CHAPTER 1

USE ACCOUNTING TO HELP YOUR BUSINESS GROW

1 WHAT IS ACCOUNTING?

In simple words, Accounting is the recording of financial transactions (dealings) as entries in the Books of Accounts. Irrespective of the size and complexity of a Business, Accounting is the technique which helps in documentation and recording of Business transactions.

The nature, frequency, complexity and quantum of transactions vary from one business to another, and can vary for a Business on a daily basis. This uniqueness of businesses requires documentation of transactions which can, over a period, show the performance of a Business.

Business transactions are all about:

- When & how much money did I receive?
- Who gave me the money & for what purpose?
- Where is the material against which I had made advance payment?
- How much is owed to me, and when is it payable?
- Who do I owe money to?
- What was the payment made for & to whom?
- How much profit did I make?

Accounting is recorded in Books of Accounts and has different meanings for different businesses. A small business may consider a simple system to be sufficient for its requirements while a large manufacturing business may need a more sophisticated system. The decision on how elaborate or simple an Accounting system should be depends on the type and quality of information that the owners expect to get out of such a system.

Accounting is not a science; it is simply an application of accounting rules that have been standardized all over the world. These rules ensure that transactions of similar type get recorded by different accounting users globally in a similar and consistent manner.

2 WHAT ARE ACCOUNTS?

While Accounting is the recording of financial transactions in a business's Books of Accounts, Accounts is the consolidation of financial information extracted from Books of Accounts and presented in a meaningful format. The manner in which information is presented in Accounts is to show a business's performance and highlight results achieved in any given period.

Commonly, whenever the term Accounts is used, it refers to:

- Balance Sheet; AND
- Profit & Loss Account (also known as Income & Expenditure Account OR Receipt & Payment Account).

Additionally, a Cash flow statement may also be used besides those mentioned above.

The format of these three statements is standardized in Pakistan for businesses operating as companies incorporated under Companies Ordinance, 1984. For businesses operating as Partnerships or Sole Proprietorships, while there are no strict requirements, some standardized formats have been developed over time that are now generally used by Accounting staff. The commonly used format of these statements is attached as Appendices to this Chapter.

While all information in these statements is derived from Books of Accounts, each statement has a different purpose.

These statements are now briefly described below.

2.1 BALANCE SHEET

A balance sheet provides Accounting information about the Business situation vis-à-vis its assets and liabilities at one particular time of the year. It acts as a snap shot of the Business and is always prepared as of a certain date e.g.

Balance Sheet
Hussain Khaddar & Looms (Pvt) Limited
Balance Sheet
As of June 30, 2006

The Balance Sheet presents a Business's position vis-à-vis its assets, liabilities, capital, and accumulated profits as of any given date. This date is commonly referred to as the Balance Sheet date.

The standard format of a Balance Sheet is shown in Appendix 01-01.

2.2 PROFIT & LOSS ACCOUNT

A Profit & Loss Account provides information of the Business transactions across one year, i.e. reflects the financial performance of a Business between two dates, e.g.

Profit & Loss Account
Hussain Khaddar & Looms (Pvt) Limited
Profit & Loss Account
For the period from July 1, 2005 to June 30, 2006

The Profit & Loss Account shows the total revenue earned, expenses incurred, inventory purchased and / or manufactured and inventory unsold in between two dates ending with net profit earned or loss incurred in that period.

The standard format of a Profit & Loss Account is shown in Appendix 01-02.

2.3 CASH FLOW STATEMENT

A Cash Flow Statement provides information on all 'cash' transactions of the Business. It translates profitability of a Business into 'actual cash' across a period i.e. between two dates, e.g.

Cash Flow Statement
Hussain Khaddar & Looms (Pvt) Limited
Cash Flow Statement
For the period from July 1, 2005 to June 30, 2006

The Cash Flow Statement shows how cash was received by a business during a period and where it was spent by reconciling opening and closing cash positions. In other words, a Cash Flow Statement provides a link between a Balance Sheet and a Profit & Loss Account by translating accounting information into cash.

The standard format of a Cash Flow Statement is shown in Appendix 01-03.

3 WHY DO BUSINESSES NEED ACCOUNTS?

Accounts are required by businesses for many different purposes. Uses of Accounts can be summed up in two broad categories, Internal Uses and External Uses. Some examples of each category are as follows:

3.1 INTERNAL USES

3.1.1 EVALUATION OF BUSINESS PERFORMANCE

Accounts summarize the financial performance of a Business by showing profitability and other financial results. This can be compared with previous year(s) and / or month(s) to show whether performance is improving.

3.1.2 TREND ANALYSIS

Accounts can also be used to analyze trends in a Business's performance. Ratio analysis and analytical review (see Chapter 15) techniques can be employed to establish reasons for adverse and favorable changes in a Business's performance.

3.1.3 PEER COMPARISON

A Business may want to see its performance compared to that of its competitors to analyze whether the competitor is doing better, and if so, why can it not be matched?

3.2 EXTERNAL USES

3.2.1 BANKS

Banks require Businesses to furnish their Accounts when seeking financing, and even when financing facilities are being renewed. In fact, State Bank of Pakistan requires Accounts to be certified by a Chartered Accountant when financing facilities exceed PKR 10 million.

