CHAPTER 14

ACCOUNTING IS DONE - NOW WE NEED TO PREPARE ACCOUNTS

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104 WHAT HAVE WE COVERED SO FAR?

We have covered how Accounting is done for typically encountered Business situations. We have also covered the basics of Accounting rules & regulations to have an understanding of the Why & How of Accounting which can then be applied to any real Business situation. We have also learnt how to record financial transactions in the Books of Accounts.

In this Chapter, we will now learn how to prepare Accounts after various Accounting entries have been recorded in the Books of Accounts.

105 HOW FREQUENTLY ARE ACCOUNTS PREPARED?

You will recall from Chapter 1 that Accounts are needed for a number of reasons – these reasons can be broadly classified as follows:

Internal management purposes:

Where Accounts are prepared for internal management reporting purposes, the duration of accounts can be as per management's discretion, be it daily, weekly, monthly, quarterly six monthly or annually.

For regulatory & reporting purposes:

For external purposes, a Business will normally prepare accounts for a 12 month period. For most Businesses, every 12 month period will end on June 30th.

106 WHAT ARE ACCOUNTS?

In Chapter 2, we discussed that the term Accounts usually refers to the following:

- Balance Sheet
- Profit and Loss
- Cash Flow Statement

Before we start making these Accounts, we have also learnt that all financial transactions get recorded in the various Books of Accounts. Accounting entries from these Books of Accounts are consolidated and get recorded in the General Ledger which then contains a record of all transactions. This means that Accounts can be prepared from a single source, i.e. the General Ledger.

Now, before we make Accounts, we need to discuss "Final Adjustments" and "Trial Balance".

107 WHAT ARE FINAL ADJUSTMENTS?

Final adjustments are a number of steps which are followed every time that Accounts are prepared. While we have already discussed most of these "Final Adjustments" in the foregoing Chapters, we will briefly mention these various steps which are followed every time that Accounts are prepared.

107.1 BANK RECONCILIATION

If a Business wants to know the status of how much funds are available, should the Business check the bank statement? No!

Bank statements may not always show the correct balance which is available to a Business - there may be cheques issued by a Business and certain cheques deposited which are not showing on the bank statements - it is these timing differences which usually result in differences between balances on bank statements and those on General Ledger. Moreover, there may also be other reasons e.g. transactions (whether debit or credit) may have been recorded by the Bank in the Account such as interest credited, bank charges, mark up payments which the Business may not even be aware of until the time that bank statements are received.

For these reasons, a Business should always match (or reconcile) the balances on its general ledger with those on the bank statements to make sure that all transactions have indeed been recorded in the General Ledger and that too correctly. This will ensure that the Business always knows how much money is available to it at all times. Therefore, whenever accounts are prepared, the first step is to prepare a Bank Reconciliation Statement.

An important note: As you may be already aware, the way transactions are recorded by a Business are the exact opposite of the way in which those same transactions are recorded by the Bank.

The following tables will show the general when recorded by the Business in General Ledger:

	Category	Increase / decrease	Debit /Credit
Bank Book	Receipt	Increase	Debit
Bank Book	Payment	Decrease	Credit

When recorded by the Bank in bank statement:

	Category	Increase / decrease	Debit /Credit
Bank Statement	Receipt	Increase	Credit
Bank Statement	Payment	Decrease	Debit

Why is there a difference? For a Business, a receipt of funds is an asset (more funds in the Account), but for the same transaction an increase in account balance means that the Bank has more liability towards its customer which is a Credit entry. And, the reverse is true for payments.

In the following sections, we will discuss the different steps which are followed to prepare a Bank Reconciliation Statement.

107.2 TYPES OF DIFFERENCES

Following are some of the reasons which may cause a difference to arise between balances on a Business's General Ledger and the bank statement:

- Cheques may have been issued which have not been presented to the Bank.
- Cheques have been deposited in the Bank but the credit against these cheques has not been given by the Bank.
- Credit or Debit entries have been passed by the Bank and those entries have not been recorded by the Business.

