?

**Marginal cost:** This is the additional cost incurred in making one more unit of production. In normal circumstances, this will equate to the variable cost of production, but it may be that normal capacity is exceeded by the production of this next unit and that overtime has to be worked, or, taking it to the real extreme that another factory needs to be built to meet the order.

In summary, when discussing costs with the business, there are no hard and fast rules. We must make sure we understand the business and how the cost structure works. We need to consider:

1. Are costs direct or indirect?
2. Are costs variable or fixed (or indeed semi – variable)?
3. Is there a standard costing system in operation?

Consider, as an example, the manufacture of motor vehicle sub-assemblies which requires raw materials to be machined by the workshop staff to form a manufactured part which is then assembled with a purchased part prior to incorporation into the vehicle. The machining process uses power and needs consumables such as lubricants. Workshop staff are paid for a 40-hour week irrespective of the number of parts produced.
In this example variable costs are those which vary directly with the number of sub-assemblies manufactured. Raw materials, purchased parts, and power and consumables associated with machining are all variable costs - if the Insured manufactures one more sub-assembly, then the value of these costs will all increase. By contrast, labour is not variable, it is fixed at least in the short term as the wages bill for the workshop will be the same whether 20 or 40 units are produced. We would, however, say that labour is semi-variable if overtime can be worked to meet production over 40 units, or variable in the long term if additional staff are recruited to meet demand. We would expect the cost of the workshop’s supervision, power for light and heating, and general routine repairs to be fixed in the short term.

This points up a problem with simple labelling of costs as fixed or variable. In the very short term (say a stoppage of a few hours only) almost all costs except for raw materials will be fixed, but as the period of stoppage increases more costs become variable – for instance staff may be laid off or made redundant, rent and rates may cease to be payable etc.

**Profit and Loss Account**

The profit and loss account summarises trading during a period, normally a financial year (not necessarily a calendar year) if presented as “financial accounts” as opposed to “management accounts” which are more likely to be monthly.

The P & L account arrives at a net profit figure for the year. We can summarise it as:

\[
\begin{align*}
\text{Turnover} & \quad \text{A} \\
\text{Cost of Sales} & \quad \text{(B)} \\
\text{Gross Profit} & \quad \text{C} \\
\text{Overheads} & \quad \text{(D)} \\
\text{Net Profit} & \quad \text{E}
\end{align*}
\]

- **A** **Turnover** – sales achieved during the year, net of VAT (NB sometimes in management accounts as opposed to financial accounts VAT can be included in this figure – particularly in the retail industry – so always check)
B  **Cost of Sales** – normally the variable cost of making or buying the goods that have been sold but this caption can include “direct” costs that are, in fact, fixed such as leasing charges on manufacturing equipment, direct labour etc.

If the business is a retailer, cost of sales will simply be the cost of buying goods from suppliers, but if a manufacturer then it will include cost of raw materials, power and other variable costs.

When calculating cost of sales we need to take into account opening and closing stock.

Typically cost of sales could be:

- Opening Stock  X
- Purchases  X
- Labour used in manufacture  X
- Power used in manufacture  X
- Less Closing Stock  (X)

Cost of Sales  B

C  **Gross Profit** – the difference between sales and cost of sales; or the profit after deducting only variable costs; or contribution to fixed overheads and net profit

D  **Overheads** – all of the other costs of running the business. For example salaries, rent, rates, cars, computers etc.

E  **Net Profit** – The profit ‘left’ for the owner or shareholder
The Balance Sheet

The balance sheet is a ‘snapshot’ of the assets and liabilities of the business at a particular moment – usually the financial year end (although this could be each month end if looking at management accounts).