3.2.2 INCOME TAX DEPARTMENT

Income Tax regulations require Businesses, subject to certain conditions (see Chapter 16) to submit their Accounts as part of the annual tax return filing procedures. In addition, the tax authorities may also require Books of Accounts to be submitted.

3.2.3 SUPPLIER & BUYERS

When Businesses consider pursuing import or export options, it is usual for overseas trade partners to ask for Accounts to derive confidence on the overall financial soundness of the Business.

4 USE ACCOUNTING TO YOUR ADVANTAGE

Accounting has wide applications and using it to your advantage is your choice.

In today's Business environment, with increased competition from neighboring countries and shrinking margins, timely availability of accurate and relevant information on a Business's performance is critical for success.

Using Accounting information will vary from one user to another – some may use it only to see the profit or loss position, while others may use the same information for dynamic analysis and decision making.

Below are some examples of how Accounting information can be used to your advantage.

4.1 BENCHMARKING TO ACCEPTABLE STANDARDS

Every industry and each sector therein has certain accepted performance norms. Benchmarking performance levels to the industry norms (whether local or global) is a useful tool to evaluate the direction in which your Business is heading.

4.2 BUDGETING & VARIANCE ANALYSIS

Businesses which have been in operations for some years have a history of performance including ability to sell its products, pricing levels, expenses / overheads to be spent and margins to be expected.

It is this experience of running a Business which enables Budgets to be prepared for any

Business and for any given future period; be it a month, a quarter, six months, a year or multiple years. Budget is, therefore, an assessment of the expected or future performance from running a Business.

On regular basis, the actual financial performance of Business should be compared to Budgets to assess whether the Business is performing better than expected, at par with expectations, or below expectations. This comparison is even more useful where the Business is managed by a manager and where the Owner himself is not very actively involved in running the Business.

Further analysis on variances (variances are the changes between expected and actual performances) will indicate the reasons why performance was different from Budgets. This will enable a corrective action to be taken where performance was below expectations; or where performance was better than expected, will enable the Business to concentrate more aggressively on the reasons which have resulted in improvement.

4.3 Product viability analysis

Launching a new product is a common activity undertaken by most Businesses. However, before a new product is launched, a Business should carry out an analysis of demand & supply situation, pricing and cost structures in order to assess the commercial viability of launching every new product. Accounting can help Businesses to estimate this commercial viability so that correct decisions can be made.

4.4 Financial projections

Businesses are dynamic and rules of business i.e. market conditions change over time. Performance levels achieved in prior years may not get repeated because, for example, new competitor may enter the market, alternate options may become available and cost of manufacturing may have increased. All these, in addition to various other factors, may result in future performance levels to be different.

Financial projections enable Businesses to keep in touch with such events and to take corrective action on a timely basis, e.g., a Business may find out that because of a new product launched by a competitor in the market, price of its best selling product needs to be revised downwards in order to sell the same quantity of items as in the past (also called the market share). Despite this strategy, some market share will still be lost to the competitor. Additionally, depending on the extent of decline in sales volume, the Business may need additional capital (whether equity or bank financing) to continue with its operations.

If financial projections were prepared, the Owner would know the potential impact so that a plan can be prepared and implemented on a timely basis.

APPENDIX

APPENDIX 01-01 Balance Sheet

Balance Sheet
As of June 30, 2006

Share Capital & Liabilities	Rs.	Assets	Rs.
Share Capital & Reserves		Fixed Assets	
Capital		Land & building	
Reserves		Plant & machinery	
Surplus on revaluation of		Furniture & fittings	
Fixed assets		Vehicles	
Current liabilities		Current Assets	
Short term loans		Stores & spares	
Creditors		Stock in trade	
Bills payable		Debtors	
Interest payable		Bills receivable	
Provision for taxation		Cash at bank	
Bank overdraft		Cash in hand	
	TOTAL		TOTAL

APPENDIX 01-02 Profit & Loss Account

Profit & Loss Account For the period from July 1, 2005 to June 30, 2006	Rs.
Sales	
Less: Cost of Sales	
Gross Profit	
Operating Expenses	
Administrative & General Expenses	
Selling & Distribution Expenses	
Operating Profit	
Other Income	
Financial Charges	
Profit or (Loss) Before Taxation	
Provision for Taxation	
Profit or (Loss) After Tax	

APPENDIX 01-03 Cash Flow Statement

Cash Flow Statement For the period from July 1, 2005 to June 30, 2006	Rs.
Cash Flow From Operating Activities	
Cash generated from operations	
Financial charges paid	
Taxes paid	
Net Cash Flow from Operating Activities	
Cash Flow From Investing Activities	
Fixed capital expenditure	
Proceeds from sale of fixed assets	
Net Cash Flow from Investing Activities	
Cash Flow From Financing Activities	
Disbursements against new loan(s)	
Repayment of loan(s)	
Net Cash Flow from Financing Activities	
Net increase in Cash & Cash Equivalent	
Cash & Cash Equivalent at the beginning of the period	
Cash & Cash Equivalent at the end of the period	