Where differences have resulted from errors and omissions, appropriate adjustments will be required; while for those differences which have arisen from timing differences, no adjustments will be required.

The best way to overcome these differences is to prepare a Reconciliation Statement. The way to go about this is to check each and every entry recorded in the General Ledger with those recorded by the Bank in the Bank Statement, for the similar period, to identify causes of these differences.

Once the differences are highlighted, a Reconciliation Statement is prepared to see whether, using these differences, the balances on General Ledger and bank statement can be reconciled. This Statement will also highlight whether any adjustments are also required to the General Ledger or not.

107.3 BANK RECONCILIATION STATEMENT

The following example will show how a typical reconciliation statement is prepared:

EXAMPLE # 14.1

Bank Reconciliation

On 30/6/06, Hanif Auto's bank statement shows a balance of Rs. 284,329 whereas the balance on the General Ledger was Rs. 270,729. After all transactions were scrutinized, the following instances were identified:

A cheque of Rs. 10,000 was deposited on 28/6/06 which was credited on 2/7/06.

On 15/06/06, a cheque for Rs. 18,000 was issued in favor of ABC & Co. which was presented to the Bank on 1/7/06.

Bank deducted processing charges of Rs. 600 on clearing various cheques in June '06 and the account was debited on 29/6/06.

Instead of crediting the Bank Account, the Business's Accountant incorrectly credited the Cash Account by Rs. 5,000. This was a cash payment withdrawn by the Business on 15/6/06.

Based on the facts given in this Example, the Bank Reconciliation Statement would appear as follows:

Bank Reconciliation Statement As on 30th June, 2006	
	Rs.
Balance as per Bank Statement (Cr.)	284,329
Less: (i) Un presented Cheques	(18,000)
(ii) Processing Charges	(600)
(iii) Due to incorrect credit of Cash Account	(5,000)
	260,729
Add: (iv) Un credited Cheques	10,000
Balance as per Bank Book. (Dr.)	270,729

If we look at the reasons for differences, we will see that the differences mentioned in (iii) and (iv) require adjustments. The other differences, i.e. those mentioned in (i) and (ii) are only timing differences and do not need to be adjusted for. In order to arrive at the correct balances, the Journal Entries on the next page will need be passed in the General Ledger.

Bank charges of Rs. 600/- debited by the Bank on 29/6/06:

	Category	Increase / decrease	Debit /Credit
Bank Charges	Expense	Increase	Debit
Bank	Asset	Decrease	Credit

Based on this Journal Entry, the following Accounting entry will be recorded:

GENERAL LEDGER							
BANK CHARGES ACCOUNT							GL-50
	Debit				Credit		
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/6/06	GL-25	Bank Account	600				

CASH & BANK BOOK							
BANK ACCOUNT							GL-25
	Debit				Credit		
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/6/06	GL-50	Bank charges Account	600

Cash account incorrectly credited by the Business on 15/6/06:

	Category	Increase / decrease	Debit /Credit
Cash	Expense	Increase	Debit
Bank	Asset	Decrease	Credit

Based on this Journal Entry, the following Accounting entry will be recorded:

CASH & BANK BOOK							
CASH ACCOUNT							GL-22
	Debit				Credit		
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/6/06	GL-25	Bank Account	5,000				

CASH & BANK BOOK							
BANK ACCOUNT							GL-25
	Debit				Credit		
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/6/06	GL-22	Cash Account	5,000

107.4 PREPAYMENTS & ACCRUALS

You will recall from Chapter 12 that Accruals and Prepayments for expenses are recorded whenever Accounts are prepared.

We have already discussed the Accounting of Accruals and Prepayments in Chapter 12.

107.5 DEPRECIATION

In Chapter 7, we had discussed the concept underlying depreciation and how its accounting is recorded in the Books of Accounts. Businesses may record depreciation expense on a monthly basis or may choose to do so at the end of every year.

We have already discussed the Accounting of Depreciation in Chapter 7.