**Assets** – things that belong to the business or amounts that are owed to it

**Liabilities** – amounts that the business owes to someone else

The balance sheet can be summarised as:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>T</td>
<td>U</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>Current Assets</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>Net Current Assets</td>
</tr>
<tr>
<td>Long Term Liabilities</td>
<td>Net Assets</td>
</tr>
</tbody>
</table>

**T** Fixed Assets – land and buildings, plant, machinery, vehicles, intangibles (e.g. brand names)

**U** Current Assets – Assets that can readily be converted to cash to pay debts as they fall due:

- Cash
- Debtors (amounts customers owe us – also called “accounts receivable”)
- Stock

**V** Current Liabilities – Amounts the business owes that fall due within 12 months

- Overdraft
- Creditors (amounts we owe suppliers – also called “accounts payable” – including short term loans and taxes such as PAYE, NIC, VAT)

**W** Net Current Assets – this is the total of current assets less current liabilities. It is traditionally said that a ‘healthy’ business operates with net current assets although some businesses operate normally by being financed by creditors.
Long Term Liabilities – amounts that fall due in more than 12 months’ time e.g. long term bank loans or a mortgage.

Net Assets – a measure of the ‘worth’ of the business – if the business has net liabilities then it is probably trading while insolvent.

Types of business

We commonly come across the following business entities. Each is required to keep different records and prepare different documents for various purposes. We will consider:

Sole Trader / Partnership

Limited Company

PLC (Public Limited Company)

Sole trader/partnership

- Not a Company – usually individual(s) ‘trading as’.
  
  The business is owned by the proprietors who retain the profits.

- Liability is not limited.

- Note that partnerships can vary from two people running a shop to multi-national partnerships of hundreds of partners

- This form of business is only required to have records to comply with VAT and Income Tax rules. For a very small business these might only be a cashbook / bank statements / pile of invoices and the accountant prepares accounts at the end of the year. However, if registered for VAT (check HMRC website for current turnover requirements for VAT registration) then accounting records will be required and usually quarterly returns will be submitted electronically (HMRC requires VAT – compliant software to be used as part of “making tax digital” requirements)
No requirement for the accounts to be audited but the HMRC does require a set of accounts to be prepared in order to be able to calculate tax owed. The accountants report usually says accounts have been prepared based upon ‘information and explanations provided by the client’ – the figures have not necessarily been verified or ‘certified’.

As the business is not a limited company there is no requirement to submit accounts and annual returns to Companies House and we cannot therefore carry out a Company Search.

We need to treat these accounts with caution – interpret them in the context of the business.

NB the requirement to deliver monthly or quarterly VAT returns does not imply any audit by HMRC so the business could be mis-declaring VAT.

If the accounts do not give a true picture then it is most likely that turnover will be understated and expenses overstated in the accounts to reduce VAT and Income Tax payable. Both work in Insurers’ favour in a claims situation as, if a claimant seeks to claim for loss of gross profit on sales, the calculation should only be based on information provided / reconciled to HMRC.

Limited company

Name of business is followed by ‘Limited’

The business is owned by the shareholders (also known as “members”) who receive dividends. Shares are not quoted – usually owned by family or the directors.

Liability is limited (i.e. if the company goes into liquidation the shareholders do not have to pay the creditors).

Records and accounts etc. are governed by The Companies Acts – this protects shareholders as those running the business (directors) are not necessarily those who ‘own’ the business (shareholders). Companies Acts require:

Proper records must be kept.
Financial accounts to be prepared and audited and filed at Companies House (which can be accessed for free using the [https://beta.companieshouse.gov.uk/search/companies](https://beta.companieshouse.gov.uk/search/companies) service (NB this service can also be used for finding out about other directorships etc. held by company directors)

Financial accounts that need to be filed at Companies House are abbreviated for small and medium companies and very limited profit and loss accounts and balance sheets may be provided. These accounts may be many months old as companies are allowed time to prepare and have the accounts audited before filing. However these can still be useful to compare to historical management accounts information presented by the Insured to support a claim in order to see whether the management accounts reconcile to the totals (e.g. for sales in the abbreviated profit and loss account in the published financial accounts)

Accounts are usually audited (although not always – dependent on size) and we can place more reliance on the records of the business and the accounts.

