Jayva | Demystifying financial terminology

Struggling to grasp legal accounting terminology? Here, we present no-jargon, straight-talking explanations of accounting vocabulary which is often used in business and rarely described in layman's terms for those people less familiar with financial language.

What's the difference between bookkeeping and accounting?

- **Bookkeeping** is the recording of the firm's financial transactions in an accounting system.
- **Accounting** is the production of the firm's financial statements and tax liabilities, from the accounting records, in accordance with the governing body of that country.

What is double entry bookkeeping?

Every single transaction in a firm's accounts must have two sides and they must always balance to zero.

For example, when a firm pays its staff's wages, the cost of expenses on salaries increases while the amount of money in the bank account decreases. The debit and credit balance to zero.

Accruals v cash

Accruals
Accruals means you account for the transaction irrespective of whether the cash has hit the bank account.

Cash
Cash accounting means you only account for it when it hits the bank.

What is the general ledger?

Sometimes called the nominal ledger, chart of accounts and GL, this is the list of accounts which make up the firm's accounting system, allowing for financial transactions to be categorised and stored accurately.

What types of accounts are in the general ledger?

General ledger categories are:

- **Assets** - Things that are owned by or owed to the business.
- **Liabilities** - Things that the firm owes third parties for.
- **Equity/capital** - The money invested in the company by the owners, including any retained profits from previous years.

Balance sheet

- **Income** - Monies coming into the business for either sales (operating income) or other revenue (non-operating income).
- **Expenditure** - Money the company is spending either to service its operations (operating expenses) or for other income (non-operating expenses).

Profit & loss or income statement

When we add up all our income from our services and subtract the costs we have paid out to operate the business - is the result **positive (profit)** or **negative (loss)**?

What is a trial balance?

The trial balance is a list of every single account in the general ledger, including all the accounts in the profit & loss account and balance sheet, compiled into one document.

The sum of all the accounts must balance to zero, hence the term "trial balance".

Why do accountants always talk about debits and credits?

All accounting principles come back to "double entry". For every transaction, there are two sides, a debit and a credit. The two counter one another out and balance to zero. The trial balance proves that no one-sided entries exist. Debits increase asset or expense accounts and decrease liability, revenue or equity accounts. Credits do the reverse.

Why is cashflow different to profit?

A firm's profit is a record of its income less its expenses. If the firm is making a profit then cash will generally increase, but not always.

The firm could be undertaking a large capital project (such as renovating a building), this may cost thousands, but it would not affect the profit & loss account because that would be a balance sheet item, as we are increasing the firm's fixed assets. This would impact cashflow but not profit, until that asset was depreciated.

Also, firms on an accruals basis for accounting may show a profit because they have raised lots of invoices for their services. If those invoices have not been paid by the clients, the assets in the balance sheet for unpaid bills or receivables will be high, but the bank balance may be low.

What are profit & loss and balance sheets? And, what's the difference?

- **Profit & loss** - sometimes called an income statement, this is a report which includes all the income and expense accounts from the general ledger. The sum of all income less all expenses determines the firm's profit or loss. A positive figure shows the firm has made a profit, if the sum is negative the firm has made a loss in that financial period (usually a financial/fiscal year).
- **The balance sheet** - is a report which includes all the asset and liability accounts. The sum of the assets less any liabilities should always match exactly to the equity for the firm.
- Both reports make up the financial statements for a business which are required by many regulatory bodies and organisations for taxation and other financial purposes.

What is depreciation?

When a firm invests in an asset, this asset has a useful life to the business. For buildings, this period could be 25 years but for IT equipment it is more likely to be 3 years. Rather than the firm's profit taking the full cost of the investment in the year they buy it, depreciation enables a firm to spread the expense across the life of the asset until the value of the asset is fully allocated into the firm's expenses.

What are prepayments and accruals?

Prepayments - where the business has paid for something which covers an extended period. For example, paying all at once for annual professional indemnity insurance (PII) which may cost thousands. If you accounted for PII in the month you pay it, there would be no profit that month. By spreading the cost across the months it relates to equally, you're able to manage the expense so that it accurately reflects the cost in the month, not just when the cash left the bank.

Accruals - you would not expect to see accruals in a cash-based system (see the 'Accruals v cash' section above), but if you are operating on an accruals basis and you have incurred a significant expense in a financial period (month, quarter, year), you can accrue that expense even if you haven't received the invoice or paid for it yet. That recognises it as a liability in the balance sheet, and also correctly reflects the expense that would be in the profit & loss account had the invoice been received on time.

What is a bank reconciliation?

The bank reconciliation is one of the most important processes which an accounts department will do. Most large firms will do them weekly, if not daily, and all firms SHOULD do them monthly. The purpose of a bank reconciliation is to prove that every single transaction which hits the firm's bank account is correctly recorded in the accounting system.

A process is followed where the system presents a list of all the bank statement entries and these are cross referenced against every entry made on the accounting system. Any anomalies are clearly identified and rectified before finalising the bank reconciliation and confirming the closing balance.

Law firms are required by their regulators to carry out bank reconciliations at least every 5 weeks, and most apply the rule that they will complete the task at month end. The legal accounts rules which law firms follow vary depending on their jurisdiction and specialisms, but every single penny of client monies has to be accounted for in a timely manner. The reconciliation report provides evidence that robust controls are in place.

Let us help your business.

Speak to one of our no-jargon, highly experienced accounting experts today.

US: +1 888 563 9342 UK: +44 (0) 333 202 0995 info@jayvaglobal.com www.jayvaglobal.com