107.6 BAD & DOUBTFUL DEBTS

Usually, provision for bad & doubtful debts is made as and when a Business comes across information which affects the recoverability of its debts. However, at the end of every year, or whenever accounts are prepared, an assessment should be made once again to evaluate whether all receivables recorded as such are expected to be received or not.

We have already covered Accounting for Bad & Doubtful Debts in Chapter 6.

107.7 STOCK ADJUSTMENTS

It may be useful for Businesses to periodically carry out physical count of all inventory items to ensure that all inventory which should be in physical existence (as per the Books of Accounts) does actually exist.

There may be various reasons why this may not be the case – these differences may have resulted from any of the following:

- Accidental loss of goods.
- Theft of goods.
- Goods are sold but not delivered to the customer.
- Goods purchased are recorded in the books but not received physically.

Books of Accounts should always reflect inventory which is also physically in the Business's custody. Appropriate adjustments will need to be made in the Books of Accounts where there are differences.

The following example will show how this can be done:

EXAMPLE # 14.2

Lost Items

On 30/6/06 when stock counting of Hanif auto was done it was found that 10 Clutch Plates were missing. The management decided that the Clutch Plates have indeed been misplaced and decided to record this as a "loss" to the Business. The weighted average cost of these clutch plates on 30/6/06 in the Business's Books of Accounts was Rs. 500 each. Let's assume that Hanif Autos had 100 clutch plates in stock as per Books of Accounts.

The following Accounting entry will be made to record this "loss":

GENERAL LEDGER							
	INVENTORY LOSS ACCOUNT					GL-49	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/6/06	GL-10	Inventory control Account	5,000				

GENERAL LEDGER							
INVENTORY CONTROL ACCOUNT						GL-10	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/6/06	GL-49	Inventory Loss	5,000

And, the memorandum Inventory Ledger will also be updated:

INVENTORY LEDGER										
CLUTCH PLATES									IL-6	
Date	Ref No.	Receipt			Issue			Balance		
		Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)
30/6/06								100	500	50,000
30/6/06	JV 089/06				10	500	5,000	90	500	5,000

The "loss" entries are recorded by assigning a different colour to the entry so as to distinguish these transactions from normal Business issuance transactions.

107.8 CLASSIFICATION

Because Accounting is keeping a record of a large number of transactions spread over (usually) a 12-month period, there can be various instances where "errors" get made in recording Accounting transactions. Alternatively, it is also possible that expenses get incorrectly charged to wrong account heads (usually referred to as classification issues).

Final adjustments are a good time to "clean" the Books by making sure that such classification issues are not there.

107.9 CONSISTENCY OF POLICIES

Accounts are meaningful if the Accounting rules & regulations have been consistently applied from month to month and from year to year.

The impact of changing the Accounting Policy can be quite different e.g. using straight line depreciation instead of diminishing balance method, or using FIFO basis for inventory valuation instead of weighted average to name just a few of them.

Accounting policies should not be changed too frequently, otherwise the results shown by Accounts are not comparable to the previous Accounts. However, Business circumstances change over time and there may be reasons which necessitate a change in Accounting policies. Where a Business feels that a change is warranted or needed, they may do so. In such cases, the reason for the change should be disclosed in the Accounts.

108 CLOSING OF ACCOUNTS

After Accounting has been done and final adjustments made, it is time to know the balance on each Account in the general ledger. The process through which balances are derived from Accounts in the general ledger is called "closing of accounts".

Closing of Accounts has two sides to it:

- To determine the balances for current year Accounts purposes.
- To determine the balances to be taken forward for next year's Accounts.

The Accounting rule in this regard is as follows:

Rule for Closing of Accounts	
Income & Expense Accounts	Balances are not carried forward to next year
Asset & Liability Accounts	Balances are carried forward to the next year

In case of Income & Expense Accounts, balances are transferred to the Profit & Loss Account. When a new year starts, balances on these accounts will be "nil". To show how Accounts are "closed off"; we will take two accounts as follows:

- Machinery Account (liability accounts are similar).
- Rent Account (income accounts are similar).
- Using these Accounts, we will show the procedure for closing of accounts.