In addition to the accounts actually submitted to Companies House, it is normal for a detailed trading and profit and loss account to be prepared (as the last few pages of a set of accounts) showing costs, expenses etc. in some detail. If the adjuster is given a set of accounts without these pages, he / she should query why there are not there as they are normally very useful in a claim situation.

PLC (Public Limited Company)

- Name of business is followed by ‘PLC’

  The business is owned by the shareholders who receive dividends. Shares are often (but not always) quoted on the stock exchange – usually owned by many different people.

  Liability is limited.

- Records and accounts etc. governed by The Companies Acts – this protects shareholders as those running the business (directors) are not necessarily those who ‘own’ the business (shareholders). Companies Acts require all that smaller “limited” companies are

  Proper records must be kept.
Financial accounts to be prepared and audited and filed at Companies House (which can be accessed for free using the [https://beta.companieshouse.gov.uk/search/companies](https://beta.companieshouse.gov.uk/search/companies) service (NB this service can also be used for finding out about other directorships etc. held by company directors and gives access to the annual returns that must be submitted which include: -

- Names and addresses of current directors and those who have resigned
- Other directorships the directors hold
- List of all shareholders at that time
- List of subsidiary and associated companies
- Mortgages and Charges over assets of the business)

Accounts are audited and we can place more reliance on the records of the business and the accounts – published accounts will only show an overview and will be of little help to us in a claims situation. However these accounts provide useful background information such as divisional breakdown of activities, directors’ reports indicating key risks, trends etc.

Companies Act

Every company must keep records that are sufficient to show and explain the company’s transactions and also to disclose, with reasonable accuracy, the financial position of the company at any time.

Officers who knowingly or wilfully permit or authorise inadequate records commit an offence.

<table>
<thead>
<tr>
<th>Type of Company</th>
<th>Records Retention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private company</td>
<td>Keep records for 3 years</td>
</tr>
<tr>
<td>Public company</td>
<td>Keep records for 6 years</td>
</tr>
</tbody>
</table>

Records must contain:

- Day books or journals (records sales, purchases and cash transactions)
- Record of assets and liabilities (fixed assets, creditors, debtors)
- If dealing in goods: Statement of stock held at the year end
- Stock records
- Record of all goods sold other than in normal course of trade
• It is the Directors’ responsibility to maintain records.

  Given that almost all companies use computerised accounting software such as SAP for large companies and QuickBooks for smaller companies the amount and detail potentially available for scrutiny is vast. Most accounting systems allow download into Excel spreadsheets for further analysis of trends etc.

• It is the Auditor’s duty to give an opinion as to whether the accounts ‘give a true and fair view’ of the business and are ‘materially’ correct. Also that they have been prepared in accordance with recognised standards. They do not ‘certify’ that they are totally correct.

Annual Accounts

• Directors must lay copies of Balance Sheet, Profit and Loss Account, Directors’ Report and Auditor’s Report before the members at the AGM each year

• Accounts must be filed at Companies House within the following periods:

<table>
<thead>
<tr>
<th>Company Type</th>
<th>Time Frame</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited Company</td>
<td>10 months from year end</td>
</tr>
<tr>
<td>PLC</td>
<td>7 months from year end</td>
</tr>
</tbody>
</table>

Abbreviated Accounts

• Full accounts must be prepared but ‘small’ and ‘medium’ sized companies are permitted to deliver only an abbreviated version to Companies House.

• The rules governing the definition of small and medium vary from time to time but are based on size of turnover, balance sheet totals and the numbers of employees

• The rules are complex but generally such companies do not have to file a full balance sheet and only need to file a summary profit and loss account

Group Accounts

• A Group is a holding company and its subsidiary companies.

• Subsidiary means that all or just a majority of the shares are held by the holding company.

• Companies that have common directors or shareholders do not necessarily make a Group.
• If at the end of the year a company has a subsidiary and is not itself a subsidiary then it must include in its accounts group accounts dealing with the affairs of itself and its subsidiaries as a single unit.

• This is to give a truer picture of the real transactions of the business.