108.1 MACHINERY ACCOUNT

Let us assume that the following transactions have taken place in the Machinery Account till 30/6/06.

GENERAL LEDGER							
		MACHINERY ACCOUNT				GL-25	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
21/1/06	GL-20	Cash Account	500,000	22/2/06	GL-40	Machinery Disposal Account	500,000
27/5/06	GL-20	Bank Account	600,000				

The first step is to balance the Account – this is done by adding transactions separately on the Debit and the Credit side.

In our example, the Debit side has a larger balance:

GENERAL LEDGER							
		MACHINERY ACCOUNT				GL-25	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
21/1/06	GL-20	Cash Account	500,000	22/2/06	GL-40	Machinery Disposal Account	500,000
27/5/06	GL-20	Bank Account	600,000				
			1,100,000				1,100,000

Although the total of Debit & Credit columns is shown as being equal, clearly the Credit side is lesser by Rs. 600,000. This gap is filled up as follows.

GENERAL LEDGER							
		MACHINERY ACCOUNT				GL-25	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
21/1/06	GL-20	Cash Account	500,000	22/2/06	GL-40	Machinery Disposal Account	500,000
27/5/06	GL-20	Bank Account	600,000	30/6/06		Balance c/fwd	600,000
			1,100,000				1,100,000

The general rule of thumb also applies here. When an asset account has the "Balance c/fwd" appears on the credit side, it means that the balance on that account is a Debit balance. And lastly, when Accounting is started for the next year, the Machinery Account will appear as follows:

GENERAL LEDGER							
		MACHINERY ACCOUNT				GL-25	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/7/07	Opening Balance	Balance b/fwd	600,000				

108.2 RENT ACCOUNT

When it comes to Income & Expense Accounts, the process is similar to that described above for Assets & Liabilities. If you recall the Accounting equation that we covered in Chapter 2, it was as follows:

ASSETS = LIABILITIES + [CAPITAL + {INCOME –EXPENSES}]

Since Income & Expense Accounts add up to either Profit or Loss, these accounts are closed off to an Account called "Retained Profits" or "Profit & Loss Account" which appears as part of a Business's Balance Sheet.

If we show this in the case of Rent Account, it will be shown as follows:

GENERAL LEDGER							
		RENT ACCOUNT				GL-26	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/4/06	GL-20	Bank Account	20,000	30/6/06		Balance transferred to Retained Profits	60,000
1/5/06	GL-20	Bank Account	20,000				
1/6/06	GL-20	Bank Account	20,000				
			60,000				60,000

And, when this account is opened in the next Accounting period, there is no "balance b/fwd" since the complete balance has already been transferred to Retained Profits or Profit & Loss Account.

109 HOW IS A TRIAL BALANCE MADE?

After accounts have been closed and balances have been determined on each account head in the General Ledger, the Accounts and balances are then transferred to Trial Balance. The Trial Balance shows respective balances as "Debit" or "Credit".

A typical Trial Balance looks as follows:

NAME OF BUSINESS				
Trial Balance as of 30-6-06				
Account Code	Account Names	Folio	Debit	Credit
0001	Cash	GL-1	20,000	
0002	Bank	GL-2	100,000	
0003	Rent	GL-3	80,000	
0004	Loan	GL-4		100,000
0005	Accrued Expenses	GL-5		10,000
0006	Purchases	GL-6	100,000	
0007	Sales	GL-7		100,000
0008	Capital	GL-8		200,000
0009	Machinery	GL-9	110,000	
	TOTAL		410,000	410,000

Sum total of all Debit balances must equal the sum total of all Credit balances

An important note: If Accounting has been done properly based on the principles of Double Entry System, the sum total of all Accounts with Debit balances will and should always equal the sum total of all Credit balances. Where there are differences, it is a clear indication that Accounting has not been correctly done in recording of one or more transactions.

Having understood how Accounts are closed off and after having passed the necessary final adjustments, we are now in a position to prepare a Trial Balance for our two case studies.

The Trial Balance for Hanif Auto Engineering for the period ending on 30/6/06 is shown on next page.

HANIF AUTO ENGINEERING TRIAL BALANCE as at 30-06-06		
	Debit	Credit
Capital- Hanif		500,000
Capital- Nabeel		250,000
Cash	91,000	
Bank	247,129	
Tools and Machinery	150,000	
Workshop Shed	100,000	
Machinery	100,000	
Acc Dep Tools and Mach		29,800
Acc Dep Workshop Shed		19,000
Acc Dep Machinery		18,000
Purchase Control		81,000
Sales Control	120,000	
Provision for Bad Debt		1,000
Salary payable		20,000
Income Tax payable		1,000
Inventory Control	112,450	
Repair Account	14,500	
Stock Consumed	612,550	
Interest	18,771	
Depreciation	66,800	
Salary Expense	330,000	
Machinery Repair	37,000	
Utility Expenses	188,000	
Postage & Telegram	7,000	
Petrol Expenses	28,000	
Canteen Expenses	40,000	
Sales		1,350,000
Bad Debt expense	6,000	
Bad debt recovered		5,000
Bank Charges	600	
Inventory Loss	5,000	
TOTAL	2,274,800	2,274,800

Similarly, for Hussain Khaddar (Private) Limited, the Trial Balance on next page is prepared as of 30/6/06.

HUSSAIN KHADDAR (PRIVATE) LIMITED

TRIAL BALANCE
as at 30-06-06

	Debit	Credit
Equity		
Share Capital		2,700,000
Revaluation Reserve		500,000
Long Term Liabilities		
Long term loan		4,000,000
Lease Liability		694,513
Short Term Liabilities		
Purchase Control		43,500
Accrued Interest Payable		297,333
Current Maturity of Lease Liability		177,502
Current Maturity of Long term loan		1,600,000
Salary Payable		23,750
Income Tax Payable		16,100
Accrued Electricity		50,000
Fixed Assets		
Land	3,000,000	
Factory Building	2,100,000	
Machinery	2,945,096	
Vehicle	900,000	
Accumulated depreciation Building		92,500
Accumulated depreciation Machinery		105,817
Amortization Vehicle		225,000
Current Assets		
Prepaid Insurance	10,000	
Sales Control	500,000	
Inventory Control	261,000	
Cash	199,000	
Bank	2,069,019	
Sales		
Local Sales		3,220,000
Export Sales		1,001,250
Cost of Sales		
Stock Consumed	1,300,000	
Depreciation Building 50%	46,250	
Depreciation Machinery 60%	66,784	
Salary 50%	150,000	
Electricity 60%	73,500	
Administrative Expenses		
Rent	240,700	
Amortization	225,000	
Depreciation Building 50%	46,250	
Depreciation Machinery 40%	44,523	
Salary 50%	150,000	
Insurance	14,000	
Electricity 40%	49,000	
Tax Expense	16,100	
Travelling 30%	8,100	
Petrol Expense	28,000	
Building Repairs	6,000	
Selling Expenses		
Travelling 70%	18,900	
Financing Expenses		
Interest Expense-Lease	12,715	
Interest Expense-Loan	297,333	
Other Gain		
Discount Received		1,919
Asset Disposal Account		40,586
Other Loss		
Reduction in value of inventory	2,500	
Exchange Loss	10,000	
TOTAL	14,789,770	14,789,770

110 PROFIT & LOSS ACCOUNT

We have already discussed the format of a Profit and Loss Account in Chapter 1. Since we now want to prepare Profit and Loss Accounts from Trial Balances, we simply need to copy amounts into the relevant sections of Profit and Loss Account.

110.1 HANIF AUTO

HANIF AUTO ENGINEERING PROFIT AND LOSS ACCOUNT FOR THE PERIOD ENDED JUNE 30, 2006	
	June 2006 Rupees
Revenue	
Sales	1,350,000
Bad Debt Recovered	5,000
	1,355,000
Expenditures	
Repair Account	14,500
Stock Consumed	612,550
Interest	18,771
Depreciation	66,800
Salary Expense	330,000
Machinery Repair	37,000
Utility Expenses	188,000
Postage & Telegram	7,000
Petrol Expenses	28,000
Canteen Expenses	40,000
Bad Debt expense	6,000
Bank Charges	600
Inventory Loss	5,000
	1,354,221
Net Loss Before Taxation	779
Taxation	(155)
Loss Before Appropriation	624
Hanif Muhammad	*416*
Nabeel Mansoor	*208*
	624

110.2 HUSSAIN KHADDAR (PRIVATE) LIMITED

HUSSAIN KHADDAR (PRIVATE) LIMITED

PROFIT AND LOSS ACCOUNT
FOR THE PERIOD ENDED JUNE 30, 2006

		June 2006 Rupees
Sales		
- Local Sales	3,220,000	
- Export Sales	1,001,250	
		4,221,250
Cost of Sales		1,636,534
Gross Profit		2,584,716
Operating Expenses		
- Administrative Expenses	827,673	
- Selling Expenses	18,900	
		846,573
Operating Profit		1,738,143
Gain on sale of fixed asset		40,586
Discount Received		1,919
		1,780,648
Reduction in Value of Inventory	2,500	
Exchange Loss	10,000	
Financial charges	310,048	
		322,548
Profit before Taxation		1,458,100
Provision for taxation		16,100
Profit after Taxation Transferred to Balance Sheet		1,442,000

CHIEF EXECUTIVE DIRECTOR

111 BALANCE SHEET

We have already discussed the format of a Balance Sheet in Chapter 1. Since we now want to prepare Balance Sheets from Trial Balances, we simply need to copy amounts into the relevant sections of the Balance Sheet.

111.1 HANIF AUTO

HANIF AUTO ENGINEERING

BALANCE SHEET
AS AT JUNE 30, 2006

EQUITY & LIABILITIES	June 2006 Rupees	ASSETS	June 2006 Rupees
Capital		NON CURRENT ASSETS	
Hanif Muhammad			
Share Capital	500,000	Tangible Fixed Assets-Owned	283,200
Profit for the year	416		
	500,416		
Nabeel Mansoor			
Share Capital	250,000		
Profit for the year	208		
	250,208		
CURRENT LIABILITIES		CURRENT ASSETS	
Creditors and accrued liabilities	102,000	Stock in Trade	112,450
Provision for taxation	155	Trade debts	119,000
	102,155	Cash and bank balances	338,129
			569,579
	852,779		852,779

111.2 HUSSAIN KHADDAR (PRIVATE) LIMITED

HUSSAIN KHADDAR (PRIVATE) LIMITED

BALANCE SHEET
AS AT JUNE 30, 2006

EQUITY & LIABILITIES	June 2006 Rupees	ASSETS	June 2006 Rupees
SHARE CAPITAL & RESERVES		NON CURRENT ASSETS	
Authorized Capital			
Authorized Capital	10,000,000		
Share capital	2,700,000	Tangible Fixed Assets-Owned	7,846,779
Retained Earning	1,442,000	Tangible Fixed Assets-Leased	675,000
	4,142,000		8,521,779
SURPLUS ON REVALUATION OF FIXED ASSETS	500,000		
LONG-TERM LIABILITIES			
Long term loan	4,000,000		
Long Term Lease Liability	694,513		
	4,694,513	CURRENT ASSETS	
CURRENT LIABILITIES		Stock-in-trade	261,000
Current portion of long term loan	1,600,000	Trade debts	500,000
Current portion of lease Liability	177,502	Advances, deposits, prepayments and other receivables	10,000
Creditors and accrued liabilities	430,683		
Provision for taxation	16,100	Cash and bank balances	2,268,019
	2,224,285		3,039,019
	11,560,798		11,560,798

112 CASH FLOW STATEMENT

Cash Flow Statement provides an understanding of how cash is being generated by a Business, where the funds are coming from and how they are being utilized. In this section, we will learn how a Cash Flow Statement is prepared from the Profit & Loss Account and the Balance Sheet.

For a Business, cash and profits do not mean one and the same thing! There are various reasons why cash and profits are not equal – some of which are:

- Accruals concept.
- Matching concept.
- Prudence concept.

These concepts have been described in Chapter 2.

The important point to note is that the Cash Flow statement is prepared from the information in both the Balance Sheet and the Profit and Loss Account. The manner in which information gets presented in the Cash Flow Statement can vary but the essence of information that is intended to be shown remains the same.

Before we show how a Cash Flow Statement is derived, we need to understand a few concepts which will make our understanding easier:

112.1 NON-CASH ITEMS

Accounting requires various types of expenses to be booked which may not have a cash outflow impact. Such expenses will already have been charged in the Profit and Loss Account and will need to be excluded from the Cash Flow Statement. Examples of such expenses are:

- Depreciation & amortization.
- Provision for bad & doubtful debts.
- Inventory loss.

Increase or decrease in working capital items

These are items which are usually included under “current assets” or current liabilities”. We will take the example of one such item “inventory” to explain: an increase in inventory means that more funds of a Business are invested in inventory. On the other hand, if inventory has reduced, it means that funds have been received by a Business.

Similarly, in the case of liabilities, an increase in “accounts payable” balance means that more funds are payable by the Business but which have not been paid, i.e., funds have been generated by taking credit from suppliers. On the other hand, if the “accounts payable” balance has reduced, this shows that the Business’s funds have been utilized to repay suppliers, i.e. funds have been spent.

Based on this discussion, we can summarize the cash flow impact with respect to working capital as follows:

An increase in current assets	Cash outflow
A decrease in current assets	Cash inflow
A decrease in current liabilities	Cash outflow
An increase in current liabilities	Cash inflow

Where necessary, this general rule can be applied to calculate the cash (in or out) flow impact of working capital items.

Calculating cash flow for other items:

The "T Accounts" concept can be applied to calculate the cash flow impact of any Account. We will use "T Accounts" to calculate the amount of interest paid to Banks from the information in the Accounts.

With respect to Interest, the following information will always be available:

Interest expense	For Current Year	Profit & Loss Account	Debit
Accrued interest	For Last Year	Balance Sheet	Credit
Accrued interest	For Current Year	Balance Sheet	Credit

Please note that if this information is not available in the Accounts, it may be assumed to be "nil". If we now make a "T Account" for Interest and put in these descriptions in relevant places, we get the result shown on next page.

GENERAL LEDGER							
		INTEREST ACCOUNT				GL-28	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	OB	Accrued Interest (Last Year's Balance Sheet)	A
				30/6/06	P & L	Interest Charged for the Year	C
30/6/06		Accrued interest (from this year's Balance Sheet)	B				
			X				X

You will remember that the total of all Debits must equal all Credits which mean that the figure denoted by alphabet "X" should be equal. For this to be equal, the Debit side will need a balancing entry which is "Interest Paid".

GENERAL LEDGER							
INTEREST ACCOUNT						GL-28	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	OB	Accrued interest (from last year's Balance Sheet)	A
30/6/06	Balancing Figure	Interest Paid	A + C - B	30/6/06	P & L	Interest Charged for the Year	C
30/6/06		Accrued interest (from this year's Balance Sheet)	B				
			X				X

By applying this logic to all such relevant accounts, we can have the amount of cash paid for any account head.

By applying these three basic rules, the Cash Flow Statement for Hussain Khaddar (Private) Limited and Hanif Auto Engineering can be prepared as is shown on the next page.

112.2 HANIF AUTO ENGINEERING

HANIF AUTO ENGINEERING CASH FLOW STATEMENT FOR THE PERIOD ENDED JUNE 30, 2006		
		June 2006 Rupees
Cash Flow from Operating Activities		
Loss Before Taxation		(67,221)
Add:		
Depreciation	66,800	
Interest	19,371	
Bad Debt Expense	23,000	109,171
		41,950
Less:		
Other Gain	(22,000)	(22,000)
		19,950
Working Capital Changes		
Changes in Current Asset		
Increase in Stock	(117,885)	
Increase in Debtors	(120,000)	(237,885)
Changes in Current Liabilities		
Increase in Creditors	81,000	
Increase in Other Payables	26,435	107,435
		(130,450)
Cash Flow from Operations		(110,500)
Interest Paid	(19,371)	
Taxes Paid	-	(19,371)
Net Cash Flow from Operating Activities		(129,871)
Cash Flow from Investing Activities		
Purchase of Fixed Assets		(350,000)
Net Cash Flow from Investing Activities		(350,000)
Cash Flow from Financing Activities		
Cash received from capital		750,000
Net Cash Flow from Financing Activities		750,000
Net Increase in Cash and Cash Equivalent		270,129
Cash and Cash Equivalents at Start of the Year		-
Cash and Cash Equivalents at the end of the Year		270,129

112.3 HUSSAIN KHADDAR (PRIVATE) LIMITED

HUSSAIN KHADDAR (PRIVATE) LIMITED

CASH FLOW STATEMENT
FOR THE PERIOD ENDED JUNE 30, 2006

		June 2006 Rupees
Cash Flow from Operating Activities		
Profit Before Taxation		1,458,100
Add:		
Depreciation	203,807	
Amortization	225,000	
Interest	310,048	
Reduction in Value of Inventory	2,500	741,355
Less		
Asset Disposal	(40,586)	
Discount Received	(1,919)	(42,505)
		2,156,950
Working Capital Changes		
Changes in Current Asset		
Increase in Stock	(263,500)	
Increase in advances	(10,000)	
Increase in Debtors	(500,000)	(773,500)
Changes in Current Liabilities		
Increase in Trade Creditors	45,419	
Increase in Other Payables	89,850	135,269
		(638,231)
Cash Flow from Operations		1,518,719
Interest Paid	(12,715)	
Taxes Paid	-	(12,715)
Net Cash Flow from Operating Activities		1,506,004
Cash Flow from Investing Activities		
Increase in Fixed Assets		(7,600,000)
Sale of Fixed Assets		90,000
Net Cash Flow from Investing Activities		(7,510,000)
Cash Flow from Financing Activities		
Issue of Capital		2,700,000
Loan Received		5,600,000
Payments of lease principal		(27,985)
Net Cash Flow from Financing Activities		8,272,015
Net Increase in Cash and Cash Equivalent		2,268,019
Cash and Cash Equivalents at Start of the Year		-
Cash and Cash Equivalents at the end of the Year		2,268,019

CHAPTER HIGHLIGHTS

What have we covered?

1. Accounts are usually prepared for a 12 month period. However, Accounts can also be prepared for any time period.

2. Accounting transactions from all Books of Accounts are consolidated into the General Ledger.

3. Final adjustments may need to be made to General Ledger.

4. Bank reconciliation statement is a very important first step before Accounts are prepared.

5. Balances on income and expense accounts are closed off to the Profit & Loss Account.

6. Balances on asset & liability accounts are carried forward to the next period.

7. Trial balance is prepared from the General Ledger.

8. The debit and credit columns on Trial Balance should always be equal.

9. Profit & Loss Account and Balance Sheet are prepared by simply taking amounts from the Trial Balance.

10. Cash Flow Statements are prepared on “cash” basis and are derived from information in the Profit & Loss Account and Balance Sheet.

11. When a Cash Flow Statement is prepared, the increase or decrease in working capital account heads have a direct impact on cash in and cash out.

12. Cash inflow or outflow of any account type can be worked using T Accounts.